# Risk Management and Insurance:

## Protect Your Family's Future

### *CONTENT NOTE*

Global Financial Education Program
FROM POVERTY TO PROSPERITY

No one likes to think about the bad things that can happen to them, but for many people, unexpected shocks are a daily threat. Low-income families are particularly vulnerable to potential losses from a host of situations and may be ill-prepared to cope financially with their negative impact. Small and frequent shocks, such as children's illnesses, may only have short-term impact, while more significant events, such as the destruction wrought by natural disasters or the death of an income earner, can bring financial ruin. Such crises wipe out the hard won gains painstakingly accumulated over time. As families go deeper into debt and/or sell assets to pay their unexpected expenses, their climb out of poverty can easily be thwarted.

The purpose of this Content Note and the accompanying Trainer's Guide, entitled *Risk Management and Insurance: Protect Your Family's Future*, is to promote understanding of the options for managing risk, including both protective steps taken in anticipation of a crisis and reactive measures taken after the fact. One increasingly common risk management option is microinsurance, a financial instrument that protects assets by reducing loss from any of the many risks one might encounter. However, to date, insurance has been widely misunderstood and mistrusted. This training program explains the fundamental concepts underlying insurance and defines the terms associated with insurance. Its goal is to provide basic information and build understanding of a range of ways to manage risk—including insurance—so that people can determine which makes the most sense for them.

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## Coping with Shocks: Reaction or Protection?

Shocks are not new; neither are the pain and expense that come with dealing with them. From country to country, the list of risks is very similar: accident, illness, death of an income earner, fire, theft, natural disaster and economic shocks caused by events such as hyperinflation. The consequences of these risks are significant and may include grief, financial hardship, loss of income, loss of productive assets and lost economic opportunities. As one microfinance client in the Philippines said, "Life is one long risk."

### DEFINITIONS

**"Protection steps"** are actions taken *before* a crisis happens.

**"Reaction steps"** are actions taken *after* a crisis has occurred.

Most people react to crises *after* they occur. Faced with the unexpected and immediate costs of an emergency, they might borrow or sell something of value like an animal, jewelry or a motorcycle. Reacting to a crisis in these ways can incur additional expenses including interest on loans taken and/or lost income due to the forced sale of assets.

To cope with the threat of a crisis, it is possible to plan ahead, and protect oneself and one's family by saving independently or through a local savings and credit group. Some people have the opportunity to join a mutual aid group, such as the burial societies common in parts of Africa. These are steps to take *before* a crisis happens.

These financial protection steps are similar to other things people do to protect themselves and their families. For example, a man repairs his roof to protect his home against damage from wind and rain; a woman locks her door to protect her home (or business) against theft; and a farmer tethers his pigs to protect his crops from getting trampled. Putting some money aside for emergencies is a form of protection, making it easier to respond when a crisis does occur. Those who have savings may be able to avoid selling a valuable asset, or at least borrow less, easing the financial pressure associated with repayment.

Faced with a serious crisis, many people will not have enough money saved to pay all of the related expenses, and thus, are likely to need both protection and reaction strategies. Pedro's story (see Box: Pedro's Accident) shows how both types of strategies can be used to respond to an emergency. His family's savings enabled them to borrow less and repay their loan faster after the accident.

## PEDRO'S ACCIDENT

Last year, a terrible bus accident occurred outside the district capital. Pedro, a teacher in town who lives with his parents on their farm, broke his leg in two places. After a brief stay in the hospital, Pedro had to stay home from work for several weeks until he was strong enough to move around on crutches. At first, his family was in shock. How would they pay the hospital bill and meet daily expenses without Pedro's salary? But they sat together to figure out how much they would need and made a plan to raise the money.

- They could borrow ½ of the total amount needed from Pedro's aunt and uncle.
- Their savings (set aside to purchase a dairy cow) would cover ¼.
- Pedro's mother would take in laundry to earn ¼ and eventually repay the aunt and uncle.
- Pedro's two younger brothers would quit their after-school soccer team to replace their mother on the farm.

While saving before an event has obvious advantages for anyone who faces a crisis, it also has disadvantages. Protective measures require discipline to sacrifice and save regularly. Some protest against putting aside scarce resources for an event that might happen in the future, instead of investing surplus cash to make money now. Some are convinced that they just do not have any extra money to set aside as savings.

The following table outlines the advantages and disadvantages of reaction and protection strategies.

## COMPARING REACTION AND PROTECTION STRATEGIES

| | *Advantages* | *Disadvantages* |
|---|---|---|
| **Protection Strategies** | | |
| ▪ Savings<br>▪ Savings/Loan Groups<br>▪ Mutual Aid Groups (if they exist in the area) | ▪ Having money saved to cover at least some of the costs is less stressful<br>▪ May avoid going to family and friends or to the moneylender for money<br>▪ Saving for emergencies before they occur is less expensive than paying interest on a loan after they occur | ▪ Requires sacrificing other needs and desires<br>▪ Requires having surplus income to save or pay for membership in a mutual aid group<br>▪ It is difficult to save enough to pay all the costs of a serious crisis<br>▪ If no emergency occurs, may pay for nothing other than "peace of mind"<br>▪ Requires discipline |
| **Reaction Strategies** | | |
| ▪ Borrow<br>▪ Work longer hours<br>▪ Find new ways to earn money<br>▪ Reduce expenditures<br>▪ Sell assets | ▪ Pay only when and if something happens<br>▪ Invest surplus cash in other things like a business<br>▪ No sacrifices in the present for something that might or might not happen in the future | ▪ Interest on loans is expensive<br>▪ Loan payments are another burden, on top of the struggle to recover from lost income<br>▪ May be forced to sell assets if do not have enough income to make loan payments<br>▪ Reduces the ability to earn income in the future<br>▪ Reduces the ability to cope with future emergencies<br>▪ May reduce the ability to borrow in future if the assets sold could have been used for collateral |

## Choosing between Using Savings or Borrowing

Savings usually involves sacrifice that is made for a larger purpose such as educating children and/or buying a house. Those who have enough savings for an emergency must decide whether to use those savings or take a loan to cover expenses in response to a crisis. In some situations, borrowing may be the better option. If the crisis a victim faces *does not* keep her from earning income, she can resist using her savings and consider a loan. If she can continue working, she may have the capacity to repay a loan. Those facing a crisis should look for a loan that is tailored to emergency response, with terms and conditions designed to help people to cope with unexpected, sometimes additional, debt.

In other situations, using savings can be a better option than borrowing if the crisis does prevent the victim from earning her income. She could use savings to meet expenses instead of borrowing. Otherwise, she will be burdened with loan payments that she may not be able to make.

### GUIDELINES FOR USING SAVINGS OR CREDIT

If the emergency faced affects the ability to earn income, use savings to pay expenses. If the emergency does not stop or reduce income, consider taking a loan to pay for unexpected expenses.

## Pooled Risk

Another protection step that can help one manage risk is joining a community-based emergency fund. These exist in many forms, including welfare societies, burial societies, or Friends in Need Groups.[1] Group members deposit small amounts of money regularly in a fund in return for the right to make a claim when a crisis befalls their households. Generally, these groups define their purpose very specifically—that is, they exist to protect members against a particular type of crisis. Burial societies, for example, help members cover the costs of funerals.

[1]Known generically as "mutual aid societies," these groups exist for many different needs, but they tend to be more common in Africa.

These informal group-based mechanisms give members access to a large lump sum of cash when a crisis occurs. How are they able to do this? The small contribution of each member creates a bigger fund than any single person would be able to save up on their own. By pooling their funds in this way, members are sharing the risk of a costly crisis befalling one of them. Participants in such informal mechanisms typically know each other, which makes it easier to place their trust in the reciprocal exchanges between friends, neighbors and relatives.

A key aspect of this type of "pooled risk" is that members' contributions to the fund are not refunded even when no claim to group funds is made. Any member who is lucky enough to avoid the crisis for which the fund exists, and therefore does not need its support, does not get a refund. Members' contributions stay in the fund. Joining this type of informal mutual aid society buys peace of mind. If and when a crisis happens, the victim will be able to respond without depleting her savings or borrowing more than she can afford to repay.

However, one weakness of a local mutual aid society lies in the similarities between its members. People who live in the same community have a greater chance of experiencing the same crisis. For example, if a flood strikes a village causing many deaths, the local funeral society may not have enough money in its fund to make lump sum payments to many members at once.

## Microinsurance

Microinsurance is a financial product that offers another form of protection against the possibility of a loss. Microinsurance also applies the idea of pooled risk, just on a bigger scale. Instead of sharing the risk among a small group of community members as mutual aid groups do, microinsurance spreads the risk to a much larger number of people (i.e., policyholders) who are more diverse in where they live, what kind of work they do, and how much money they earn. When a lot of people from many different places buy the same insurance policy, the money they pay for their insurance policies goes into one fund that the insurance company uses to pay benefits to those policyholders who are hit with a crisis. In this way, everyone pools their funds and shares the risk of a crisis happening to any one of them. Microinsurance is a risk pooling mechanism tailored to the needs of low-income families in terms of costs, duration, coverage and delivery. Purchasing microinsurance is an action to take *before* a crisis occurs in order to protect against loss and give peace of mind.

In contrast to the familiarity of a community-based mutual aid society, people who buy insurance must place their trust in a commercial entity. It is the insurance company, not the policyholders, that manages the funds, collects the premiums and pays out the claims. When an insured event happens, one has to trust that the insurance company will respond. Thus, one must choose an insurance company that is reputable, financially sound, and regulated in some way.

There are many different types of insurance for each of the risks most people face. Property insurance will protect a home, business or other valuable assets against theft and damage due to fire or natural disasters. In many countries, the government requires anyone who owns a motor vehicle—such as a car or motorcycle—to purchase vehicle insurance. Health insurance can protect one against the high cost of medical care. Some health policies will only pay for the catastrophic events that require expensive hospital stays and treatment; others will pay for routine medical care, including regular check-up visits to the doctor. Life insurance provides a payment to the family of the policyholder upon his death, allowing the family to better manage the loss of his income. Many microfinance institutions require that borrowers purchase a "credit-life" policy which will pay the borrower's outstanding loan balance should the borrower die before the end of the loan term.

The confusion about what insurance is, how it works and how it can help leads to widespread reluctance to purchase insurance or renew existing policies. For many, insurance is a perplexing product. However, people can begin to find the basic answers they need by learning to ask some key questions about insurance.

The following table defines the basic terms people need to understand when discussing insurance. These terms are common to most types of insurance policies. They are likely to be used in discussions with a sales agent or an insurance company representative. However, while these are very common elements of insurance, they will be a little different with each policy. Thus, it is very important to learn everything possible about each term in relation to the specific policy under consideration. Following the table is a list of questions about each term that can serve as a guide for anyone who is trying to learn specific details about an insurance policy.

## INSURANCE TERMS AND DEFINITIONS

| *Insurance Term* | *Definition* |
|---|---|
| Policy | The printed document that states the terms and conditions of the insurance contract |
| Premium | The money a policyholder pays to the insurance company to activate an insurance policy and keep it in force |
| Benefits | The amount of money that the insurance company pays to the policyholder or to his/her beneficiary |
| Beneficiary | The person who receives the insurance money when an insured event occurs |
| Claim | A request for payment for a loss that is covered by the policy |
| Exclusions | Specific conditions or circumstances listed in the policy that are not covered and for which the policy will not pay any benefits |
| Eligibility | The criteria that determine who can purchase an insurance policy (e.g. age limits on who can buy an insurance policy; often one must at least 18 years old) |
| Deductible | The amount of money that a policyholder agrees to pay, per claim or per accident, toward the total amount of an insured loss. Insurers use this mechanism to share risk with policyholders and reduce false claims. |
| Waiting Period | The time a policyholder must wait before his or her coverage becomes effective. For example, life insurance policies typically have a delay between the time when policyholders begin paying premiums and when the coverage is active, reducing the risk that someone who is about to die will purchase a policy. |

## QUESTIONS TO ASK THE INSURANCE AGENT

**Policy**

- What type of policy is it? What events does it cover? Who does it cover?

**Premium**

- What is the amount of the premium?
- How is it to be paid? (in cash, deducted from the loan, etc.)
- How frequently is the premium paid? (monthly, quarterly, annually)

**Benefits**

- What benefits does the insurance policy guarantee to the policyholder?
- Which events will trigger payment of the benefit?

**Beneficiary**

- Who can be named as a beneficiary?
- How many beneficiaries can be named?
- Are there special provisions if benefits are paid to a named beneficiary who is a child? Does the insurer notify the beneficiary?

**Claim**

- How a claim is submitted?
- What type of documentation is needed?
- When should a claim be submitted?

**Exclusions**

- What events are named as exclusions to this policy?

**Eligibility**

- What are the criteria for who can purchase this insurance policy?

**Deductible**

- What is the amount of the deductible?
- Does this amount ever vary? Is it the same for every claim?
- What if the cost of the event (the loss or medical expense, for example) is less than the deductible amount?

**Waiting Period**

- When will the policy be active?
- What if something happens to me during the waiting period? Is one entitled any benefit?

# Most Frequently Asked Questions

Although insurance is difficult to understand, it is a critical part of good risk management. Below is a list of common questions that people often raise about insurance.

➤ **WHICH KIND OF INSURANCE SHOULD I BUY?**

*This decision depends on the events that you fear the most, those that will cause the greatest harm to your financial well-being. For many people, medical expense, especially those associated with unexpected illness or injury, prevent them from saving and attaining any financial stability. When available, health insurance is usually a good investment. Business owners must think about how to protect the tools, equipment or production space that they need to run their business. Remember also that in most places, vehicle insurance is required by law.*

➤ **WHAT DOCUMENTATION DO I NEED TO PURCHASE INSURANCE?**

*This answer will vary with each insurance company and type of policy. Health insurance may require a doctor's exam. Property insurance may require proof of ownership for the property to be insured.*

➤ **WHO SHOULD I NAME AS THE BENEFICIARY OF MY LIFE INSURANCE POLICY?**

*The choice of beneficiary depends on who needs the life insurance money and for what purpose. Money intended for children's welfare should go to either to the children or their guardian. Money intended to pay funeral expenses, outstanding loans and other expenses should go to the person responsible for handling such matters upon your death.*

➤ **DO I STILL HAVE COVERAGE IF MY POLICY HAS LAPSED AND I AM SAVING TO PAY THE RENEWAL PREMIUM?**

*No. If the insurance premium is not paid, the policy is not active.*

➤ **IF I DO NOT SUBMIT A CLAIM AGAINST MY INSURANCE POLICY DURING THE PERIOD COVERED BY MY PREMIUM, DO I GET ANY REFUND?**

*No. The premium from each policyholder is collected in a fund that is used to pay benefits when a covered event takes place. If that event does not happen to you, your premium stays with the fund to ensure that money is available to those who do face a crisis.*

➤ **CAN I SIGN UP FOR AN INSURANCE POLICY ONLY WHEN I THINK I WILL NEED IT?**

*It is very difficult to predict when a crisis will occur. Most policies are active for a defined period, such as a quarter (i.e., three-month period) or a year, and the premium charged covers that period of time only.*

Each insurance company will answer these questions a little differently. It is said that insurance companies sometimes avoid or at least delay, paying claims. But very often, negative experiences of this type are rooted in misunderstanding about the insurance product and related policies. While the insurance company has the responsibility to educate its customers, this Content Note offers some basic tools to understand insurance and acquire the information needed to decide how insurance can help manage the risks one faces.

The road to financial security often follows a zig-zag path that depends on the frequency and severity of shocks that threatened one's assets and income. It also depends on one's ability to respond to those shocks. It can be difficult to decide to spend scarce resources based on the mere possibility that something bad might happen. If the anticipated crisis does not take place, one may believe that one paid insurance premiums for nothing. However, protective measures taken in anticipation of a crisis can make a huge difference in the financial cost a family pays if the crisis does occur. Among these protective measures, microinsurance is a good investment to reduce the financial loss that shocks can cause.