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ABSTRACT. This paper examines the reasons for underinsurance of the poor in Sri Lanka. Analyze is based on the data gathered in Kurunegala and Puttalam Districts to find out the factors have so far hindered the development of a market for micro insurance. This study is based on data collected through 80 questionnaires, 20 in-depth interviews with low income people and expert interviews.

The test hypotheses for micro insurance is impeded by (1) Transaction costs,(2) Adverse selection, moral hazard and fraud,(3) Ill suited products offered,(4) Lack of scalability,(5) Lack of risk aversion, information, understanding and rationality. The first four hypothesis find that insurers can already have reduced transaction costs, adverse selection, moral hazard and fraud to levels which micro insurance feasible and further find that the products currently offered by Sri Lankan insurers are commensurately scalable (with the exemption of health insurance) and offer significant risk reduction potential to low income clients, indicating that the products offered are not ill suited to the clients' needs, therefore can be rejected. However the results proves that although they averse the risk, the target market of micro insurance products is unaware of availability of micro insurance products, lack of financial literacy and understanding the basic insurance concepts and irrational behavior impeding the demand for micro insurance. The result of Hypothesis 5 reveals that micro insurance is impeded by lack of risk aversion, information, understanding and rationality. The preliminary results suggest that effective demand staying far behind potential demand is deemed the most important reason for underinsurance in Sri Lanka.

Key words: Micro Finance, Micro Insurance and Under Insurance.