FEED THE FUTURE
The U.S. Government's Global Hunger & Food Security Initiative

So You're Thinking About Index Insurance?

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Decades of research shows that uninsured risk is a major hurdle to investment, productivity growth and poverty reduction for smallholder agriculturalists in developing countries. Insurance has the potential to unlock growth opportunities and prevent descents into poverty, though traditional claims-based insurance has proven to be prohibitively costly.

Index insurance is an increasingly popular tool being used by the international development community and national governments to help mitigate the inherent risks faced by vulnerable agriculturalists in the developing world. Index insurance can, indeed, help better manage risks and create pathways out of poverty, but only when crafted and implemented responsibly.

The Feed the Future Innovation Lab for Assets and Market Access is creating a "toolkit" for practitioners and policymakers considering index insurance. This toolkit will help identify what is needed to make sure responsible, high-value index insurance products are brought to market by helping guide implementers to ask the basic questions necessary for a successful index-insurance venture. Issues covered include:

1. Why consider index insurance for agriculture
2. How to assess if index insurance is a good fit
3. The importance of identifying a feasible high-quality index
4. New innovations in contract design that increase value to farmers
5. What institutional structures have to be assessed
6. The challenges and opportunities for marketing and distribution of insurance
7. Ongoing challenges facing the successful scaling of index insurance

1. Why consider index insurance for agriculture

When there is evidence that risk pushes people into poverty and keeps them there, insurance could be a powerful tool for change. However, when target farmers live in remote areas with limited infrastructure, as is typically the case for developing countries, traditional claims-based insurance is difficult or impossible. In these cases, index insurance is a potential solution.

2. How to assess if index insurance is a good fit

Index insurance is only an effective tool if a large portion of the risk faced by farmers is shared among a majority of farmers in a community – for example, weather-based risks like droughts or floods. If the goal of the insurance intervention is growth and poverty reduction, it is also essential that farmers can make productive investments if risk is more effectively managed. To maximize development impacts, both risk management tools and opportunities for growth must be available.

3. The importance of identifying a feasible high-quality index

Index insurance is, by definition, imprecise. It pays out based on an external measure that predict average losses after a shock, not actual losses of individual farmers. Contract designers must be able to estimate the probability that farmers will receive indemnities if they experience a loss. This probability is directly related to the strength of the external index being used to estimate farmer losses, and how well the predictions reflect the farmers' reality. Different indices – including rainfall, satellite, and area-yield – have different strengths and weaknesses, and different requirements with regard to data availability.

4. New innovations in contract design that increase value to farmers

The index is not the only important design element. Other factors can change the value of the contract to both the farmers and the insurance companies. Innovative structures, such as "audit rules" or "dual-trigger contracts," can dramatically reduce the probability that the contract doesn't pay when it should, or does pay when it shouldn't. Pricing is also an essential component. If expected average premiums dramatically exceed expected average payouts, farmers may be better off without the product.

5. What institutional structures have to be assessed

While public institutions often take responsibility for disaster relief when catastrophe strikes, the financial burden is substantial. The private sector is turning to index insurance, but a crucial element is reliable data on available indices and yields. Forming partnerships between public and private sectors can more effectively manage the breadth of risk faced by farmers, especially when it comes to the provision and sharing of data. In addition, regulations need to appropriately support the commercialization of index insurance, and the private sector needs the geographic reach to access farmers, as well as specialized knowledge to create safe and effective index insurance products.

6. The challenges and opportunities for marketing and distribution of insurance

Insurance – especially index insurance – can be a difficult concept to explain to people. Even once the concept and mechanism is understood and appreciated, there are a number of other challenges to the marketing and distribution of index insurance products, including issues of limited demand, disaggregated demand, nuanced timing for both sales and payouts, and many other issues. There are, however, opportunities for improving consumer education, bundling with other valuable tools or services, linking to banking or microfinance, and digital engagement.

7. Ongoing challenges facing the successful scaling of insurance

More work is needed to establish best practices to create and sustain a secure market for agricultural index insurance in developing countries. In addition, there is an ongoing challenge of making insurance both affordable for farmers and profitable for insurance companies while maintaining safe minimum standards for quality.

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