access to insurance initiative

Inclusive insurance protects households and promotes economic growth

Introduction

Insurance can make a difference in people's lives by cushioning them against a variety of risks, thereby empowering them to grasp opportunities and secure their livelihoods. Making insurance markets more inclusive promotes entrepreneurial activity and protects household resilience. Insurance is an omnipresent fact of life in rich countries, yet largely absent from people's lives in developing economies. This is why policy makers and development funders look at promoting insurance as an important instrument to achieve financial inclusion and development objectives.[1]

I. Uninsured risk inhibits development

Risk is pervasive in developing countries and affects especially the poor and vulnerable. All households face risks such as fire, theft, accidents, natural disasters, disease and mortality. Sources of risk for rural households are drought, floods, or pest. Businesses have to deal with business interruption, credit and political risks. Communities face infrastructure, conflict and food shortage risk. Insurance provision is still limited and state-sponsored social security or basic safety nets are often not available in most developing countries. Wealthier families have reasonable access to insurance alternatives through substantial savings or credit facilities. The poor also use relatively sophisticated mechanisms to cope with risk, such as activity diversification, mutual support networks and savings for precautionary purposes.[2] However, uninsured people often deal with risk in very costly ways or by minimising risk at all costs and thereby forego income opportunities, which has serious welfare consequences.

Risk and vulnerability are fundamental causes of underdevelopment and poverty. Shocks, in the shape of sudden misfortunes causing a loss of income and productivity, typically force low income people to dispose of productive assets, which may discourage them from engaging in higher productivity, higher income activities in the first place. The expectation of such shocks motivates the vulnerable to invest their resources in low-yield activities, such as production of subsistence crops, to avoid the big shocks that threaten livelihoods, and thus depresses their potential income. As an example research on Ethiopian droughts between 1999 and 2004 estimates that if these shocks had been insured and smoothed, poverty would have been lower by about a third.[3]

II. Two pathways lead from inclusive insurance to development outcomes

While insurance is only one of the many ways people have to manage risk and access financial services, it can be a catalytic tool. Particularly in combination with other financial services such as credit or savings, insurance can become a catalyst for on the one hand agricultural, health and financial sector development and on the other hand household resilience. These results then translate into higher welfare for people. The graphic below illustrates these two pathways from inclusive insurance to sector development and household resilience and then development outcomes: the promotion and the protection pathways.

On the *promotion pathway* insurance promotes access to markets and entrepreneurial activity which contributes to agricultural, financial, SME and health sector development, on the *protection pathway* insurance protects people from consequences of risk events and thereby enhances household resilience[4] to shocks. We describe the promotion pathway in III. On the protection pathway poor people benefit from insurance and financial inclusion generally because this way they are protected from negative economic consequences of risk events. People thereby cope with shocks without eroding their livelihood assets, because the immediate access to cash or services after the occurrence of an event mitigates some of the effects of the shock. Moreover insurance can also help to prevent shocks, by making the insured aware of risks and reduce certain risks. Shock protection and prevention together build household resilience to shocks, which protects people from falling back into poverty and thereby stabilises development outcomes.

III. Insurance promotes agricultural, SME, financial and health sector development

Insurance can generate "ex-ante" effects whereby people change behaviour thanks to the insurance coverage. This effect can be a direct one, for example when poor people participate in a contract farming scheme thanks to the insurance coverage it includes. It can also be an indirect one, whereby the insurance encourages farmers to take up riskier and more profitable activities because they are protected from the effects of a natural disaster and therefore "feel safe" to invest.

Insurance, especially in combination with other financial services, empowers farmers and entrepreneurs and therefore contributes to agricultural and SME development. Insurance contributes to more efficient resource allocation and therefore income and eventually asset creation. These effects help to develop the agricultural sector and small and medium sized enterprises (SMEs). Farmers and entrepreneurs adopt new technologies thanks to insurance and credit. This empowers farmers to engage in more lucrative and productive activities and thereby crowds in entrepreneurs and investors that create markets or make markets more efficient. In addition disaster risk insurance helps to develop the agricultural sector by transferring systemic risks that communities cannot share among themselves. It also allows creditors to finance even those farmers without collateral and facilitates agricultural buyers to provide inputs on credit to farmers.[5]

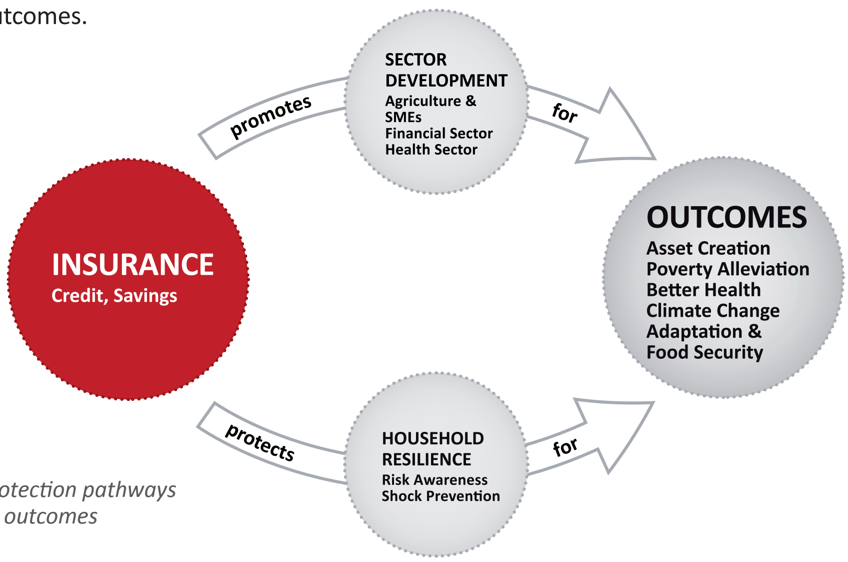

Figure 1: Promotion and protection pathways from insurance to outcomes

Box 1: Insurance empowers farmers to switch to more profitable crops in India. *Weather is a key source of income risk for many firms and households in India. Researchers investigated how weather insurance affects production decisions among a sample of Indian agricultural firms. They find that the provision of insurance induces farmers to shift production towards higher-return but higher-risk cash crops, particularly amongst more educated farmers. These results confirm that agricultural insurance may help mitigate the real effects of uninsured production risk also for smallholders and thereby promote agricultural development.*[6]

Insurance empowers entrepreneurs and their financiers to take measured risks and therby supports SME development. Entrepreneurs already put a good part of their personal and family assets at risk by engaging in an activity that takes on liabilities towards staff, clients and the state. Insurance allows the entrepreneurs to focus on the core business, because it strips out the high severity and high impact risks, in particular liability, property and mortality risk, and thereby facilitates access to finance and investment for the entrepreneur.

Insurance contributes to financial inclusion and financial sector development. Insurance supports financial inclusion, because it can catalyse other financial services such as credit. Insurance thereby helps to broaden the financial sector because it helps to make these other financial instruments viable for banks, for example insurance can make loans viable by transferring the risk of non-repayment due to the most important risk events. Insurance also deepens the financial sector by increasing the size of medium to long term assets holdings and thereby encourages the long term investment of these assets in infrastructure. Insurance unlocks credit for new borrowers because it protects for example housing assets and thereby banks' mortgage loans; or a "credit-life" insurance pays off outstanding consumer credit liabilities when the borrower passes on. These new loans increase competition and ultimately lower financial intermediation costs, which results in more credit for the private sector.[7]

Insurance also contributes to health sector development by making timely quality health care viable. Insurance helps to develop the health sector because health insurance promotes higher and timelier utilization of preventive and curative care[8] and high quality care, because insurers have a direct financial interest in good health impacts for the insured.[9] Health insurance coverage may also lead clients to seek care sooner after falling ill.[10] A vibrant health sector also generates employment and growth. Quality care development for more people especially in rural areas builds human capital and social capital in the community which protects people from losing livelihoods and social status and falling into poverty traps.

IV. Insurance makes households more resilient

Without the formal risk pooling options available in developed economies, poor households often resort to negative coping strategies, in particular sale of productive assets. Insurance therefore mitigates some of the negative financial consequences of certain risk events and protects people from the worst effects of negative coping strategies, in particular sale of livelihoods assets. Insurance also prevents certain risk events by promoting preventive measures and can strengthen social protection systems.

Insurance can have a positive welfare impact by preventing livelihood asset depletion.[11] In the aftermath of shocks households cope often by eroding important physical or human assets. For example they start selling livestock, sometimes at fire sale prices, or they take children out of school to save on school fees and obtain extra labour. Such negative coping strategies however erode livelihood assets and impair

Box 2: MicroInsurance helps to prevent child labour in Pakistan. *Child labor is a common consequence of economic shocks in developing countries. Reducing vulnerability can affect child labor and schooling. A health and accident insurance scheme by a Pakistani microfinance institution was set up as a randomized controlled trial and accompanied by household panel surveys. Together with increased coverage the MFI offered assistance with claim procedures in treatment branches. Research results show lower incidence of child labor and lower child labor earnings caused by the innovation. The effect is largely due to an ex-ante feeling of protection as opposed to a shock-mitigation effect.*[12]

future prospects for development. Insurance therefore protects households against these livelihood losses through lower out-of-pocket spending when a shock occurs. In the case of health insurance, academic studies demonstrate that insurance coverage reduces out-of-pocket health expenditure.

Insurance coverage can also prevent risk events by reducing risk before shocks occur. For example health insurance can provide access to and incentives for preventive care and better usage and quality of health care facilities. This includes all levels of care, dependent on what the benefit package covered. Such risk reduction effects can be observed with other types of insurance coverage as well, for example property insurance enforcing building codes and risk reducing property adaptation.

Insurance can strengthen social protection systems. Social protection systems set up by government to cushion the poor and most vulnerable against shocks benefit from insurance and insurers by sharing some of the costs of reserving for the larger shocks. Insurers bring vital risk assessment skills to these systems and signal the cost of risk to beneficiaries. Insurers can also make these systems more efficient by handling claims and contributory payments sometimes better than the state, especially in countries with weak governance and public administration.

V. Insurance contributes to development outcomes through the promotion and protection pathways

Insurance supports the development of certain sectors and household resilience. Productive and growing agriculture, financial and health sectors coupled with resilient households contribute to wealth creation and poverty alleviation, food security, climate change adaptation and better health.

Agricultural development lifts rural people's income levels and directly leads to asset creation and poverty alleviation. Three quarters of the poor live in rural areas and directly benefit from agricultural development and growth[13] in rural areas, especially when more resilient households are empowered to grasp opportunities. Insured and more resilient households are also more protected from falling back into poverty when shocks occur, which protects livelihood assets.

Insurance can enhance food security indirectly and directly by insuring households and governments against drought. Insurance helps to ensure food security indirectly by stimulating agricultural credit and agricultural sector development, which usually result in better functioning food markets and therefore better access to food. Disaster insurance can also directly ensure food security by providing early relief to households in disaster situations. Insurance can also directly protect government grain reserves and access to food supplies. Macro level transactions in Ethiopia and Malawi have shown that governments can make good use of insurance and insurance-like mechanisms to ensure food security for drought exposed rural populations.[14]

Agricultural and financial sector development coupled with household resilience help people adapt to climate change. Climate change results in more erratic weather patterns and often more frequent extreme events. Certain layers of these risks need to be transferred away from households and market operators that are exposed to these households. Insurance can support agricultural development and the adoption of new technologies, which can also help to adapt to climate change. Insurance premiums vary with changing risk profiles and therefore signal cost of doing business. As a result farmers and entrepreneurs become risk aware and adopt climate smart solutions, such as different crops or drought resistant seeds. Risk aware farmers then can better adapt to the new weather risk profiles due to climate change and choose climate adapted crops or activities. In addition, risk transfer through the insurance route is particularly effective and comparatively efficient when it comes to natural disaster risk and other systemic risk which helps to share and transfer these risks globally among the "winners" and "losers" of climate change.

Health sector development and improvements in health-seeking behaviour and quality of care brought about by insurance coverage can translate into better health outcomes. While health outcomes are difficult to prove, they may often be inferred from outputs (such as seeking care sooner, more often, and at better facilities) if combined with other research linking those outputs to improved health outcomes in other contexts.[15] There is therefore strong suggestive evidence that inclusive insurance coverage can lead to positive health outcomes.

VI. Concerted action of policy makers, regulators and supervisors is needed to develop inclusive insurance markets and protect consumers

Inclusive insurance markets develop if policy makers commit to financial inclusion and enable existing and new market makers to innovate with appropriate policy measures. Reaching out to low income consumers with lower policy values with sometimes higher transaction costs is as such not profitable for traditional insurance intermediators. However, aggregators such as mobile network operators or supermarkets have additional motives for promoting insurance and can overcome the high transaction cost hurdle thanks to existing distribution networks. These innovative insurance intermediators require adequate policy measures followed by proper regulation to protect consumers and insurers' solvency. In order for regulators to be capable to regulate and supervise these new inclusive insurance actors, policy makers need to commit to financial inclusion and mandate supervisors to encourage inclusive insurance market development. Policy makers can do so "by designing and implementing the chosen regulatory solution while taking account of issues including clarity, consistency, proportionality and accountability"[16].

Insurance supervisors and regulators have a key role to play in making sure that inclusive insurance markets happen and support development. They can do this by designing effective enforcement strategies, preferably leveraging off existing incentive structures. Supervisors deploy specific regulatory tools to regulate preconditions for entry into the market and on-going conditions for continued market participation. Enforcement measures should be fair and transparent and well-integrated in the overall regulatory decision-making process.[17]

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[1] G20 leaders have endorsed financial inclusion as "one of the main pillars of the global development agenda" and state that "Inclusive financial sector development makes two complementary contributions to poverty alleviation: financial sector development is a driver of economic growth which indirectly reduces poverty and inequality; and appropriate, affordable, financial services for poor people can improve their welfare." G20's Financial Inclusion Experts Group (2010): G20 Principles for Innovative Financial Inclusion – Principles and Report on Innovative Financial Inclusion from the Access through Innovation Sub-Group of the G20 Financial Inclusion Experts Group, http://www.gpfi.org/sites/default_files/documents/Principles%20and%20Report%20on%20Innovative%20Financial%20Inclusion_0.pdf

[2] Townsend analyzes poor villages in India and finds five distinct risk allocation methodologies. Townsend, R. (1994): Risk and Insurance in Village India, Econometrica, Vol. 64, Issue 3, pp. 539-591, http://www.hss.caltech.edu/~camerer/SS280/TownsendEC94.pdf

[3] Dercon, S. (2005): Vulnerability: A Micro Perspective, Paper for the 2005 ABCDE Conference in Amsterdam, http://siteresources.worldbank.org/INTAMSTERDAM/Resources/StefanDercon.pdf

[4] Resilience is 'the ability of countries, communities and households to manage change, by maintaining or transforming living standards in the face of shocks or stresses – such as earthquakes, drought or violent conflict – without compromising their long term prospects'. Department for International Development DFID (2011): Defining Disaster Resilience: A DFID Approach Paper, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/186874/defining-disaster-resilience-approach-paper.pdf

[5] In Northern Ghana, Karlan and others found that insured farmers increased expenditure on chemicals (mostly fertilizer) by 24 per cent, increased the area of land cultivated by 17 per cent, and shifted a larger portion of their land to crops that were more sensitive to rainfall. Karlan, D. et al (2013): Agricultural Decisions after Relaxing Credit and Risk Constraints, http://www.econ.yale.edu/~cru2/pdf/eui.pdf. A Chinese study found that altering the timing of the premium payment not only led to greater demand, but also to greater investment amongst swine farmers in China. Zhang, Y. et al (2013): Prevention of losses for hog farmers in China: Insurance, on-farm biosecurity practices, and vaccination, in: Research in Veterinary Science, Vol. 95, Issue 2, pp. 819-824 abstract, http://www.sciencedirect.com/science/article/pii/S0034528813002014

[6] Cole, S. et al (2013): How Does Risk Management Influence Production Decisions? Evidence from a Field Experiment, World Bank Research Paper, http://www.hbs.edu/faculty/Publication%20Files/13-080_138f3c30-b5c2-4a97-bf56-9821f89fcbd3.pdf

[7] A recent literature review makes this and other arguments that summarily point to a strong positive causal relationship between insurance and inclusive growth. Lester, R. (2014): Insurance and Inclusive Growth, World Bank Policy Research Working Paper 6943, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/06/24/000158349_20140624132258/Rendered/PDF/WPS6943.pdf

[8] One study found that members of nine Oxfam operated Armenian schemes visited health facilities 3.5 times more often than uninsured persons. In the case of CARE Foundation in India, access to community health workers incentivized more frequent visits to these workers, leading to earlier identification of illnesses and more timely referrals to hospital. Dalal et al (2014): Is there value in microinsurance? Client Value series, Brief No. 1, ILO/MIF, Microinsurance Centre, http://www.impactinsurance.org/sites/default/files/Brief1-CVS140115_web2.pdf

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[10] In a study in Tanzania, insured patients waited on average of three days between feeling ill and visiting a clinic to receive outpatient care, while the uninsured waited an average of five days. Dalal et al (2014): Is there value in microinsurance? Client Value series, Brief No. 1, ILO/MIF, Microinsurance Centre, http://www.impactinsurance.org/sites/default/files/Brief1-CVS140115_web2.pdf

[11] Recently published research from Ghana using household survey data confirms that insurance helps to prevent asset depletion. Karlan, D. et al (2013): Agricultural Decisions after Relaxing Credit and Risk Constraints, http://www.econ.yale.edu/~cru2/pdf/eui.pdf

A study in Kenya found that insured households with few assets were on average 43 percentage points less likely to draw down assets, thereby improving their ability to recover after a drought. Janzen, S.; Carter, M. (2013): The Impact of Microinsurance on Consumption Smoothing and Asset Protection: Evidence from a Drought in Kenya, http://www.ferdi.fr/sites/www.ferdi.fr/files/evenements/presentations/carter_jansen_the_impact_of_microinsurance_on_consumption.pdf

Another study found that extending accident and health insurance to all members of Pakistani households resulted in an approximately 10 per cent reduction in incidences of child labor, another negative coping strategy. Landmann, A.; Frölich, M. (2013): Can Microinsurance help prevent Child labor? An impact evaluation from Pakistan, MIF Research Paper No. 32, http://www.ilo.org/public/english/employment/mifacility/download/repaper32.pdf

[12] Landmann, A.; Frölich, M. (2013): Can Microinsurance help prevent Child labor? An impact evaluation from Pakistan, MIF Research Paper No. 32, http://www.ilo.org/public/english/employment/mifacility/download/repaper32.pdf

[13] Quantitative research shows that Insurance market activity, both as a financial intermediary and a provider of risk transfer and indemnification, may contribute to economic growth by allowing different risks to be managed more efficiently and by mobilizing domestic savings. Using panel data for 56 countries and for the 1976-2004 period, World Bank researcher Arena finds robust evidence of a causal relationship between insurance market activity and economic growth. Both life and non-life insurance have a positive and significant causal effect on economic growth. High-income countries drive the results in the case of life insurance; high-income and developing countries drive the results in the case of non-life insurance. Arena, M. (2006): Does Insurance Market Promote Economic Growth? A Cross-Country Study for Industrialized and Developing Countries, World Bank Policy Research Working Paper 4098, https://www.wdronline.worldbank.org/bitstream/handle/10986/9257/wps4098.txt?sequence=2

[14] Ethiopia for example LEAP (Livelihood, Early Assessment and Protection) is the Government of Ethiopia (GOE) owned food security early warning tool embedded in the national social protection risk management framework and linked to the US$ 160 million contingent fund, which acts like insurance. LEAP converts satellite and ground based agro-meteorological data into crop or rangeland production estimates and ultimately into livelihood protection requirements. It also quantifies the financial resources needed to scale up PSNP in case of a major drought. For more information please visit the LEAP website: https://www.wfp.org/disaster-risk-reduction/leap

[15] Malaria research published in The Lancet found that delayed treatment and self-diagnosis of malaria led to poorer health outcomes among low-income people. Amexo, M. et al (2004): Malaria misdiagnosis: effects on the poor and vulnerable, in: The Lancet, Vol. 364, Issue 9448, pp. 1896 – 1898.

[16] G20's Financial Inclusion Experts Group (2010): G20 Principles for Innovative Financial Inclusion - Principles and Report on Innovative Financial Inclusion from the Access through Innovation Sub-Group of the G20 Financial Inclusion Experts Group, http://www.gpfi.org/sites/default/files/documents/Principles%20and%20Report%20on%20Innovative%20Financial%20Inclusion_0.pdf

[17] A2ii as the implementing partner of the International Association of Insurance Supervisors (IAIS) helps to build supervisor's capacity to regulate and supervise inclusive insurance. www.a2ii.org

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