



**Paving the Way Forward for Rural Finance
An International Conference on Best Practices**

Discussant Reaction Paper

Comments on Paper

**“Risk Management Challenges in Rural Financial Markets: Blending
Risk Management Innovations with Rural Finance”**

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Basic facts about Mongolia

Mongolia is a country in the northeastern part of the continental Asia bordering with Russia in the north and People's Republic of China in the south. The population is estimated at 2.617.000, population density is 1.6 per sq. km, total size of the territory is 1.5 ml. sq. km, 2,400 km from west to east and 1,260 km from north to south. Average altitude is 1,580m, capital city is Ulaanbaatar (altitude 1.380 m). The country is divided into 21 aimags (provinces), which in turn is divided into 380 soums (counties), further subdivided into baghs (communities). It has a pronounced continental climate with very cold winters (average min. -26 C), cool to hot summer (average max. +23 C), large annual and daily ranges in temperature, and generally scanty rainfall.

Transition to market economy

Mongolia is undergoing a twin transition to a political democracy and a market economy. It is an emerging country, which in the 1980s achieved outstanding results in preventive and medical care and education for all, with basic indicators equaling some of the industrialized world (e.g., a literacy rate of 98% in 2000, a vaccination rate greater than 90%). The past decade has seen the emergence of unemployment, poverty, declines in literacy, and diminished access to education and health services, as the guaranteed market within COMECON and the huge subsidies from Soviet Union which had previously supported the economy and social services were withdrawn. Mongolia has set in motion a series of institutional and structural reforms, aimed at creating a foundation for the development of an efficient economy and the improvement of the social system. It has made considerable progress; after the economic collapse of 1990-1994, Mongolia had five consecutive years of growth and brought inflation under control (below 10%). The livestock sector-the backbone of the economy-was privatized from 1991 on, and private companies are playing an increasingly important role in many key sectors.

Livestock sector in Mongolia

Nomadic and pastoral livestock production occupies a central role in the Mongolian economy. Livestock herds make up one third of the GDP, livestock herders and their families are the single most important social group for the Government as they make up a large percentage of the poor in the country and represent close to 40% of the entire population.

Pastoral livestock husbandry results in a nearly total dependency on weather and other natural conditions. This dependency in turn results in a relatively low productivity per animal and a high susceptibility to devastating livestock losses due to natural disasters (dzud) and disease. (Show slides #3,4 and 5)

Slides here will not even to begin to tell the human and economic devastations suffered by herders over the last several years because of dzud and other natural disasters. These risks create not only serious hardships in the short-term but significantly hamper the overall development process.

Need for livestock insurance

Need for livestock insurance is obvious and recognized in some important legal documents. The Mongolia Constitution, for example, states that "livestock is to be protected by the State as they are a national wealth". The Government plan of action for 2000-2004 also states that "livestock shall be insured and its legal environment shall be formed".

A number of agricultural insurance laws have been proposed since 1995 and none were adopted. There are many good reasons why it is so difficult to set up an effective, wide spread and long-term livestock insurance in general, and in the Mongolian context in particular.

The opportunities for abuse and adverse selection are significant. Moral hazard is a problem. Controlling adverse selection and moral hazard in Mongolia would require prohibitively big investments in data collection and monitoring. Huge territory, lack of infrastructure, differences in management styles and risks among herders - all these factors contribute to making traditional livestock insurance not a viable option in the long-term.

Livestock insurance experience of the past

Livestock insurance is not a totally foreign concept in Mongolia –before the market economy reforms began in the early 1990s, the government had a compulsory insurance scheme for the state-owned livestock. The Mongolia government introduced compulsory livestock insurance in 1964. As an illustration, in 1981-1985 the natural insurance organization collected annually on average 3.6-3.8 million USD in livestock insurance premium and made annual indemnity payments ranging from 0.8 to 2 million US Dollars. In 1969, following a particularly devastating dzud, the national insurance company paid close to 8 million USD in indemnity payments. The national insurance company used to reinsure these contracts with the Lloyds in London where at the time they were commonly referred to as “yak contracts”.

This insurance scheme worked despite all odds because: (1) the state owned all or most of the livestock as well as the insurance companies; and (2) the insurance companies negotiated contracts not with individual herders spread around the country but with 350 or so state-owned collective farms to which all herders belonged on a more or less compulsory basis.

With the privatization of livestock in the early 1990-s and collapse of the nation-wide network of state-owned collective farms, this compulsory insurance scheme ceased to exist. Despite numerous attempts by successive governments to re-introduce livestock insurance, today only less than 1.0% (about 35,000 out of 30 million) of livestock is insured. Total livestock and grain net premium in 2001 amounted to only MNT 115 thousands. Livestock premiums vary between 2 % and 6 %, with 80 % / 100 % indemnity.

New strategies to cope with the risks

The Government of Mongolia is working with the World Bank and other international institutions to develop new and better strategies to mitigate risks. Significant efforts are underway to provide herders with necessary information and training to make them better managers. Investments in forage equipment, improved forecasting, skill development, etc. are all targeted at helping herders become better managers and that they have incentives to work hard to reduce livestock losses.

Within the World Bank Sustainable Livelihood project, three core activities are being coordinated: (1) management of pastoral risk; (2) development of community investment funds; and (3) improving the role of rural micro finance services. A major thrust of the pastoral risk management component is to provide integrated strategies to assist herders in managing the covariant risk in Mongolian pastoral livestock production. Among a host of strategies being considered, mortality rate-based insurance as proposed by Dr J Skees and A.Enkhamgalan is growing in importance.

Dr Skees and Enkhamgalan have studied three alternatives to insure livestock deaths in Mongolia: (1) traditional livestock insurance that pays individual herders based on their specific losses; (2) weather insurance that would pay when weather events that are likely to create serious losses occur; and (3) index insurance that would pay when livestock mortality rates exceed certain thresholds, and they proposed to adopt the third option.

Government response to index insurance proposal

We in the Government of Mongolia consider the mortality rate insurance as probably the only viable option in the long term and interested in trying it out on a pilot basis in some soums. This scheme is simple, largely free of common problems of adverse selection and moral hazard, easy to administer, and, ultimately, rewards better managers.

However, promoting and implementing this insurance run into some serious challenges in Mongolia.

Firstly, the quality of annual livestock census and mortality data must be unquestionable for the insurance to work. Herders' pasture use tax depends on the number of animals they owned at the beginning of the year, and so they have an incentive to misreport on the lower side. Vast distances, difficult terrain, lack of infrastructure and constant move of herds in search of better grazing reduce bagh governors to collect census and mortality data on the basis of herders' oral reports. Simple collection of mortality data could become impossible during such disasters as dzud. Monitoring and improving the quality of the data could translate into substantial additional costs for the Government.

Secondly, costs for insurance companies to negotiate and monitor insurance contracts with 250,000 or so individual herders' families scattered around the country several times the size of France could become a significant obstacle. The Government is encouraging development of cooperatives movement and rural microfinance institutions but the inherent nature of the pastoral livestock production seems to hinder this process (on average, distance between the two herders' families must be over 50 km to allow for better pasture management).

Thirdly, pastoral livestock production and traditional culture of general public ownership of pasture and grazing grounds allow for more or less free movement of herders between bags, soums and even aimags. With different mortality rates for every soum, it may give herders incentive to shop between soums for better mortality rates and then move on to search for better grazing grounds to collect indemnity payments at the end of the year.

Fourth issue is more political in nature and, hence, more difficult to handle in the longer term. Major dzuds strike on average once in every 7 to 12 years. Experienced herders can foretell with some accuracy how severe a dzud will be and could opt-out or opt-in of the insurance contract at their will. Hence, private insurance companies would be seriously interested in the mortality rate livestock insurance only if it is introduced nation-wide on a compulsory basis and for an extended (7-12 years) term. Following the recent devastating dzuds, it may be plausible to introduce a scheme now, but the herders mood could swing back to reject the insurance after a few years of relatively soft winters (as it already happened once in the 1990-s).

Again, the twin rocks of an aversion to making livestock insurance compulsory and concerns about the financial positions of the insurers if they were required to underwrite such an arrangement, could seriously jeopardize this insurance scheme.

The fifth point of concern is the ability of the Mongolian herders to pay insurance premiums. Eighty percent of the herders have less than 200 animals which is a threshold to sustain a reasonable level of income. Provided herders want to pay premiums, more often than not all they could offer to insurance companies would either raw cashmere or meat or live animals. Insurance companies understandably ask for cash.

The sixth point of concern is the present level of development or underdevelopment of the financial and insurance markets in Mongolia. We have started our work on a more comprehensive draft framework insurance law in tandem with the preparation of the livestock insurance law. We are expecting a technical assistance project from FIRST Initiative in London on livestock insurance, and another technical assistance project is underway with the Asian Development Bank on the framework insurance law.

What we plan to do now?

Despite all the fundamental problems mentioned above we are keen in designing a pilot project to test the feasibility and acceptability of mortality index insurance. Some of the steps we plan to take would include: (1) collection of data on mortality and adult livestock numbers for more soums; (2) investigate the statistical system used to develop the census of animals and the reporting of mortality of animals; (3) select a sample of soums to offer the mortality index insurance; (4) develop an extended education and marketing program; and (5) improve legal and regulatory framework for the insurance industry.