PoP Briefing Note # 3

How do the Poor Deal with Risk?

May 2010

This brief offers insight into the ways poor households manage risks. Based on the financial diaries research outlined in *Portfolios of the Poor: How the World's Poor Live on $2 a Day* (see the Research Methodologies Briefing Note), this brief describes the formal and informal risk management tools used by poor households in Bangladesh, India and South Africa, and examines how these tools can be improved to help the poor mitigate risk and plan for the future.

Poor Households are More Vulnerable to Risk

Being poor is not just about living on $1 or $2 a day. It's also about dealing with the fact that some days you have more and some days much less. Coping with the ups and downs of irregular and unpredictable incomes is an overlooked but fundamental challenge. The poor also lack financial tools that could help them weather emergencies and protect their livelihoods (see The Poverty Trap 'Triple-Whammy' Briefing Note). As a result, they may be forced to sell assets, take on high-interest loans, or exhaust meagre savings—pushing them further into poverty.

Lacking financial tools exacerbates health emergencies

Feizal was the primary earner in his ten-member family, so when he fractured his thighbone, the family fell on hard times. Since Feizal didn't have insurance, he initially sought treatment from less costly traditional doctors. However, three months later his injury showed little sign of improvement. Feizal's father brought him to an urban doctor who successfully treated his injury, but the family exhausted nearly all of their bank savings to pay for it. In the end, the direct and indirect costs of the accident—Feizal's treatment and lost earnings—were far greater than they would have been had Feizal had the financial ability to access high quality treatment in the first place.

Table 1 shows the range of crises that poor households faced during the financial diaries research year. Illness affected 50% of diary households in Bangladesh, and 42% of households in India. Funerals were the number one event causing a financial emergency in South Africa, impacting 81% of households.

Table 1: Most Frequent Events Causing a Financial Emergency, by Country, with the Percentage of Country Sample Affected at Least Once during the Study Year

Bangladesh 42 households		**India** 48 households		**South Africa** 152 households	
Event	**%**	**Event**	**%**	**Event**	**%**
Serious injury or illness	50	Serious injury or illness	42	Funeral of family outside the household	81
Did not receive expected income	24	Loss of crop or livestock	38	Serious injury or illness	10
Fire/loss of home or property	19	Loss of regular job	10	Funeral of member of the household	7
Loss of crop or livestock	7	Theft	4	Theft	7
Business failure	7	Abandonment or divorce	4	Violent crime	4
Cheated/cash loss	7	Serious harassment by officials	4	Fire/loss of home or property	3

Source: *Portfolios of the Poor*, Table 3.1, p. 68

Current Solutions are Incomplete

Dealing with emergencies means being able to pull together adequate financing at the right moment. The diary households used credit, savings and insurance, both formal and informal, to mitigate risk.

Funeral insurance is a good example of how poor households use a combination of formal and informal insurance. Tables 2 and 3 describe these tools in detail. About 80% of diary households in South Africa had at least one funeral insurance scheme, and most had more than one. The authors report that formal funeral plans complement rather than displace traditional burial societies, in part because burial societies provide social as well as financial benefits.

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Table 2: Types of Insurance Products used by Diary Households in India and Bangladesh

	FORMAL		INFORMAL	
Coverage	*Life*	*Life*	*Credit-Life*	*Village Insurance*
Carrier	State (Life Insurance Corporation)	Private Insurers	Microfinance Institutions	Households
Country	India	Bangladesh	Bangladesh	India & Bangladesh
Policy	Quarterly or biannual premiums based on age. Recovered savings with profits if term completed.	Weekly or monthly premiums. Reclaimed savings with profits if terms completed.	Payment built into price of the loan. Debt-forgiveness upon death.	Reciprocal gifts or flexible loans between relatives.
% of diarists	15%	19%	~50%	N/A

Source: Financial Access Initiative, from *Portfolios of the Poor*, Chapter 3

Table 3: Types of Funeral Insurance in South Africa

	FORMAL		INFORMAL	
Carrier	Regulated financial Companies	Funeral parlors	Burial Societies	Less-Structured Burial Societies
Payment/ Payout	Monthly premiums. Upon death, company paid out in form of cash lump sum.	Monthly premiums. Upon death, fixed set of goods, services, and/or cash to heirs.	Monthly premiums. Upon death, relatives received a set payout of cash, in-kind support, or both.	Transactions only at time of death. Relied heavily on in-kind support where members promised to give a set amount when death occurred.
% of diarists	26%	24%	57%	n/a

Source: Financial Access Initiative, from *Portfolios of the Poor*, Chapter 3

New Ideas for Helping Poor Households Deal with Risk

Partial Coverage

Poor households don't always need full coverage insurance policies. Since they typically address emergencies by patching together funds from different sources, partial solutions that contribute to the mix can still be effective. Comprehensive health insurance for poor households most likely would require expensive premium payments to be commercially viable. But there could be substantial demand for cheaper partial health insurance, such as prescription drug benefits or catastrophic health coverage.

Product Design

Insurers use risk sharing mechanisms like co-payments and deductibles to reduce "moral hazard," the tendency of individuals to change their health seeking behavior once they have access to insurance. But high deductibles and co-payments can have unintended consequences, particularly for the poor. Feizal's case, described above, demonstrates that if a patient must pay for healthcare directly, he might avoid treatment until his health has seriously deteriorated. Additionally, insurers should consider the convenience and timing of paying the premiums. For poor households, being able to pay premiums weekly or fortnightly can matter as much as the total cost of the policy.

Beyond Insurance

Risk management doesn't always mean insurance—savings and loans also can help address crises (see the Creating Better Portfolios Briefing Note). While insurance tends to be tied to specific adverse events, savings and loan funds are fungible. For instance, a business loan can easily be diverted to deal with an emergency. Poor households may reason that, given their limited resources, they are better off using general-purpose tools than risk-specific insurance, because the insured risk may never occur. For these reasons, insurance coverage attached to savings and loan products, as in the case of credit-life insurance and life-endowment savings, may appeal to poor households more than a generous portfolio of policies insuring against each and every risk.