Unit 5 Paper: Microinsurance

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(Selected Essay 2: *What can microcredit's success teach us about microinsurance?*)

Microcredit's success in the developing world cannot foretell the future of microinsurance. Microcredit, a model by which an external financial entity pools credit-constrained neighbors and friends to share a credit line, is partially suited to address constraints to credit access that commonly appear in the developing world. Moral hazards, assymetries of information, and per-capita overheads are reduced, while migrant workers are left out of the microcredit movement. A similar model for pooling insurance risks faces different challenges: policyholders' interests are not aligned with insurers', geographic pooling increases the risk of disasters which strike multiple policyholders, and migrant workers can be served if they bear the cost of contacting the insurer in case of disaster.

By pooling credit into groups of friends or neighbors, microcredit providers reduce the risk posed by moral hazard and information assymetry. Moral hazard is policed by the group: if one member takes excessive risk, they potentially increase the amount owed by other members, who will make strides to mitigate the risk. The credit provider knows less about members of the group than their neighbors might, so pooling familiar entities gives the provider confidence that members trust each others' creditworthiness. These techniques are effective because lax enforcement within the group results in reduced credit in the future. For microinsurance, collusion has the opposite effect, and leads to a larger payout for those that break the rules. A group that takes on more risk or assists in scamming the insurer introduces a higher level of moral hazard. Similarly, information assymetry between the insured group and the insurer is higher if the group members collude to receive an unworthy payout.

To reduce per-capita overhead, a microcredit or microinsurance provider would seek to pool members that are as close as possible. This approach reduces overhead by reducing provider travel time and number of meetings. While pooling nearby neighbors reduces overhead, it increases the probability of a disaster, such as poor weather or a pandemic, striking multiple group members. While this concern affects both microcredit and microinsurance, the effect on microinsurance is greater. A disaster striking multiple members of a microcredit group does not guarantee that all of the affected members will miss their payments. If the same disaster strikes multiple members of a microinsurance group, however, the insurance provider must cover all affected members. Such risk is mitigated by insuring multiple groups across geographies, but this complicates the simple premise of microinsurance.

Microinsurance shows promise in areas where microcredit has not. One such case is that of migrant workers. Because the overhead of finding migrant workers to collect loan payments is high, microcredit providers often avoid this demograpic. The overhead arises because the burden of receiving payment is on the credit provider. For microinsurance, the scenario is the opposite: if a person is affected by some disaster, it is in their interest to find the insurer with proof of the disaster, with any associated overhead of finding the insurer taken on by the policyholder.

Microinsurance faces different challenges than microcredit, but these challenges are not insurmountable. To reduce collusion, microinsurance providers can make the microinsurance pool responsible for some fraction of the cost of a member encountering disaster. Taken to the extreme, microinsurance providers can view themselves as consultants and advisors to groups that insure internally against disaster. To reduce correlated geographic disaster risks while keeping costs low, microinsurance can target groups of relatives that live in different geographies, picking one member to be the contact for the group. Microinsurance can also pick up where microcredit left off: the interests of migrant policyholders are aligned with those of microinsurers moreso than in microcredit. We should test different microinsurance designs until we find a model that works, so that another important tool for consumption smoothing can benefit the poor.