



## Operational & Regulatory Strategies for Weather-based Index Insurance

### Overview

Smallholder farmers are constantly faced with weather risks, which define good and/or bad production years. With the majority of the labour force on the continent engaged in the agricultural sector, insurance has emerged as a critical gap in the value chain. Like all entrepreneurs, farmers make decisions in risky and uncertain environments. However, in contrast to most entrepreneurs, farmers are vulnerable to significant systemic price and weather risks, often exacerbated by the effects of climate change, with no safety net to protect their livelihoods. Smallholders are further exposed due to their limited asset base, small margins and poor decision-making. Because smallholder farmers are already vulnerable, the consequences of poor decision-making can be catastrophic. Smallholders are frequently unable to access financial services as banks are reluctant to lend money due to the potential for default resulting from crop failure. The result has been chronic underinvestment in the sector; however, insurance against such risks facilitates access to credit for smallholders. This allows them to purchase improved farm inputs such as high quality seeds and appropriate fertilizers, therefore improving crop yields, food security and the development of the rural economy. This policy brief outlines key operational and regulatory strategies that can effectively reduce the impact of severe weather on small-holder farmer productivity as well as support increased investment in farm productivity.



### Key Recommendations

- Pragmatic decisions should be made around payment of ex-gratia or discretionary pay-outs as and when required.
- Systems used to collect policy level data should be sophisticated enough to deal with scaling-up of products , however relatively simpler systems can also be used, provided data can be collected on a speedy, timely and accurate basis.
- When embedding insurance with other financial (e.g. loans) or non-financial (e.g. farm-inputs) products, there should be a particularly strong emphasis on marketing in order to inform farmers about the embedded product.
- Products should mostly be implemented on a mandatory basis to start off with, perhaps providing a relatively basic level of cover, with a clear transition plan to a voluntary basis in the medium term.
- Regulatory framework for agriculture insurance should be robust enough to enable and encourage innovative products.
- Very high rates of taxation for agriculture insurance should be avoided as this can severely erode client-value.

## Scope and Severity of Problems

The majority of the labour force in Africa is engaged in the small-scale agricultural sector (Mapfumo et al. 2014). Like all entrepreneurs, farmers make decisions in risky and uncertain environments. However, in contrast to most entrepreneurs, farmers are vulnerable to significant systemic price and weather risks. In fact, climate related shocks are among the leading cause of production and efficiency losses in smallholder agriculture production in rural Africa (Mapfumo et al. 2014). Smallholders are further exposed due to their limited asset base and small margins. Consequently, the identification of tools to help manage the risks associated with climactic extremities is increasingly considered to be amongst the key pillars of any agenda to enhance agricultural growth and welfare in rural Africa. Weather-based index insurance (WII) is one promising innovation that seeks to bring the benefits of formal insurance to help manage the weather-related risks faced by rural small-scale farmers in developing countries (Mude et al. 2010).

As with other innovative financial products, WII needs appropriate testing before it can be marketed on a large scale. Assessing the real potential of WII can take time, and setting up an appropriate pilot is recommended. With a relatively small budget, and through a real learning-by-doing experience, pilots can provide useful indications about acceptance of the product, willingness to pay and product design alternatives. Pilots can also allow market participation and stakeholder capacity to develop organically (Skees 2006).

In planning the implementation of a WII pilot, the first step is to set up the market arrangement of the risk transfer and distribution proposition. As insurers normally have limited or no business (or offices) in rural areas, distribution is best organized through a party with existing links to farmers or farmer groups (e.g. a bank, processor, cooperative or microfinancing institution) (Dick & Stoppa 2011). Moreover, embedding WII into a development programme, or into a package linked with credit, inputs or contract farming, can strongly add value to the proposition for farmers and other stakeholders and make it easier to sustain and eventually scale up (Dick & Stoppa 2011).

The process of using intermediaries may provide access to existing retail networks, potentially reaching a larger number

of clients. However, insurance agents (i.e. intermediaries) require capacity to enable them to provide appropriate information to policyholders. Agents require training on customer service and they should be up to date with policy information to be able to advise the customers appropriately (Kabiru et al. 2012). In particular, insurance companies should have service contracts so that customers may know and understand the full implications of the policy they are buying.

## Principal policy regulatory and operational challenges

The principal policy regulatory and operational challenges relate to distribution, marketing and implementing relatively complex products to farmers and aggregators with very little prior experience of insurance. Many insurance pilots, particularly in agriculture, face technical, operational and institutional challenges when they are scaled up (Cummins & Mahul 2009). The key challenges encountered are summarised below:

- Agriculture insurance for small-scale farmers is typically not purchased on a stand-alone basis but is often bundled with other products, such as health insurance.
- The distribution channels are critical for the adoption and scaling up of WII, but sometimes they may not be sufficiently motivated to play an active role in increase the outreach of agriculture insurance.
- The cost of the products (on a sustainable basis) may be much higher than what the farmers and/or aggregators are prepared to pay.
- The regulatory framework for this type of product is often not structured sufficiently for the conducive development of products and for consumer protection.
- Specialist co-insurance pools for agriculture insurance may not function as efficiently as expected and may hinder competition and innovation in this field.
- The tax environment is generally harsh, and unfortunately, related costs are passed on to the farmers.
- Level of awareness about insurance among farmers is very low and this leads often leads to challenges when policyholders have high expectations, which the product cannot necessarily meet.
- Payment of the premium is often a challenge due to cash flow problems at the start of the season.

## Improving Weather-based Index Insurance Operational & Regulatory Frameworks

- ***There are opportunities of bundling agriculture insurance with other types of insurance without significantly eroding the value of the agriculture product.*** Bundling with other types of insurance can increase the value proposition for clients and save on product costs. However, care should be taken that there is sufficient proportion of the premium allocated towards agriculture insurance, so as not to significantly reduce the client-value of this component.
- ***There should be a strong business case to support the product, and products and processes should be***

***designed to make business sense for the distribution channel.*** Active collaboration with the distribution channels is essential for the successful implementation of agriculture insurance and this collaboration can only happen sustainably if there is a strong business case for the distribution channels. The business case may include reduction in lending risks, reduction in portfolio exposure to weather risks, improving relationships with farmers, increased farmer loyalty in terms of contracting with an agribusiness or increased sales of farming inputs etc.



- **Costs of the premium (and any other insurance related costs) should be shared between the farmers and distribution channels**, where possible, especially in cases where there is a strong business case for distributors. For example, if the product reduces the distributor's lending risk, the distributor can contribute to the premium, instead of reducing the lending interest rate.
- **Farmers should be aware and have a basic level of understanding of the workings and limitations of the product.** Awareness raising is important from the perspective of responsible selling practices and also leads to greater appreciation of the product, generates additional demand and willingness to pay for the product. This can also result in fewer disputes and lower reputation risk for the insurance company and associated distribution channels.
- **In implementing portfolio products, there should be a certain critical economic value insured and farmers should also be aware of the product**, at least to some extent. If a portfolio product is implemented at a very small-scale and with farmers not being aware of the product, it is very likely that no tangible impact will be seen, which can lead to the products being discontinued.
- **Pragmatic decisions should be made around payment of ex-gratia or discretionary pay outs as and when required, and there should be scope for both insurer and reinsurer to consider such payments**, particularly to manage basis risk situations. It is very important to consider all available options to deal with a major basis risk event. One of the options can be to consider discretionary pay outs, with a clear communication strategy. This can be affordable, particularly in seasons, which are profitable for the insurers. In the absence of any pay outs, market confidence in products can be particularly damaged and take a long time to recover.
- **Systems used to collect policy level data should be sophisticated enough to deal with scaling-up of products but relatively simpler systems can also be used, provided data can be collected on a speedy, timely and accurate basis.** Relatively simple data collection processes in the absence of more sophisticated technology. However, better ICT systems have a crucial role to play for agriculture insurance processes, such as for marketing, premium collection, claims notification etc. However, in addition to using technology, a relatively 'high touch' approach (involving field operatives) is needed for farmer level awareness raising and training distribution channels to market the product.
- **When embedding insurance with other financial (e.g. loans) or non financial (e.g. farm-inputs) products, there should be a particularly strong emphasis on marketing in order to inform farmers about the embedded product**, and also if insurance is being used as a sales promotion tool. Insurance bundled with other services (e.g. loans, inputs) has good potential for increasing outreach, however the cost implications on the other services and the competitive environment should be considered for the long-term feasibility of bundled

products.

**Payment of the premium is often a challenge due to cash flow problems at the start of the season.** This challenge should be recognised and different options looked at for ensuring payment of the premium on an affordable basis. For example, the premium may be shared between farmers and distributors or the premium may be payable from the sale proceeds of the previous season or payment via instalments can also be considered.

**Field level operatives involved in distribution products should be adequately incentivised** to sell products, particularly if the product is sold on a voluntary basis. Significant effort should be allocated for the training of trainers for product awareness, data collection, sales and distribution process etc.

**Products should mostly be implemented on a mandatory basis to start off with, perhaps providing a relatively basic level of cover, with a clear transition plan to a voluntary basis in the medium term.** This is because typically take-up rate is very low if the products are sold on a voluntary basis from the outset. However, after customers are acquainted with the product over a few years, a demand for the product can be generated based on the customers' experience. In some cases, though, farmers may have a voluntary appetite for insurance, particularly if insurance is being used as collateral in order for farmers to access agriculture production loans.

**Regulatory framework for agriculture insurance should be robust enough to enable and encourage innovative products**, while still providing adequate consumer protection and ensuring financial sustainability for the insurers. Regulatory guidelines should particularly focus on areas such as management of basis risk, selling practices, client-value, role played by distribution channels, premium collection and claim payment processes etc.

**Local insurance companies should have a sense of ownership of agriculture insurance products for long term underwriting.** It is very important that local insurers own the products, and are motivated to find new ways and routes to distribute and develop the products. The insurers should not simply rely on third parties and donors to drive the agenda for agriculture insurance, but should underwrite products from a commercial perspective.



- **Sudden exit of agriculture insurance intermediaries and other technical service providers can be very harmful to the market and should be avoided or contingency plans put in place** to deal with default risks. Products can be discontinued completely if an intermediary or third party exits the market. This can be very harmful for market confidence in agriculture insurance and can lead to serious reputation risks for both insurers and other parties involved. Hence, for the sustainable implementation of products, it is very important that there are some safeguards or contingency plans in place in case the intermediary or technical service provider leaves the market. For example, there could be requirements for adequate levels of capacity building of local insurance companies and regular monitoring of the same. There could also be provision for adequate notice before a product is discontinued or a continuation route, in the event of a particular product being discontinued, is prescribed at the outset.
- **Competition between multiple insurers and reinsurers can be beneficial for optimising the client-value of products** and leading to more innovation. It has been observed that higher competition can lead to more flexibility around insurers' requirements for underwriting, better pricing for clients, more flexibility around the product terms and conditions and willingness to consider more innovative products.
- **Very high rates of taxation for agriculture insurance should be avoided as this can severely erode client-value.** Unlike some types of micro insurance (e.g. life insurance) agriculture insurance is usually subject to VAT and often other taxes as well. The taxes are typically passed on to the farmers and this results in a lower amount of the premium actually going towards the insurer's risk premium. This can erode the client value of products and can be damaging for client confidence, particularly in the early years. Taxes on reinsurance can make products very expensive as most of the risk is typically reinsured via proportional reinsurance arrangements.
- **Insurance pools can be a good alternative to high dependency on reinsurers, however the benefits of a pool should be compared to the disadvantages** of reduced innovation by individual insurers. In some countries, the insurance pool arrangement has resulted in market barriers for non-participating insurers to underwrite products on their own. This has resulted in a few insurance companies becoming the only market players, which is detrimental from the perspective of developing the agriculture insurance market.

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