Constraints on agricultural microinsurance

In recent years, microfinance institutions have realised that "credit only" is not sufficient to meet the needs of the poor. While adding new financial services such as savings, remittances and insurances has been successful in urban centres, extending these services to rural areas is hampered by high risks and costs, particularly in introducing microinsurance for agriculture.

The microfinance industry started to develop considerably in the mid 90's. "Credit only" microfinance institutions (MFIs) perceived that low income families also needed access to other financial services alongside regular loans. In urban areas, more and more institutions transformed into regulated institutions in order to offer additional financial services such as savings, deposits, remittances, basic payment services, local transfers and insurance. As the urban markets became more competitive, many of these institutions saw the possibility to expand their business in rural areas by paying more attention to their rural finance activities.

MFIs first started offering credit to rural entrepreneurs. Financing farmers' agricultural and livestock activities was and still is quite limited. Eventually, the MFIs offered additional financial products, among others, insurance products. So far insurance is generally linked to loans with the main purpose of covering the credit risk. However, insurance covering farming activities (agriculture and livestock) is rare. This is surprising, given the fact that most of the rural population work in the agricultural sector (see Box).

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There are many reasons why MFIs do not offer more insurance products for agriculture and livestock production. In this article, we provide a short analysis of possible reasons and recommend how to overcome this obstacle in order to make microinsurance available to farmers and contribute to poverty reduction in the rural areas.

Problems of agricultural microinsurance

The high risks and costs in agricultural production not only pose difficulties for financial institutions offering credits but also for insurance companies to enter this market segment.

Farmers are permanently confronted with different types of risk: production and yield risks, price and market risks as well as climate and biological risks. Financial and insurance institutions are faced with additional risks which is why they are relatively reluctant to engage in agricultural insurance (Werner 2005):

- Lack of reliable statistical information (i.e. weather, prices)
- Disperse and heterogeneous client base
- Small production units
- Moral hazard and asymmetric information
- High administrative costs of risk measurement and evaluation
- Mismatch between contract payouts and actual loss experienced by individual farmers
- Lack of financial education: benefits and functioning of the insurance products
- Lack of qualified and committed local institutions (finance and risk management providers, qualified sales staff, etc.)
- Inadequate or unclear legal and regulatory frameworks

Rural people in developing countries

According to the UN Food and Agriculture Organization (FAO) a total of 5 billion people lived in developing countries in 2005. 57 percent of this population lived in rural areas, 49 percent of whom were employed in agriculture. The highest rates of the population earning a living through agriculture were found in Asia and sub-Saharan Africa and the lowest in Latin America and the Caribbean (64 % and 57 %, and 23 % and 19 % respectively). In comparison, in developed market economies, 22 percent of the population lived in rural areas while only 3 percent were active in the agricultural sector.

- Political risk: governmental interventions (subsidised crop insurance programmes, government debt relief, emergency measures, etc.)
- Index-based insurance only covers adverse weather risk, and not exogenous risks (price risks, availability of inputs, pests, etc.)

Without access to agricultural insurance, small farmers hesitate to invest in new crops or new technologies and may not obtain an agricultural loan from banks or MFIs, since these institutions are not ready to take the risk involved in agriculture.

After positive experiences with other microinsurance products such as life, health and housing, insurance companies are slowly getting more interested in agriculture microinsurance, while still taking the high and complex risks into consideration.

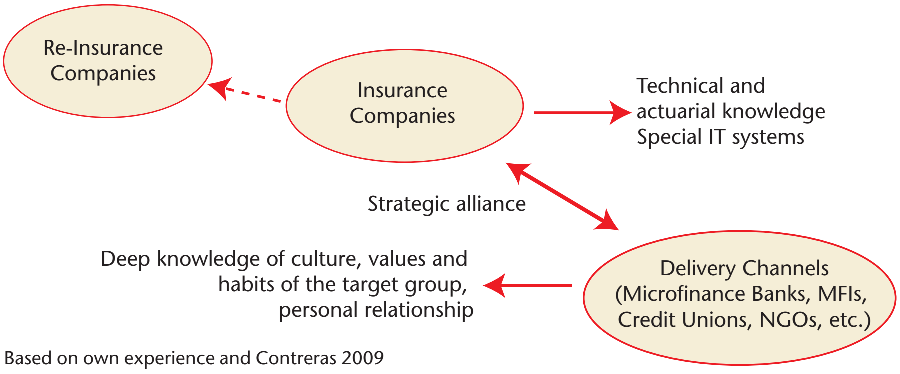
Feasibility of microinsurance for agriculture

Insurance companies have recognised the possibility of reducing their administrative, evaluation and payment costs and thus adjusting the costs of premiums by transferring these tasks to their strategic partners (most of them MFIs, co-operatives, NGOs), developing new risk models and thus ensuring their profitability. This interest has also increased due to the need to ensure competency, since natural disasters of the last few years have strengthened people's interest in ensuring their assets and lives.

In light of the improvements in the legal and regulatory framework in many countries, the strategic alliances with insurance companies (partner-agent) allow MFIs to offer insurance products and consequently reduce credit losses as well as to expand their services, business and outreach. MFIs have the commitment and mission to offer financial services to market segments that commercial banks would normally not attend and thus have the advantage of using client-oriented credit technologies (on-site visits to the business, industry or farm), which give them insight into the special characteristics of the clientele, while insurance companies for their part possess the expertise to design insurance products and train the staff of MFIs on the products and their characteristics as well as in the marketing of those products (see Figure above). Insurance companies can also apply the pattern shown in the Figure for agricultural insurance, by making use of MFIs that are working in rural areas and thus are close to the target groups. However, the market for this product is still limited compared to the big market of credits to microentrepreneurs. Agriculture microinsurance for small farmers should be designed to cover the protection needs derived from the activity, and products should be easy to understand, affordable and used on a long-term basis.

Agricultural insurance can help farmers to protect themselves and their families from adverse events and improve yields if the insurance premium does not affect the household expenses significantly and if they understand the advantages of having insurance. Otherwise, they will perceive the payment of premiums as a waste of money, or they will wait for governmental measures such as debt forgiveness or emergency programmes. Therefore, insurance companies should find the best mechanism to build an effective system by considering aspects as shown in the Figure on page 21.

Actors in an efficient microfinance system



Based on own experience and Contreras 2009

The situation in Latin America

Although insurance penetration in Latin America is higher than in Africa and Asia, it is still minimal compared to developed countries. According to data of the World Bank, insurance penetration in countries with more developed insurance industries in Latin America ranges from 1.1 percent in Peru, 1.85 percent in Bolivia, 1.95 percent in México, and 2.13 percent in Colombia to 4.11 percent in Chile.

In a survey conducted with MFIs of 15 Latin American countries, a total of ten countries offered insurance products to their clients with coverage from 0.8 percent in Venezuela to 55.7 percent in Bolivia. Even in Chile, which has a highly developed financial sector, only 28 percent of the microfinance clients were interested in insurance products (ComunIICA 33, Año 5).

Moreover, in rural areas too, the majority of the microinsurance offered is life insurance for the borrowers and, often, for their relatives (spouses, children and parents): In some cases burial costs are additionally covered. Even though this system does help to protect clients against unforeseen events

Criteria for building up an effective microinsurance system in agriculture

Large data base:
- approximate knowledge of probable losses
- measure historical and current losses
- risk pools – risk diversification
- reliable information on: weather, yields, market trends, capacity to pay
- calculate expected frequency

Strategic links:
- increase outreach
- reduce administrative costs

Limited political/governmental intervention:
- avoid moral hazard
- increase repayment culture

Agricultural insurance will:
- be more efficient for farmers than using liquid assets or family help
- reduce vulnerability of rural families
- facilitate adoption of higher yielding technologies
- be an efficient tool to reduce credit default and portfolio losses
- lead to more competitiveness

(death, invalidity, accidental injury, etc.) it seems to be more oriented on reducing the credit risk for MFIs and does not make insurance sustainable, if insurance is to become a tool to support the improvement of farmers' living standards.

Introducing agricultural microinsurance turns out to be more difficult than allocating life insurance; first, because of the inherent risks of the activity and, second, because the number of clients in this market segment is still small and dispersed. In the loan portfolio of MFIs, only a very small part is dedicated to this activity. The only country where a high percentage of the microfinance business of MFIs goes into agrilending in Central America is Nicaragua (52 % of the loan portfolio and 32 % of the clients). In the region's other countries, like Guatemala, for example, MFIs allocate just 8 percent of the loan portfolio to the agriculture sector, while in Colombia, three of the largest MFIs lend a mere 3 to 6 percent of their loan portfolio for agriculture and livestock activities (Web publications of Network and MFIs). Consequently, interest in introducing agriculture microinsurance is not as high as interest in life insurance that is being promoted by many MFIs and insurance companies in the region.

In Colombia local insurance companies have signed agreements with MFIs offering some incentive schemes to the loan officers so that when they visit credit clients, including farmers in rural areas, they immediately offer them life insurance for them and their family. The insurance period is equal to the loan maturity, while the cost of the prime is minimal (USD 1–2) and is included in the loan instalment.

Photo: Becerra

Zusammenfassung

Mikroversicherungen sind für viele Mikrofinanzinstitutionen (MFIs) zu einem wichtigen Finanzprodukt geworden. Sie werden normalerweise im Rahmen eines Partner-Agenten-Vertrags zwischen Versicherungsgesellschaften und MFIs verkauft, wobei letztere als direkte Vertriebskanäle fungieren. Noch sind Mikroversicherungen wenig verbreitet, vor allem in Marktsegmenten mit einkommensschwachen Haushalten und in ländlichen Gebieten. Sie sind derzeit hauptsächlich auf Lebensversicherungen konzentriert und mit Krediten verknüpft mit dem Ziel, das Kreditrisiko zu senken. In Landwirtschaft und Viehzucht sind Mikroversicherungen sogar noch seltener, da die hohen Risiken und Kosten in dieser Branche für Finanzinstitute und für Versicherungsgesellschaften, die sich diesen Sektor erschließen wollen, problematisch sind.

Resumen

Los microseguros han resultado ser un producto financiero importante para muchas instituciones de microfinanzas (IMF). Suelen venderse mediante un mecanismo de agentes asociados, es decir, un acuerdo entre las empresas de seguros y las IMF, donde estas últimas actúan como canales de distribución. Los microseguros todavía tienen una penetración muy baja y se concentran principalmente en los segmentos de mercado de hogares de bajos ingresos y además en las áreas rurales. Actualmente, los microseguros son sobre todo seguros de vida vinculados a préstamos, cuyo principal objetivo es reducir el riesgo crediticio. Los microseguros agrícolas y pecuarios se comercializan menos aún, puesto que los altos riesgos y costos inherentes a estas actividades plantean dificultades tanto para las instituciones financieras como para las empresas de seguros que entran a este sector del mercado.