

“Developing partnerships to insure the world’s poor”

MicroInsurance Centre Briefing Note # 2

How Poor People Manage Risk¹

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In the precarious world of the poor, a shock such as illness, death of a loved one, fire or theft can erode hard won gains on the slow road out of poverty.

Though poor people have developed a variety of formal and informal ways of coping with crises, they now have a new option, microinsurance. With fewer assets and lower incomes than most traditional insurance clients, poor people often are hit harder by shocks. Field research conducted in Tanzania, Kenya and Uganda in May and June 2002 suggests that there is a strong demand among poor people for better ways to manage risk. Microinsurance can respond to this demand through products and services tailored to poor people’s needs. The research from East Africa helps us to identify and develop appropriate products by addressing the questions, “What is the impact of shock on poor households? How do they cope? Is there a role for microinsurance?”

Risks and the Impact of Shocks

Vulnerability for the poor is an everyday reality. In the words of one microfinance client in the Philippines, “life for the poor is one long risk.” The study in East Africa found that the most frequent and stressful risks poor people face are death of an income earner or other family members, illness, and property loss resulting from theft and fire. The impact of these shocks comes in two stages (see figure):

- The immediate impact is the loss of an asset and/or income and the need for lump sums of cash.
- The medium and longer-term impact can be more or less stressful, depending on the situation of the household. It calls for strategic choices by households about the reallocation of household resources to respond to changes in cash flow and loss of assets and to get back on their feet.

Responses at each stage vary according to a household’s resource endowment and the range of coping mechanisms available. The least stressful usually involve modifying consumption, calling in small debts, improving household budgeting, or using

formal or informal insurance mechanisms. Somewhat more stressful strategies involve using savings, seeking new and different income sources, borrowing from formal or informal sources, and asking friends and relatives for help. As a last resort, people may sell major assets, default on loans, take children out of school, or use up resources that reduce their future productive capacity.

Risk Management

To cope with shocks, poor people primarily use informal group-based and self-insurance mechanisms. Formal insurance is still new and not widely available. However, expressed demand is high.

Self-Insurance

Self-insurance is the most common way people in East Africa respond to shocks such as illness or property loss. This involves, for example:

- Borrowing from MFIs, ROSCAs or money lenders
- Borrowing from family and friends
- Depleting assets such as savings and consumer durables
- Pledging land title and mortgaging assets

These *ex post* (after the shock) responses can drain households of existing resources and place demands beyond the cash flow capacity of most households. Coping strategies that involve borrowing often exacerbate the pressures of debt.

Informal Insurance

In addition to self-insurance, people in East Africa use a wide array of informal group mechanisms to cope with shocks. Among the mechanisms identified in East Africa were:

- Burial societies and Friends in Need Groups. These membership groups require payment of dues in return for the right to access group resources, in cash or in kind, for a specified need (for example, funeral transport or burial expenses);
- Church groups that sometimes give small loans or other forms of support to people in need;

¹ This Briefing Note is based on a study by Monique Cohen and Jennefer Sebstad. “Reducing Vulnerability: The Demand for Microinsurance.” *MicroSave-Africa* 2003. The study is available on the MicroInsurance Centre website: www.microinsurancecentre.org.

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- Reciprocal social networks involving family, kin, and friends who provide small amounts of financial support for certain types of risks that require repeated expenditures of money (such as short term illnesses); and
- Fund raising events such as *harambees* in Kenya. These are used to mobilize larger sums of money required for hospitalization or surgery.

Lea is a client of the Youth Self Employment Foundation in Tanzania. After bandits killed her husband in 1993, she observed “edda” or seclusion in accordance with Muslim tradition. While observing the “edda,” her brother-in-law sold all her household property including a car and a house that was under construction. He also took all of her household savings. All were assets to which Lea had contributed, using the income from her own microenterprise. After her husband’s death, she and her children were left with nothing. With a business that did not generate enough income to feed her four children, pay the rent, health bills and school fees, she struggled to make ends meet. (Millinga, 2002)

Formal Insurance

The study found that poor households have very few formal insurance options to respond to risks and perceive this primarily as a financial service for the top 10 percent of the population. A few formal insurance programs targeted at poor people were identified:

- Two MFIs in Uganda require life insurance linked to their credit products. If a borrower dies, the client’s family receives a lump sum that can vary in amount with the size of the loan balance and the cause of death. Coverage under these policies can include a spouse and children.
- A few people have health insurance provided by Microcare Health Plan in Uganda and Poverty Africa’s Health Scheme in Tanzania.

Gender Differences in Coping with Shocks

Not only do many women have fewer assets, and less control over assets than men, but they also can be limited in their ability to exercise legal rights to these assets. This limits their options for managing risk.

Other gender based factors may also narrow women’s options for managing risk. Among the informal group-based insurance options, for example, some welfare societies exclude women-headed households. Self-insurance in the form of savings, income diversification, or borrowing, is less of a choice for resource poor women. With limited options, women use complex, yet inventive, ways to access lumps sums of cash when an emergency demands: they join more than one informal insurance scheme, become a client of multiple MFIs, or work at maintaining reciprocal social relationships.

Poor People’s Ability to Cope

While everyone stands to benefit from formal insurance, few people currently see it as an option. It is viewed as a province of the rich who are in a better position to take precautionary measures to avert illness and to protect against property loss. The poor live life in a reactive mode, moving from crisis to crisis.

For many poorer households, risk management strategies usually involve reacting to a shock *ex post*. The lucky ones have access to informal insurance. Even this is limited in effectiveness when seen against the cost of meeting the immediate expenses associated with a shock, feeding the family and keeping children in school. Coping strategies that involve taking on more debt make the escape from poverty seem ever more distant. The very poor often fall out of informal group-based systems if they cannot keep up with reciprocal obligations and depend almost entirely on inadequate self-insurance mechanisms. Some are lucky but many remain in debt, in a permanent race to stay one step ahead of the next shock.

A Role for Microinsurance

While insurance is not the answer for all shocks, there is wide scope for developing new microinsurance products and services. There is a clear demand and it can play an important role in reducing the vulnerability of the poor. Understanding what risks most affect the lives of the poor and how they currently manage these risks is an important starting point for designing demand driven microinsurance products.

