

CGAP WORKING GROUP ON

MICROINSURANCE

Making insurance markets work for the poor: microinsurance policy, regulation and supervision



Evidence from Five Country Case Studies





29/10/2008: **VERSION 5**

This document presents the synthesis findings from of a five-country case study on the role of regulation in the development of microinsurance markets. The objectives of this project were to map the experience in a sample of five developing countries (Colombia, India, the Philippines, South Africa and Uganda) where microinsurance products have evolved and to consider the influence that policy, regulation and supervision on the development of these markets. From this evidence base, cross-country lessons were extracted that seek to offer guidance to policymakers, regulators and supervisors who are looking to support the development of microinsurance in their jurisdiction. It must be emphasized that these findings do not provide an easy recipe for developing microinsurance but only identifies some of the key issues that need to be considered. In fact, the findings emphasize the need for a comprehensive approach informed by and tailored to domestic conditions and adjusted continuously as the environment evolves.

The project was majority funded by the Canadian International Development Research Centre (www.idrc.ca) and the Bill & Melinda Gates Foundation (www.gatesfoundation.org) along with funding and technical support from the South Africa-based FinMark Trust (www.finmarktrust.org.za)¹ and the German GTZ² (www.gtz.de) and BMZ³ (www.bmz.de). FinMark Trust was contracted to design and manage the project. Together with representatives of the IAIS, the Microinsurance Centre and the International Cooperative and Mutual Insurance Federation (ICMIF) the funders are represented on an advisory committee overseeing the study. The project was undertaken under the guidance of the International Association of Insurance Supervisors (IAIS) and Consultative Group to Assist the Poor (CGAP) Joint Working Group on Microinsurance.

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¹ Funded by the UK Department for International Development – DFID.

² Deutsche Gesellschaft für Technische Zusammenarbeit GmbH.

³ Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung - Federal Ministry of Economic Cooperation and Development

We would like to acknowledge the following funders for making this project possible:

- International Development Research Centre (IDRC), Canada
- Bill & Melinda Gates Foundation
- FinMark Trust, South Africa
- Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (GTZ) and Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung (BMZ), Germany

We would also like to thank the members of the advisory committee for their comments on the draft document and their engagement and guidance throughout the study:

- Jeremy Leach (FinMark Trust)
- Arup Chatterjee (IAIS)
- Craig Churchill (ILO)
- Tammy Durbin (Bill & Melinda Gates Foundation)
- Brigitte Klein (GTZ)
- Michael McCord (Microinsurance Centre)
- Martha Melesse (IDRC)
- Craig Thorburn (World Bank)
- Sabir Patel (ICMIF)
- Martina Wiedmaier-Pfister (GTZ)

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List of abbreviations

AML/CFT	Anti-money laundering/Combating the financing of terrorism
ATM	Automatic teller machine
DFID	Department for International Development
FAIS	Financial Advisory and Intermediary Services
FLFS	Fundamental Law of the Financial System
FS	Financial Superintendence
FSB	Financial Services Board
FSP	Financial service provider
GDP	Gross domestic product
HMO	Health maintenance organisations
IAA	International Actuarial Association
IAIS	International Association of Insurance Supervisors
IDRC	Canadian International Development Research Centre
ICMIF	International Co-operative and Mutual Insurance Federation

Glossary

Aggregators	Any group or entity that aggregates clients and that can therefore be used for insurance distribution purposes. Can take two forms: (i) mutual or other membership-based groups (affinity groups, cell phone client bases, utility companies, etc.) formed for non-insurance purposes or (ii) groups that are not membership-based but allow access to client concentrations (e.g. or cash retailers).
Bancassurance	Insurance distributed through the premises of a bank, including but not limited to credit life insurance to cover the bank's outstanding loans. Such bancassurance is usually provided as a partnership between an insurer and a bank. In some instances, banks also have their own insurance companies.
(Consumer) Credit insurance	Consumer credit insurance is the insurance a consumer takes out to cover an outstanding debt.
Credit life insurance⁴	Credit life insurance is a sub-category of both life insurance and consumer credit insurance in that it is life insurance to cover the outstanding debt of a person in the event of the debtor's death (though it is sometimes expanded to also include the debtor's disability, critical illness and retrenchment). Such insurance is usually included in the credit agreement and may be compulsory.
Demarcation	The regulatory distinction between various types of insurance (life, non-life, health) including the potential restrictions on insurers offering insurance under more than one of these categories. Demarcation is therefore usually an aspect of product regulation.
Market discovery	The process whereby an individual is introduced to the insurance market. Discovery can either be positive (e.g. where risk was covered when needed), in which case the individual will tend to use insurance again in future, or negative (e.g. rejected claim to do conditions not understood by the client), in which case the client may be discouraged from using insurance again or for other purposes. Where clients are unaware of insurance cover that they may have (e.g. the case for some credit life products), there is no market discovery.
Financial inclusion	Financial inclusion is achieved when consumers across the income spectrum in a country can access and sustainably use financial services that are affordable and appropriate to their needs.
Financial inclusion policy/regulation	Various forms of regulation or policy promulgated with the objective of extending access to and usage of formal financial

⁴ Definitions for consumer credit insurance and credit life insurance are taken from Nienaber, Moeletsi et al (2008).

	services.
Financial service providers	Any institution/organisation/entity providing financial services – in this instance insurance/cover/risk-pooling.
Formal insurance	Provision of insurance by an entity that is registered and supervised to do so.
Greenfields sales	Where insurance sales are sold on its own merit as a standalone product to people that do not currently have insurance
Group underwriting	<p>An insurance product usually sold through a master policy where risk is not evaluated or underwritten on an individual basis, but is based on the general characteristics of a group. Individuals can then buy such policies without the need to submit their individual risk characteristics. Group versus individual underwriting therefore defines the way in which the insurer designs and prices the product, rather than who exactly is covered by the product or how it is distributed.</p> <p>Group policies may be distributed through the group mechanism, for example to all members of a labour union or burial society. Group policies may however also be sold to the general public on an individual basis.</p>
Health insurance	Health insurance refers to insurance products providing capital (fixed sum) cover, as well as to products offering indemnity cover (i.e. the reimbursement of actual health expenses occurred). Indemnity is excluded from the scope of this study.
Informal insurance	This refers to an entity providing insurance without being regulated for doing so. In some cases these may be formal legal entities (e.g. funeral parlours) but they are not regulated for the purposes of providing insurance. Informal insurance is not necessarily illegal. Specific providers or products may be exempted from insurance regulation or may simply be operating in the absence of regulation.
Institutional regulation	Regulation focused on establishing and regulating specific institutional types rather than the functional activities (e.g. provision of insurance) of those entities. This may include general companies acts or acts specific to categories of legal entities (e.g. co-operatives acts). In combination with references in insurance legislation these acts determine the legal forms or persons that can underwrite insurance, as well as the corporate governance requirements applicable to these legal forms.
Insurance	A contract whereby the insurer, in return for a premium, undertakes to provide specified benefits upon the occurrence of specifically defined events.

	<p>Where such benefits or the levels thereof are not contractually guaranteed, this document refers to “cover” or “risk-pooling” to distinguish it from insurance as defined above.</p>
<p>Low-income population/ “the poor”</p>	<p>Income levels and poverty was considered both in terms of the country context (using national poverty lines as guidance) as well as comparatively amongst the different countries studied (using standard measures benchmarks of those living below \$1 and \$2 per day adjusted for purchasing power parity).</p> <p>This does not propose that the microinsurance target market for each country is limited to those living under the national poverty line or the comparative \$ measures. Generally low income levels means that even the middle-income class in a particular country will have relatively low income levels and, therefore, require low-premium products.</p>
<p>Market conduct regulation</p>	<p>The regulation of the distribution or intermediation of insurance products.</p>
<p>Microinsurance</p>	<p>Microinsurance refers to insurance that is accessed by or accessible to the low-income population, potentially provided by a variety of different providers and managed in accordance with generally accepted insurance practices.</p> <p>In practice microinsurance definitions, as adopted by a regulator or market, may differ from jurisdiction to jurisdiction, and is typically based on criteria such as the maximum benefit or premium, the simplicity of the product, the maximum contract term, etc.</p> <p>Microinsurance is not strictly limited to those living under the national poverty line or the comparative \$ measures. Many of these households may actually be beyond the reach (e.g. affordability) of an insurance mechanism and will remain dependent on the social security system. Furthermore, generally low income levels means that even the middle-income class (not classified as poor under the national poverty line) in a particular country will have relatively low income levels and, therefore, require low-premium products.</p>

Mutual/member-based organisation	For the purpose of this study, a member-based organisation refers to any entity based on the principle of shared member ownership and governance, as well as distribution of proceeds to members. This can include both mutual insurers and co-operatives, as well as various other forms referred to in the country summaries, such as burial societies, mutual benefit associations, co-operative insurers, co-operative insurance societies, etc.
Policy/policy stance/policy framework	<p>The declared intention of government on how it wishes to order the financial sector (or any other sector or sphere) and the objectives it wishes to achieve.</p> <p>Policy need not only be contained in official policy documents (i.e. a formal policy framework), but can also be stated in speeches, in the press or in other government documentation (i.e. government takes an implicit policy stance).</p>
Product regulation	Regulation relating to the product or product category in question. While provisions relating to product regulation are usually contained within either prudential, institutional or market conduct legislation, it represents a distinct regulatory approach.
Prudential regulation	Prudential risk refers to the risk that the insurer becomes insolvent and is unable to meet its obligations under an insurance contract as well as the impact that one insurer's insolvency may have on the rest of the market and financial sector. Regulation that seeks to manage this risk is referred to as prudential regulation. This typically includes consideration of various categories of risks including: underwriting, credit, market, operational, etc.
Regulation	Various legal instruments with binding legal power – i.e. the set of legislation and subordinate legislation (including acts, regulations, circulars, memoranda, etc) that comprises the regulatory framework for a specific industry or area.
Supervision	The oversight and monitoring of compliance with regulation with the power to impose some form of sanction allowed for by regulation should regulation not be adhered to.
Tiered regulation	A regulatory approach whereby regulation is tiered according to certain rules defining categories or tiers. These tiers may be based on risk.
Underwriting	The process of assessing and pricing risk. It can also refer to the carrying of risk associated with an insurance policy. The insurer who takes on the risk is therefore the underwriter of that risk.

Executive summary

In times of crisis, poor people are often the most at risk and least able to protect themselves. Calamities such as the sudden death of a family member, illness or injury, and loss of income or property can increase the vulnerability of poor people and perpetuate poverty. Insurance can mitigate the losses from such risks. However, despite the growing importance and rapid expansion of insurance services geared to low-income households (microinsurance), many poor people remain without adequate protection.

This report presents an overview of the role of policy, regulation and supervision in the development of microinsurance markets in Colombia, India, the Philippines, South Africa and Uganda. This evidence is then used to extract cross-country lessons for policymakers, regulators and supervisors looking to support the development of microinsurance in their jurisdictions.

Salient features of microinsurance markets in the sample countries

The microinsurance markets in the five sample countries share a number of key features. These are important for understanding the evolution of microinsurance markets:

Low uptake of insurance and microinsurance: Total insurance use is extremely low in the sample countries. With the exception of South Africa, insurance penetration is consistently below 5% of Gross Domestic Product (GDP). Within this, the take-up of microinsurance among adults is even more constrained: only in South Africa and Colombia do more than 10% of adults have microinsurance – and much of this provided by informal insurers.

Large proportion of the population falls into low-income categories: A large proportion of the population live on less than \$2⁵ a day. This ranges from 19% in Colombia to 96% in Uganda. The number of ultra-poor people, those living on less than \$1 a day, is also significant. The low level of income has two immediate implications. Firstly, it suggests that microinsurance is not a peripheral topic but is the appropriate insurance category for a substantial proportion of the population. Secondly, it implies a limited disposable income for insurance products and a high opportunity cost of doing so.

High levels of informality: In all of the countries except Uganda the informal sector is estimated to account for a sizable amount of the total microinsurance market, ranging from 20% of microinsurance policyholders in India to 52% in Colombia.

Large reliance on compulsory credit-based insurance: Formal microinsurance is largely comprised of compulsory credit life policies sold on the back of microcredit. Even in the countries where credit life does not make up most of the microinsurance market, it is still significant. The growth of microcredit is therefore an important driver of microinsurance growth.

Voluntary sales bundled with other products or services and/or through mutual/co-operative channels: Where there is voluntary take-up, it tends to be funeral insurance

⁵ In 1993 dollars. Adjusted for purchasing power parity.

policies (South Africa and Colombia) or policies bundled with other products and services. The overwhelming majority of voluntary products are sold via client aggregators such as co-operatives/mutual associations, microfinance institution (MFI) networks, retailer networks (in the case of South Africa) or even utility companies (in the case of Colombia).

Microinsurance definitions vary but share low-risk features: The bulk of microinsurance products offered in the sample countries share features that help to limit the risk (prudential and market conduct) of these products. This includes limited benefits, short-term contracts, simplified products typically underwritten on a group basis and the coverage of limited risk events (typically high frequency, low impact).

Various factors affect the development of the microinsurance market. These include factors relating to the demand side, supply side and regulatory environment as well as to the overall macroeconomic context and infrastructure.

Demand-side factors: understanding the insurance decision

Responses in focus groups conducted as part of each country study, as well as the salient features of the microinsurance market described above, suggest fairly consistent patterns of behaviour in the individual client's decision to buy insurance or not. Unless compelled, an individual will only buy insurance if the perceived value of the insurance product exceeds the perceived opportunity cost of purchasing it. The insurance decision can thus be analysed in terms of the various factors that determine perceived cost and perceived value.

Perceived cost is determined not only by the level of the premium, but also by what the person needs to sacrifice to buy insurance. This opportunity cost is much higher for a low-income consumer. Perceived value, in turn, is impacted by (1) the fact that low-income people place a disproportionately high value on current consumption, given their budget constraints, rather than future benefits (they have a high discount rate), (2) the level of trust in the institution to successfully deliver on claims, and (3) the probability of the risk event occurring (with high frequency and/or probability risks such as health and life likely to receive priority in the minds of consumers).

Supply-side factors: making microinsurance markets

Making a market for voluntary microinsurance where none exists needs business models that facilitate **positive market discovery**, i.e. that the consumers are introduced to the product in a way that allows them to understand its potential value and that they must be able to institute a successful claim. No discovery will take place if the client is unaware that they are covered by insurance, and the discovery will be negative if a claim is rejected for reasons that were not explained at the time of purchase. The experience in the sample countries suggests that the likelihood of positive discovery among low-income clients depends on the distribution channel or business model used to deliver microinsurance. Five distinctive (though not exhaustive) channels were identified:

1. **Compulsion:** Compulsory insurance in the form of credit insurance on the back of loans is the single biggest category of microinsurance across the sample countries.

2. **Reinvention:** In the absence of formal insurance provision, or simply because they are unable to afford it, low-income communities develop informal risk pooling mechanisms to cope with risk events, thereby effectively reinventing insurance.
3. **Derived demand:** This happens when the client does not set out to buy insurance, and may not even be aware of the existence of insurance products, but is induced to buy a product based on his or her demand for another product or service such as a funeral service.
4. **Passive aggregators:** Such models leverage existing client bases (e.g. retailers as aggregators) or reach out through low-cost passive sales strategies. Products need to be simplified to be sold through such channels.
5. **Individual agent-based outbound sales:** The traditional model where an individual agent sells insurance that is not attached to another product, typically face-to-face with the client, but it can also be done through out-bound call centres.

The country experience is that the bulk of microinsurance is sold through **channels 1, 2 and 3**. However, regulatory models often favour **channel 5**. In practice, however, such distribution may be too expensive for low-premium products, making this model unattractive for providers. Regulation may (sometimes unintentionally) also facilitate **channel 1** by allowing compulsion, but few regulators consider the consumer protection concerns arising from the captive client base and limited competition. **Channel 4** holds great potential for market development, but evidence suggests that these agents are unable to create a market for a new product – they rely on prior discovery through another channel before they can achieve success.

Impact of policy, regulation and supervision on market development

The experience of the sample countries shows that policy, regulation (including regulation not specific to insurance) and supervision impacts on microinsurance development in various ways:

General features of the policy, regulatory and supervisory framework

- Pro-active and inclusionary regulatory approaches generally are more supportive of microinsurance development than reactive and exclusionary approaches.
- Regulatory uncertainty undermines microinsurance development.
- The overall regulatory burden determines the need for a dedicated microinsurance dispensation. If the overall regulatory burden is low, the need for a dedicated microinsurance dispensation is reduced.

Financial inclusion policy and regulation

- Financial inclusion policy and regulation can push microinsurance development but long-term market growth and scale depends on the financial viability of selling the products in the given market.
- Regulators and supervisors need a clear mandate to support development.

Prudential regulation

- **Unnecessarily high regulatory barriers** undermine the entry and formalisation of potentially legitimate providers. As a strategy to compensate for limited supervisory capacity, prudential barriers are not successful as the supervisor does not have the

capacity to enforce the regulations on all potential market participants. The result may often be to fuel the informal sector.

- **Tiering and graduation** have been used in the sample countries to facilitate entry, formalisation and growth while still maintaining prudential standards.
- **Unlevel playing fields** introduce a bias against provision by potentially legitimate players. Following a risk-based approach, entities writing the same kind of risk should face a similar regulatory burden.
- **Unnecessary restrictions on institutional types** may exclude legitimate providers. Where regulators follow an exclusionary approach they may limit underwriting (and intermediation) to specific and predetermined institutional types, making it difficult for new business models with different legal identities to enter the market. This approach effectively requires the regulator to be able to 'pick winners', which it often does not have the capacity to do.
- **Sound corporate governance allows** regulators and supervisors to leverage non-traditional institutional types. Weak governance for a particular category of institution (such as co-operatives) means that a much higher regulatory effort is required to ensure compliance. However, excluding such institutional types may impede development. Where the regulator has implemented measures to improve governance structures rather than excluding such institutions, a whole new category of entities were able to support market development.
- **Demarcation shapes provider models.** Strict demarcation increases the cost of offering a product that combines life, non-life and health elements.

Product regulation

- **Weak insurance definitions result in regulatory avoidance and arbitrage.** In several of the sample countries weaknesses and gaps in insurance definitions have been exploited to avoid regulation, illustrating the need for clear definitions of insurance business.
- **Low-risk features** of microinsurance products have allowed regulators to structure regulatory definitions suited to the risk.

Impact of macro-economic conditions and infrastructure

These factors are often beyond the control of the authorities, but may still have a significant impact on microinsurance development and need to be taken into account:

- Economic growth stimulates insurance take-up by increasing available income.
- Privatisation/liberalisation may increase competition and have been associated with the development of insurance markets in the sample countries.
- High levels of inflation may undermine the insurance value proposition if not managed.
- Financial crises can destroy trust in insurance products if they destroy policyholder value or insurance providers go bust, but may subsequently lead to improved regulation and increased competition.
- Strong physical, social and commercial infrastructure aid microinsurance development.

Emerging guidelines

The following guidelines, for consideration by policymakers, regulators and supervisors looking to support the development of microinsurance in their jurisdictions, are based on the analysis of the experience of the sample countries.

Policy guidelines

Guideline 1: Take active steps to develop a microinsurance market. Most microinsurance markets develop by extending insurance to client groups not currently served by formal insurers. Low-premium products are often regarded as unprofitable by insurers. At the same time, low-income clients may have limited knowledge of insurance, may have a high internal discount rate and often exhibit an inherent distrust of formal insurers. To overcome these challenges microinsurance markets have to be triggered or made. For this reason, it is important to confer a market development mandate on regulators over and above their normal supervisory mandate. This mandate requires an understanding of both the existing and potential market, and implies that regulators will consider both formal and informal providers and formalisation challenges. It also allows space for market experimentation while monitoring risk and responding with appropriate policy statements and regulatory adjustments.

Guideline 2: Adopt a policy on microinsurance as part of the broader goal of financial inclusion. Public policy expresses the intent of government. Explicit policy objectives on microinsurance market development provide market players with the necessary security and guidance to invest with confidence in market areas where the regulatory framework may still be uncertain or in the process of development, as is often the case with microinsurance. The policy must be aligned with other government policy objectives, appropriate to the circumstances of the country and preceded by broad-ranging consultations. It should be located within government's broader approach to financial inclusion. The policy should facilitate both outreach by registered insurers and formalisation of informal insurers.

Prudential guidelines

Guideline 3: Define a microinsurance product category. Microinsurance products require small premiums to be affordable to low-income clients. Profitable microinsurance operations therefore depend on least-cost underwriting and distribution. Achieving this may necessitate a reduced compliance burden (both prudential and market conduct) in jurisdictions with a high regulatory burden. Such a reduced compliance burden can, however, only be justified on the basis of reduced risk. This requires the regulatory definition of a microinsurance product category that entails systematically lower risk. This can be achieved through limits on benefit values, policy contract duration and the risk events covered, as well as the simplification of policy terms. The income level of the prospective policyholder is not considered a viable element of a microinsurance definition as the verification of income is too expensive and often of suspect integrity.

Guideline 4: Tailor regulation to the risk character of the microinsurance product category. Once a product category has been defined to lower risk, prudential and market conduct requirements can be tailored accordingly to allow for lower-cost underwriting and distribution targeted at the low-income market (while maintaining sufficient standards to

protect clients and maintain trust). Generally, this can either be done through exemptions from certain requirements, or by creating a reduced-burden (in terms of entry and other requirements) regulatory tier for microinsurance. The option implemented must be based on a detailed assessment of the local market and regulatory environment to ensure the development of risk-proportionate rules.

Guideline 5: Allow microinsurance underwriting by multiple entities. Member-based mutual-type institutions tend to fare better than traditional insurers in offering microinsurance in countries where this is part of the social life. Existing regulation, however, often makes it too onerous for these community-based mutuals to register as formal insurers, or may even explicitly exclude them. Allowing various institutional forms to register as microinsurance providers, should they meet the same regulatory and corporate governance requirements, levels the playing field

Guideline 6: Provide a path for formalisation. Unlicensed insurance providers usually emerge in response to real needs for risk mitigation within low-income communities, and serve a valuable social and economic function. Yet they may lead to consumer abuse and may fail due to inadequate risk management. Therefore formalisation is in the public interest. However, limited supervisory resources usually make this difficult to achieve. The best way forward is to define a clear evolution path whereby informal institutions can gradually and realistically meet the minimum regulatory requirements. Throughout the formalisation process, the supervisor must be careful not to overreach its capacity or make idle threats, thereby undermining its credibility.

Market conduct guidelines

Guideline 7: Create a flexible regime for the distribution of microinsurance. Low-cost, geographically accessible distribution through trusted channels is essential for successful microinsurance development. Increasingly new technologies are being employed in this quest, as well as alternative channels such as retailers, labour unions, church groups or public utilities. Not all of these intermediaries fit comfortably into the traditional broker/agent regulatory definitions. Substantial benefit can therefore be obtained by allowing these channels to grow and intermediate microinsurance. Appropriate measures to control market conduct risk need to be in place.

Guideline 8: Facilitate the active selling of microinsurance. Experience shows that voluntary microinsurance uptake is highest when it is actively sold, particularly with another product or service, such as loans or credit goods, future funeral services, mobile phones or other financial services such as banking services. One-on-one sales are, however, expensive and can easily push already thin-margin, low-premium microinsurance products into unprofitability. The imperative is therefore to avoid market conduct regulation that can make the individual sales process too costly. This is best done by standardising microinsurance products, simplifying terms and conditions, ensuring adequate disclosure, and by avoiding price controls on the intermediation process.

Supervision and enforcement

Guideline 9: Monitor market developments and respond with appropriate regulatory adjustments. While effective enforcement of regulation is needed, the microinsurance

market at the same time needs the space for innovation. The supervisor's task is therefore a balancing act: to regulate and enforce in such a way as not to make conditions overly onerous on market players, while at the same time responding to abuse through careful market monitoring. For this purpose, it is important that minimum levels of information must be submitted to the supervisor. The reality of limited capacity may also mean that some areas of the market may remain completely unregulated. Directing capacity to high-risk areas while monitoring unregulated areas for changes in risk profile may, therefore, be the only option available within resource constraints.

Guideline 10: Use market capacity to support supervision in low-risk areas. In an environment of constrained supervisory capacity, supervisory approaches that draw on the capacity of market participants and other entities may enhance supervision. This may take several forms and should be designed around the specific conditions and entities in the market. For example, the supervision of certain market players (such as primary co-operatives) may be delegated to entities such as secondary/umbrella co-operatives providing services to primary co-operatives. The supervision of tied agents may also be delegated to insurers to ensure that agents are appropriately trained and behave in an appropriate manner.

1. Introduction

In times of crisis, poor people are often the most at risk and the least able to protect themselves. Calamities such as the sudden death of a family member, illness or injury, and loss of income or property can increase the vulnerability of poor people and perpetuate poverty. Financial markets – and insurance services in particular – can mitigate the losses resulting from such risks. These services, however, are out of reach for millions of poor people and disadvantaged groups. Despite the growing importance and rapid expansion of microinsurance (i.e. insurance services geared to low-income households⁶), most poor people are still without adequate protection.

This report presents an overview of the findings of a five-country case study on the role of regulation in the development of microinsurance markets. The objectives of this project are to map the experience in a sample of five developing countries, Colombia, India, the Philippines, South Africa and Uganda, where microinsurance products have evolved and to consider the influence of policy, regulation and supervision on the development of these markets. From this evidence, cross-country lessons are extracted that offer guidance to policymakers, regulators and supervisors who are looking to support the development of microinsurance in their jurisdictions. It must be emphasised that these findings do not provide an easy recipe for developing microinsurance but only identify some of the key issues. In fact, the findings emphasise the need for a comprehensive approach informed by, and tailored to, domestic conditions and adjusted continuously as the environment evolves.

The project is majority funded by the Canadian International Development Research Centre (www.idrc.ca) and the Bill & Melinda Gates Foundation (www.gatesfoundation.org) along with funding and technical support from the South Africa-based FinMark Trust (www.finmarktrust.org.za)⁷ and the German GTZ⁸ (www.gtz.de) and BMZ⁹ (www.bmz.de/en/). FinMark Trust was contracted to design and manage the project. Together with representatives of the IAIS, the Microinsurance Centre and the International Co-operative and Mutual Insurance Federation (ICMIF) the funders are represented on an advisory committee overseeing the study.

This document is organised in five sections: Section 2 sets out the analytical framework applied in the rest of the study, Section 3 summarises the microinsurance experience of the five countries. Section 4 looks at the drivers of microinsurance market development in the countries, Section 5 proposes an approach to carving out a microinsurance space within regulation, and Section 6 concludes with the emerging guidelines arising from the cross-country lessons. The emerging guidelines are intended as informative implementation tools for developing country policymakers, regulators and supervisors.

⁶ See Section 2.4 for a more detailed definition.

⁷ Funded by the UK DFID.

⁸ Deutsche Gesellschaft für Technische Zusammenarbeit GmbH.

⁹ Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung - Federal Ministry of Economic Cooperation and Development

2. Analytical framework

This study applies a number of lenses to the evolution of microinsurance markets in the five countries. These lenses, collectively referred to as the analytical framework, in turn inform the synthesis of drivers and cross-cutting findings. We start with a description of the analytical framework.

2.1. Financial inclusion framework

The five country studies explored the drivers of financial inclusion within the insurance market, in particular considering the impact of regulation. Ultimately, more inclusive financial systems are the desired outcome of the emerging guidelines proposed in this report.

Financial inclusion is achieved when consumers across the income spectrum in a country can access and sustainably use financial services that are affordable and appropriate to their needs. The overall level of inclusion achieved is determined by a variety of factors affecting the individual directly (demand-side factors) as well as the institutions providing the services (supply-side factors). Figure 1 indicates this schematically.

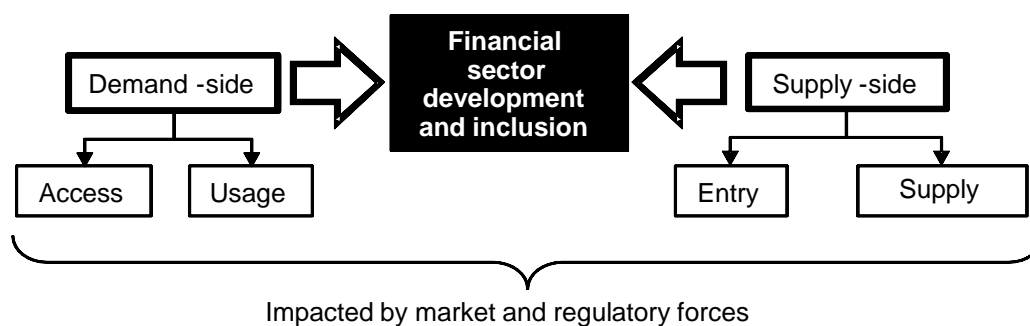


Figure 1: Financial inclusion framework

Source: Da Silva & Chamberlain, 2008

These factors may explicitly exclude people from using a particular service (referred to as access barriers) or may discourage users from using a particular service even if they are not explicitly excluded (referred to as usage barriers). Similarly, impacts may completely exclude or may discourage financial service providers from providing a particular financial service to the lower-income market – termed entry and supply barriers respectively. These concepts are briefly explained below.

- Access barriers consider the factors that make it impossible for an individual to use a particular financial service. The FinMark access methodology¹⁰ identifies five factors that impact on access: physical proximity, affordability, eligibility, appropriate product features/terms and regulation.

¹⁰ For more information see the discussion contained in Chamberlain (2005).

- Usage focuses on factors that may discourage individuals to take up formal financial services even if they do not present an absolute barrier. Usage decisions involve the exercise of judgment by individuals on the value of the product and its ability to meet their needs based on their experience and knowledge. This judgment is exercised within a complex set of considerations, constraints and priorities. Usage drivers may include: the value proposition of the formal product (e.g. the perception of “throwing money in the water” by paying insurance premiums when you do not necessarily claim); relative cost (e.g. compared to informal alternatives); the “hassle factor” (e.g. of filling out forms); and perceptions of formal products and institutions (e.g. the fear of “officialdom” and the belief that financial institutions are for the rich).
- Entry factors include market and regulatory forces that may prevent particular players from operating in the low-income market, or may make it difficult for informal providers to become formal sector players. This may include regulations restricting the type of legal entity that may for example provide insurance.
- Similar to the demand-side, supply factors do not explicitly prohibit institutions to enter into the low-income market but may discourage them from doing so. These may for example include proportionately increased regulatory costs on low-value transactions that undermine their already marginal profitability. While not necessarily making it impossible to serve the low-income market, it makes operating in this market unattractive.

The state of financial inclusion in a country is a composite of these four factors. The question this project seeks to answer is how regulation, propagated through the various drivers of access, usage, entry and supply, affects the overall level of financial inclusion in the insurance sector.

2.2. Access frontier

The access frontier (Porteous, 2005) seeks to map the current and potential market for financial products and providers. It also seeks to identify those segments of the market which will remain beyond the reach of the market and therefore fall within the scope of government social welfare. Four segments are identified (see Figure 2): the current market; the market enablement zone; the market development zone; and the market redistributive zone.

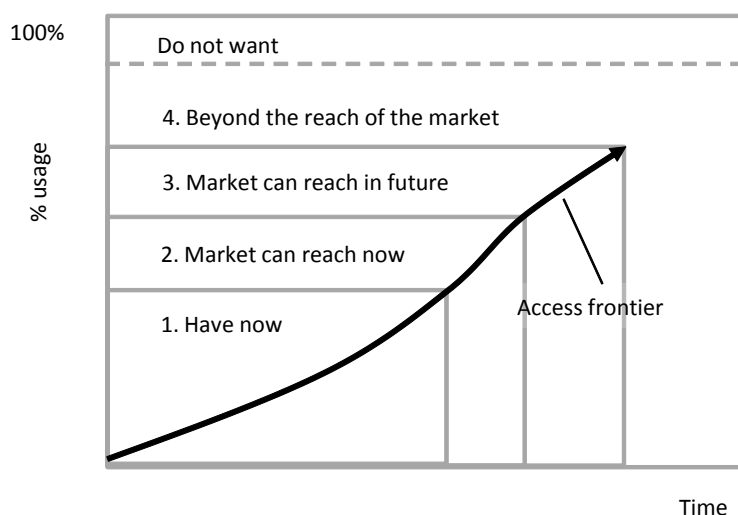


Figure 2: Access frontier map

Source: Porteous, 2005.

The various blocks in the diagram can be explained as follows:

- **“Have now”**: The current market is defined people who are currently using the product, i.e. a measure of usage or effective access.
- **“Market can reach now”**: The market enablement zone comprises all the people who have access to the product but are not using it. As there are no explicit access barriers, this group is the most susceptible to improving the levels of inclusion for financial products. They could be incorporated into the market by addressing usage factors, without any regulatory changes needed.
- **“Market can reach in future”**: The market development zone includes all the people who do not currently have access to the product because of reasons such as proximity, affordability, eligibility, terms of the product or knowledge of the product. Regulatory changes, as well as product and distribution innovation, can be used to extend the reach of the market to this segment.
- **“Beyond the reach of the market”**: The market redistribution zone is made up of all the people who are outside the scope of the market because they are simply too poor. These people cannot sustainably be reached by the market without support from government and may remain dependent on social security.

Implications of the access frontier: The access frontier is represented by the diagonal line on the diagram and represents the frontier beyond which market provision can sustainably reach. A proportion of the market is left, with people in this group dependent on social security and other government support. The diagram also shows the natural progression of market provision from block one, to block two and eventually to block three. The logical process of market extension is therefore to move along the access frontier rather than to jump over the next most profitable market segment to the very poor. This raises a number of key policy questions, including: Where exactly is the access frontier? What happens if the regulatory definition of microinsurance limits provision to those that fall beyond the current access frontier? Should the government seek to push providers along the frontier or must

they be forced to jump the gap into the market of the truly poor as defined and targeted by the government? Does regulation unintentionally inhibit or delay the progression of players towards the access frontier (e.g. by limiting entry and competition)? Given that it may take a long time for the market to serve all those within its reach, what should government's role be towards the unserved in the interim period? These questions are at the core of this analysis and are considered in the rest of this document.

2.3. Goal of microinsurance

The country studies in this report focus on the role the insurance market can play in reducing the vulnerability of poor people. Why is it important to develop microinsurance markets? The ultimate goal of microinsurance is to enable the poor to mitigate their material risks through the insurance market in order to reduce vulnerability, thereby increasing their welfare. To be successful, microinsurance should mitigate the most material risks of a poor client in a way that is affordable and appropriate to the low-income market.

In the process of mitigating their risk, microinsurance may also stimulate the provision of other services that are important to the poor, for example, credit services, funeral services or health services. This is achieved by more predictable income flows to providers, which in turn ensure viability of the provision of such services to the low-income market. Microinsurance enhances the welfare of the poor by addressing material risks as well as supporting the delivery of critical services.

It must be noted that the availability, or even take-up, of insurance products is not sufficient to achieve the goal of reduced vulnerability and improved welfare. To deliver value, low-income insurance products should also be affordable and appropriate to the needs of the poor. This requires sufficient awareness of the availability and value of insurance among the poor as well as the ability to claim on policies. Providers and intermediaries should also treat consumers fairly. If it is difficult or impossible for a low-income client to make a legitimate claim on their insurance policy it will not reduce vulnerability and renders the product of little value.

The country evidence shows that microinsurance take-up is often not the result of voluntary strategies by the poor to mitigate their material risks. Rather, it is the outcome of compulsion by credit providers seeking to cover their own exposure to default. In this case, microinsurance may still deliver significant value to the client but care is needed to ensure fair treatment of the low-income consumer.

2.4. Definition of microinsurance

Conceptual definition: Microinsurance is defined by the IAIS (2007b) as “insurance that is accessed by [or accessible to¹¹] the low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which should include the Insurance Core Principles). Importantly, this means that the risk insured under a microinsurance policy is managed based on insurance principles and funded by premiums”. It therefore excludes social welfare as well as emergency assistance by governments, “as this

¹¹ Authors' own insertion.

is not funded by premiums relating to the risk, and benefits are not paid out of a pool of funds that is managed based on insurance and risk principles”.

This definition encompasses three concepts that require further explanation in the context of this study: “insurance, “accessible to/accessed by”, the “low-income population”.

- **Insurance:** Generally, insurance denotes a contract whereby an insurer, in return for a premium, undertakes to provide policy benefits. It is distinguished from, for example, social welfare in that it is funded by premiums relating to the risk, and in that benefits are paid out of a pool of funds that is managed on insurance and risk principles (IAIS, 2007). Benefits may include one or more sums of money, services or other benefits, including an annuity. Microinsurance forms part of the broader insurance market, distinguished by its particular low-income market segment focus. This market often needs distinctive methods of distribution and distinctly structured products.
- **Accessible to:** Microinsurance products need to be accessible and appropriate to the low-income population, i.e. that the low-income population be in a position to sustainably use such products (including claiming).
- **The low-income population:** This study does not propose a specific income cut-off for the microinsurance target market. The target market should be defined within the local country context. Microinsurance is not strictly limited to those living under the national poverty line or the comparative measures (e.g. \$1 or \$2 adjusted for purchasing power parity). Many of these households may actually be beyond the reach (e.g. affordability) of an insurance mechanism and will remain the dependent on the social security system. Furthermore, low-income levels generally mean that even the middle-income class (not classified as poor under the national poverty line) in a particular country will have relatively low income levels and, therefore, require low-premium products.

Operational definition: Definitions based on the income levels of the purchaser, or the client, are difficult and costly to implement in practice. As result, the practical definitions applied by the market or regulator mostly define microinsurance policies by setting benefit or premium limits, thereby ensuring that it is mostly (but not exclusively) targeted at the poor. Other functional criteria used to define microinsurance (virtually always in combination with a benefit cap) include the following:

- Product categories that particularly reflect the needs of the poor (e.g. funeral insurance, or insurance for motorcycles or cellphones, which are important to the low-income market for business purposes)
- Distribution channels, especially channels accessible to the poor;
- Simplicity of terms, conditions and processes; and
- Contract characteristics, for example limiting exclusions that may be difficult for clients to understand or allowing clients to catch up on occasionally missed premiums without lapsing the policy

More details on the definitions applied in the sample countries are in Section 3.

2.5. The insurance value chain

Delivering an insurance product to a client comprises a number of activities collectively referred to as the insurance value chain. Unlike the transaction banking value chain, where

the activities are often performed by the same legal entity, the various activities comprising the insurance value chain are typically performed by more than one legal entity. The risks attached to the various activities differ and they are regulated by different regulators and supervisors or not at all. A picture of the generalised structure of the insurance value chain is provided in Figure 3.

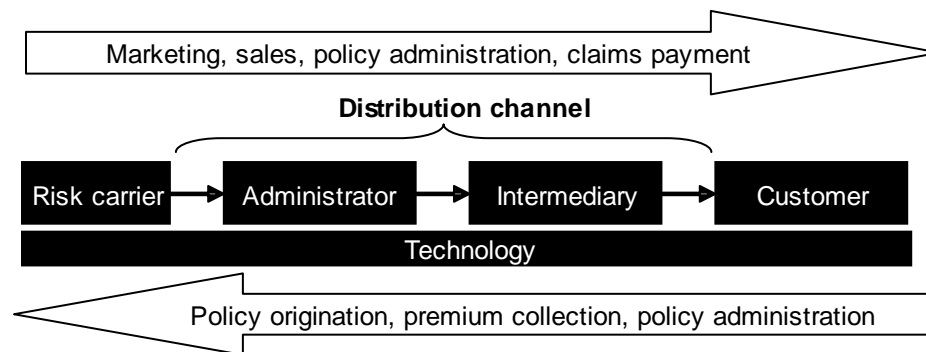


Figure 3: Insurance value chain

Source: Chamberlain, Bester et al, 2006, quoting Leach, FinMark 2005.

The functions of the various components of the insurance value chain are:

- **Underwriting:** This is the responsibility the risk carrier, defined as the entity that in the final instance is liable for the insurance risk. In the formal financial sector, the risk carrier is usually a registered insurer (that may obtain re-insurance) or another entity (such as a co-operative) authorised to provide insurance.
- **Administration:** Administration may be done at the level of risk carrier or intermediary, or may even be outsourced to a specialised entity that often does not fall under the jurisdiction of the insurance supervisor. Administrative costs contribute a substantial proportion to overall insurance costs and innovation on this aspect is, therefore, of particular interest for microinsurance.
- **Intermediation:** Intermediation deals with all aspects of client contact and related activities (e.g. product origination) and may take a variety of forms including an insurer's direct sales division, captive or independent agents, retailers, banks and non-bank financial service providers, Non-governmental organisations (NGOs) MFIs, credit co-operatives, etc. Different types of intermediaries may be more or less suited to distribute microinsurance and may also be affected differently by regulation.
- **Technology:** Technology plays a role across the value chain and may include a variety of technologies ranging from sophisticated electronic solutions such as mobile phones to social technologies such as premium collection through self-help groups. The appropriate use of technology may facilitate better risk management as well as lower the costs for microinsurance.

Understanding microinsurance in a particular market therefore entails focusing on more than just insurers and products. Particular attention has been paid to the intermediation of insurance in the markets reviewed to better understand the regulatory ramifications on each part of the value chain. This is especially true for emerging technologies and innovations (for example mobile phone payments and distribution through retailers).

2.6. The distinction between formal and informal

Throughout this document, reference is made to informal and formal (or regulated and unregulated) markets, products, providers or distribution channels. Key issues to consider include the reasons for informality and what the appropriate policy and regulatory response should be. It is therefore important to clarify what is implied by informality:

Formal: Formal financial products and services are defined as products or services provided by financial service providers¹² that are registered with a public authority to provide such services¹³.

Informal: Informal financial services refer to everything that is not formal as defined above and includes a wide range of providers. At its simplest this includes completely informal societies that are often of a community and mutual nature. In some cases informal markets may also include formal legal entities (e.g. funeral parlours) providing insurance without being regulated for the purposes of doing so. Informal insurance is not necessarily illegal. Specific providers or products may be exempted from insurance regulation or may simply be operating in the absence of regulation. When a particular section of the formal market is regulated in theory but not supervised in practice, it may actually present similar risk and challenges to the informal sector.

The informal financial sector can play a crucial role in financial sector development. The existence of large informal markets is a key indication of demand for insurance products not met by the formal market as well as potential barriers to formalisation and market development. Informal institutions often fill the vacuum created in the process of formalisation by acting as distribution mechanisms or by providing the service themselves. The scale and number of informal insurance providers provides a reality check on the challenges for supervisors and regulation that attempts to formalise these markets. In many cases, the supervision of this sector may simply fall beyond the logistical or resource capacity of the supervisor.

From an inclusion perspective, the objective is to facilitate the development of the formal sector and encourage formalisation while at the same time preserving the critical services the informal sector is providing.

2.7. Categories of risk

The definition and analysis of risk and its various drivers is central to the analysis and proposals in this document. In this section we note the definitions and concepts that are applied in the discussion of risk.

The Insurance Core Principles (ICPs – IAIS, 2003) hold that “the supervisory authority requires insurers to recognise the range of risks that they face and to assess and manage them effectively” (ICP 18) and to “evaluate and manage the risks that they underwrite, in particular through reinsurance, and to have the tools to establish an adequate level of premiums” (ICP 19). ICP 18 states that the insurance supervisor plays a critical role by

¹² In turn defined broadly as any provider of financial services – in this instance insurance.

¹³ This is the definition generally applied by the World Bank.

reviewing the insurer's risk management controls and monitoring systems, and by developing prudential requirements to contain these risks. In the final instance, it is the responsibility of the board (via good corporate governance practices) to ensure that risk is adequately managed.

The risk of insurance business stems from a variety of reasons. To simplify the discussion in this document we distinguish three (interdependent) categories of risks: prudential risk, market conduct risk¹⁴ and supervisory risk:

- **Prudential risk** refers to the risk that the insurer is unable to meet its obligations under an insurance contract. Insurance provides benefits on a defined risk event in return for premiums that are paid in advance. A contractual commitment to provide benefits creates the risk that the insurer's liabilities in respect of expected future claims at some point in time may exceed the assets they have available to meet those claims. This is driven by a number of more specific risks categorised by the International Actuarial Association (IAA) as underwriting risk, credit risk, market risk, operational risk and liquidity risk (IAA, 2004). Prudential risk is in the first instance determined by the nature of the insurance products in an insurance portfolio (underwriting risk determined by the likelihood and size of exposure) and secondly by how the insurer is managing and providing for its obligations under these policies. Key insurance product features that affect risk are: the nature of the risk event covered and its expected frequency and impact; the duration of the product contract; the benefit value; and the complexity of the product. The product-driven nature of underwriting risk is a key feature of risk that we return to later in this document.
- **Market conduct risk**¹⁵ refers to the risk that the client is not treated fairly and/or the does not receive a payout on a valid claim. Effectively, this is the risk that clients are sold products they do not understand, are not appropriate to their needs, and/or will not be able to claim on. This risk is driven by various factors including: *the nature of the product* (product complexity, level of cover provided), *the nature of the intermediation process* (compulsory/voluntary nature of the purchase, standalone/embedded nature of the product, the level of disclosure or advice, nature of the claims process) and *the nature of the client* (level of sophistication and financial literacy). In some insurance literature, market conduct risk may also refer to the risk arising from the insufficient disclosure of financial information by the insurer to investors and supervisors. This is not included in the definition of market conduct applied in this document.
- **Supervisory risk** refers to the risk that the supervisor is unable to sufficiently supervise (due to limited capacity) specific components of the market. The result of this is that an insurer or insurance product with low technical/underwriting risk may actually turn out to have a high risk to the system because it is not appropriately supervised.

¹⁴ These categories as are in line with the solvency methodologies as outlined in IAA (2004) and IAIS (2007a).

¹⁵ Market conduct concerns may impact on prudential risk in that the reputational damage may, e.g., lead to an insurer becoming insolvent but it is still quite distinct from it.

2.8. Policy, regulation and supervision

2.8.1. Regulatory vs non-regulatory drivers of market development

This report is about the impact of regulation on the development of microinsurance markets. Many insurance markets initially developed in an unregulated environment. The first pitfall to guard against is therefore to think that markets develop as a result of regulation. Largely they do not. The insurance sector is affected by external factors in the financial sector and by the economic and country context more broadly, such as the macro-economic environment, the political economy, the general and financial sector infrastructure, and the demographic profile of the country (gender, age, income levels and the distribution of income). For example, a country undergoing financial liberalisation or recovering from a financial sector crisis or recession will face different policy challenges with its insurance regulatory framework than other countries. Likewise, a country where the majority of the population is poor, or where the financial sector and other infrastructure are poorly developed, will face different circumstances and goals than other countries.

The first challenge is to distinguish between the regulatory and non-regulatory drivers of market development. Whereas this distinction is quite clear in certain cases, causality is often a matter of degree and even opinion. The approach in this study is to identify the non-regulatory drivers of market development at a high level to provide the general context for tracing the impact of regulation. As far as possible we identify all the potential impacts of regulation, even though in many cases regulatory drivers may have been overridden by other market factors.

2.8.2. Purpose of insurance regulation

It is important to note that regulation is not an end-goal in itself, but is the means to ensure the existence and development of a well-functioning market. A well-functioning market includes serving the broadest possible client base, including the poor. In seeking to achieve the goal of a well-functioning market, policymakers, regulators and supervisors pursue a number of more specific objectives including:

- **Stability of the sector:** This objective is sought by ensuring the soundness of operators and may resonate in capital requirements, corporate governance requirements, fit and proper requirements and other aspects of the regulatory framework. Among the regulatory objectives, this is often the one that has been pursued for the longest time.
- **Consumer protection:** While this is also an implicit goal in the stability objective, this objective most often resonates in market conduct/intermediation regulation (both in terms of the intermediation channels permitted, the due process to be followed, the commissions that can be charged and the requirements placed on intermediaries).
- **Improving market efficiency:** This may entail preventing anti-competitive behaviour and overcoming information asymmetries. In its application, such regulation may overlap with both stability and market conduct regulation.
- **Market development** (or financial inclusion more specifically) is sometimes included as an explicit policy or regulatory/supervisory objective – for example in India, where the supervisor, the Insurance Regulatory and Development Authority (IRDA), is also explicitly tasked with a development mandate.

- **Other strategic objectives:** This can, for example, include the prevention and control of financial crime as required by international standards imposed by the Financial Action Task Force or the economic empowerment of previously disadvantaged citizens as in South Africa.

Given the ultimate goal, none of these individual objectives should be pursued at the cost of a well-functioning market. Some objectives may also conflict. For example: when an authority has the explicit mandate to develop the market, this may require the relaxation of regulations imposed for stability purposes. Therefore the market development objective may clash with the way the stability objective was pursued. Various objectives, however, often mutually enhance each another.

2.8.3. Public policy instruments

To achieve its stated objective, a government uses three categories of public policy instruments to influence markets:

- **Policy:** The term “policy” denotes the declared intention of a government on how it wishes to order the financial sector and the objectives that it wishes to achieve. The trade-offs between various government objectives (for example consumer protection and financial inclusion) is therefore managed within the policy domain. Such policy can be contained in a specific policy document (i.e. can comprise a dedicated policy framework), but can also be the stated intention of government, more broadly/generally contained in speeches, in the preamble to legislation and in other documents (i.e. the general policy stance). Policy may sometimes be sufficient, in itself, to achieve government objectives without regulation following from the policy. This may be the case particularly when government wants the market to achieve the stated goals. In most instances, however, policy is the canvas against which regulation is then developed.
- **Regulation:** Technically speaking, the statutes of a country are termed legislation. They are passed by the national legislative authority (be it parliament or congress). Legislation represents a relatively rigid public policy tool that is normally difficult and time consuming to pass and difficult to amend. In addition to legislation, subordinate legislation may be issued by the executive authority or regulator. Such instruments are more flexible, yet still have the force of law. In the event of conflicts, legislation will take precedence. In some jurisdictions, subordinate legislation is referred to as regulations. When referring to regulation, this document bestows a broader meaning on the term than subordinate legislation, namely: the various legal instruments with binding legal powers (legislation as well as subordinate legislation) that together comprise the regulatory body or regulatory framework pertaining to insurance. Regulation furthermore includes the action of regulating the insurance industry to achieve the policy goals. This in turn includes the development of regulatory requirements. The regulator may issue guidance in relation to regulation. Such guidance can be in the form of memoranda or circulars. It does not have the force of law, but can be converted into legally binding regulations if required.
- **Supervision:** Supervision describes the functions whereby the state seeks to ensure compliance with regulation. The supervisor’s role can be defined as the oversight and

compliance, on behalf of the state, of the implementation of regulation by private entities, with the power to impose the penalties allowed for if not adhered to.

Generally, the policymaker will be the national government or the ministry with jurisdiction over the insurance industry; the regulator will be the ministry issuing the legislation pertaining to insurance or a statutory body issuing subsidiary rules; and the supervisor will be a statutory body for implementing such regulation, e.g. an insurance commission or financial services board, superintendence or authority more broadly. In many jurisdictions the supervisor, as defined here, can therefore simultaneously be the regulator.

2.8.4. Insurance regulatory scheme

Different categories of regulation are used to influence the behaviour of participants in the insurance value chain. These are collectively referred to as the insurance regulatory scheme, which is captured in Figure 4. The report uses this scheme to analyse the impact of policy and regulation on the development of microinsurance markets in the sample countries.

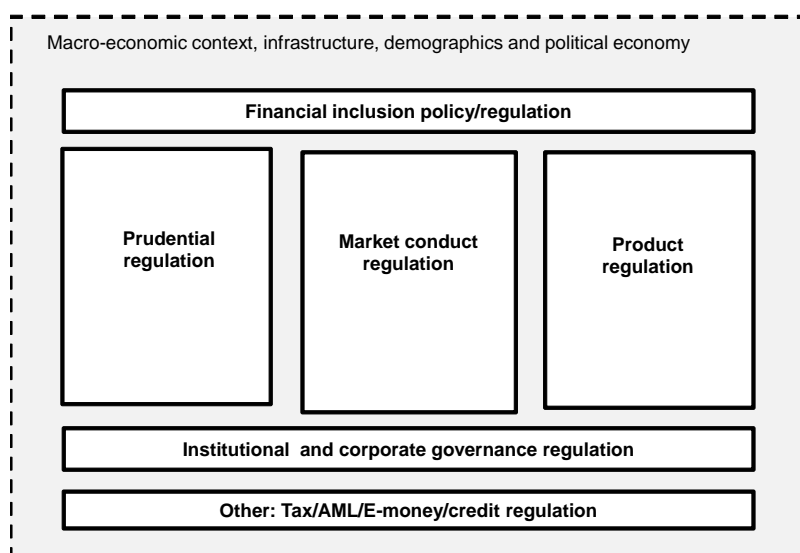


Figure 4: The insurance regulatory scheme

Source: Authors

Financial inclusion policy/regulation refers to policy or regulation promulgated with the objective of extending access to, and usage of, formal financial services by people who are either excluded from or who do not use formal financial services (provided by registered/licensed and supervised financial institutions). Such regulation takes various forms, for example compulsory or consensual quotas targeting defined population segments, financial literacy provisions, tax incentives, extending the reach of the formal payment system, etc. Sometimes a government may choose not to regulate financial inclusion, but simply to adopt financial inclusion policies with the explicit aim that financial institutions would pursue inclusion on a voluntary basis. Although these do not have the force of law, they directly influence the conduct of providers.

Prudential regulation seeks to ensure that insurers are able to meet their contractual obligations to their clients. This is done by, for example, setting minimum entry requirements such as minimum levels of capital and requiring compliance with a set of prudential regulations governing the functioning of the insurer.

Market conduct regulation refers to the regulation of the distribution, or intermediation, of insurance products. Regulation of this kind could include requirements as to who can intermediate insurance, fit and proper requirements for agents and brokers and other intermediaries, regulation of the selling process, including disclosure requirements and giving of advice, regulation of the payment of commission, statutory requirements that make the take-up of certain types of insurance compulsory (for example credit life insurance may be declared compulsory when taking out a non-collateralised loan), etc.

Product regulation can be distinguished from prudential and market conduct regulation in that it does not relate to the insurer or the sales/intermediation process, but to the product. While provisions relating to product regulation are usually contained within either prudential, institutional or market conduct legislation, there is a distinct regulatory angle. Product regulation aims to ensure stability and consumer protection by regulating the nature and structure of insurance products. In the most basic form, regulatory systems are often structured around definitions of specific products or product categories.

Box 1. Aspects of product regulation.

Product regulation may involve one or more of the following:

- **Registration/ approval:** In some jurisdictions, regulation stipulates that products need to be filed with the regulator/supervisor, with a window period for response by the supervisor, before the product is launched. If no objection is made by the supervisor within the stipulated timeframe, the product is automatically approved. In other instances, explicit approval is required by the regulator before offering products. This may be used as a way of compensating for an otherwise light regulatory burden and to allow innovation.
- **Standards:** Regulation may require microinsurance to meet specific standards on simplification, standardisation, documentation, cool-off periods, term, exclusions, etc. In some instances, requirements relating to terms and provisions may be quite onerous; in others it may facilitate innovation.
- **Price control:** Regulation may set specific minimum or maximum prices for product categories. Premium floors are mostly aimed at trying to ensure solvency of the insurer by avoiding price competition, whereas premium ceilings are mostly motivated by consumer protection considerations (though in practice they often serve to protect insurers against intermediaries with bargaining power, rather than protecting the consumer).
- **Demarcation:** Regulation may also prohibit particular players from providing products (e.g. non-corporates) or may determine that certain types of products may be provided by only certain types of providers (demarcation). Creating a product-based approach to microinsurance where a regulatory space is created for those who can comply with product standards is therefore a further instance of product

regulation. The intention is to limit the risk, thereby justifying different market conduct and prudential standards.

- **Compulsory products:** Lastly, regulation may compel insurers to offer specific products.

Institutional regulation, which includes corporate governance regulation, refers to those statutory requirements that determine the legal forms or persons, for example public companies and co-operatives that can underwrite insurance, as well as the regulatory corporate governance requirements applicable to these legal forms. The nature and extent of the corporate governance requirements normally determine whether that particular legal institution is suitable to manage the risks inherent in underwriting insurance. The institutional and corporate governance regulation is generally not specific to the insurance sector but generic across sectors. However, some countries have a tradition of passing specific statutes for individual insurance firms, especially mutuals.

Other regulation: A number of other regulatory requirements could also affect the development of the microinsurance market. Although not insurance-specific, they affect the underwriting and intermediation of insurance products. Examples include anti-money laundering provisions, taxation, regulation of the payment system (that impacts the ease whereby premiums can be paid), regulation of the microfinance sector and credit regulation generally.

It is not only regulation that affects market developments. The absence of regulation can play an equally powerful role. Similarly, even if regulation exists, a supervisory approach of “benign neglect” or “forbearance” can allow the market to develop in ways that cannot be foreseen ex ante by a regulator.

2.9. Methodological approach

In each country study, the following research process was followed:

- **Understanding the microinsurance market.** Each country study describes the microinsurance market in terms of: (i) the various players (corporate and mutual/co-operative, formal and informal) active in the low-income market; (ii) the products available and any low-income market product innovations; (iii) usage among the low-income population of formal and informal insurance products; as well as (iii) distribution channels employed in the low-income market and any distribution innovations. These findings are used to make conclusions about the key characteristics of the microinsurance market. Focus group research was used to identify the need for and understanding of insurance among the target market. This included an investigation into the risk experience, provider, product and channel preferences of the focus group participants, as well their trust in the insurance market in general.
- **Understanding the insurance regulatory framework.** Each study gives an overview of the insurance regulatory framework, in general and as pertaining to microinsurance.
- **Drivers of microinsurance.** In light of the above, each study seeks to draw out respectively the non-regulatory (market, macroeconomic and political economy context-related) and regulatory drivers of the state of microinsurance. In this report, cross-

cutting drivers of market development are developed. In capturing the cross-country findings, we also develop a model of the way that microinsurance markets develop.

- **Emerging guidelines.** The drivers are used as the basis for determining lessons for the regulation of microinsurance as supported by the country experience. These are then used as a basis to formulate potential guidelines. The aim is to identify common themes across the countries and distil guidelines for policymakers, regulators and supervisors that facilitate microinsurance market development while also protecting consumers.

The methodology for each country consists of desktop research as well as consultations with industry roleplayers, regulators, supervisors and other stakeholders. The methodologies applied involved:

- Traditional demand and supply mapping;
- Qualitative focus group research;
- Insights from behavioural economics that, together with focus group findings, allow for a hypothesis on how insurance usage is triggered and insurance markets are developed;
- Regulatory and policy analysis; and
- Controlling for context and the distinctive evolution of the broader insurance market in each country in deriving conclusions.

2.10. Project scope

The scope of the study covers all life and non-life insurance products targeted at the low-income market, including savings products provided by insurers (endowments) where it includes an element of guarantee. Pure savings products and retirement savings products are excluded from the scope of the study, as is government social welfare and social security provision.

While capital health insurance products are considered, indemnity health insurance is excluded from the scope of the study. Indemnity health insurance is an extremely important product for the low-income market but needs a dedicated study as it often is regulated and supervised differently to other insurance business and is a complex field, intricately linked to health service provision.

The study covers all categories of providers and intermediaries including informal markets.

The next section provides an overview of the context and main findings arising from each of the countries reviewed providing the basis for the cross-cutting findings in Section 4.

3. Country context

This section provides a brief overview of the country context and microinsurance market composition for each of the sample countries¹⁶.

3.1. Colombia

Over the past two decades, Colombia has experienced financial liberalisation and growth, but also a major financial sector crisis. Against this backdrop, there has been significant microinsurance development, traditionally through large co-operative insurers, and more recently also on the back of microfinance development. This is all the more remarkable as there is no microinsurance regulation and only indicative financial inclusion policies. Colombia illustrates that microinsurance can develop where external circumstances are favourable and where the policymaker and regulator have a fairly open stance, even without a dedicated microinsurance regime. Yet uniform prudential requirements mean that it remains difficult to provide microinsurance “from the bottom up”.

3.1.1. Context

Despite the informal economy employing almost 60% of the workforce and contributing at least half of GDP, Colombia compares favourably to the other sample countries for literacy, urbanisation and poverty levels:

	Colombia	India	Philippines	South Africa	Uganda
Population	46m	1.1bn	89m	47m	29m
Urbanisation	57%	29%	63%	59%	13%
Literacy (% of adults)	93%	61%	93%	82%	67%
Population <\$1/day	8%	40% rural; 20% urban	14%	23%	82%
Population <\$2/day	19%	88% rural; 61% urban	44%	36%	96%

Table 1: Cross-country comparison: population and poverty statistics¹⁷.

Source: World Population Datasheet, 2007; World Bank World Development Indicators, 2007; country studies

In the early 1990s, the Colombian government embarked on a comprehensive economic liberalisation process that included trade and financial liberalisation measures, the independence of the central bank and the end to its monopoly on foreign exchange

¹⁶ Note that all information and market data quoted in the country overviews stem from the respective unpublished country reports and reflect the latest data available at the time of research (late 2007), subject to availability. Dollar conversions were made from www.oanda.com and reflect the respective exchange rates on 11 March 2008.

¹⁷ For a full cross-country summary, see Appendix 1.

transactions, as well as various fiscal and public sector reforms. This laid the foundation for an average growth rate of almost 6% between 1991 and 1995. With the reforms, however, also came an imbalance on the current account and a fiscal deficit – factors that made Colombia vulnerable to the spillover effects of the Asian financial crisis at the end of the 1990s. The subsequent financial sector crisis saw the banking sector lose 40% of its equity and GDP contract by 4.2% in 1999. In the insurance sector, the impact was less severe and no insurers failed during the crisis. Post-crisis, government strengthened financial sector regulation and in 2006 a new financial regulatory agency, the Financial Superintendence, was formed by merging the agencies in charge of supervising financial institutions and securities.

Insurance premiums per capita are relatively low compared to other Latin American countries. Penetration of life insurance is surprisingly low and accounts for only 11% of total premiums. It is suggested that this low figure is partly because traditionally high-income individuals tended to obtain insurance abroad (even though it is in contravention of the Colombian insurance law¹⁸). The share of life insurance is, however, increasing (premium growth amounted to almost 24% in 2006), driven largely by improved macroeconomic performance and hence lower inflation rates since the turn of the century. In addition, credit life insurance has shown significant growth recently. This is the result of the quest for micro-credit expansion by formal financial service providers, a movement catalysed by financial liberalisation. This increased competition and led to a reduction of margins in traditional segments of the market, thereby prompting commercial banks to enter lower-income markets in search of new clients. It was also further spurred by government's financial inclusion policy, called Opportunity Banking, which was implemented in 2006. Therefore, despite the fact that usage of formal financial services is estimated to be as low as 34% of the population¹⁹, the Colombian financial sector has recently experienced a distinct move downmarket.

3.1.2. Salient features of the microinsurance market

Usage: An estimated 19% of Colombian adults are microinsurance clients. There are about 2.74-million²⁰ formal microinsurance policies (9% of the adult population). Informal microinsurance, most notably funeral insurance provided by so-called funeral entities, is also important. Industry sources estimate the informal market reach up to three-million clients (10% of adults), making it slightly bigger than the formal market (at 52% of the total microinsurance market).

¹⁸ The insurance law, the Fundamental Law of the Financial System (FLFS), requires foreign companies to set up a local subsidiary in order to sell policies locally. This phenomenon, the result of a high inflationary environment, was most prevalent in the 1970s and 1980s in Colombia, but is now on the decline.

¹⁹ National Banking Association Survey, 2007, as quoted in country report. Note that this figure may be overestimated, as it is not clear that the actual number of account holders, rather than accounts, was measured. There may be some duplication of accounts per person.

²⁰ This may be a slight overestimation of policyholders, as some people may have more than one policy.

The salient features of the Colombian microinsurance market are represented in Figure 5.

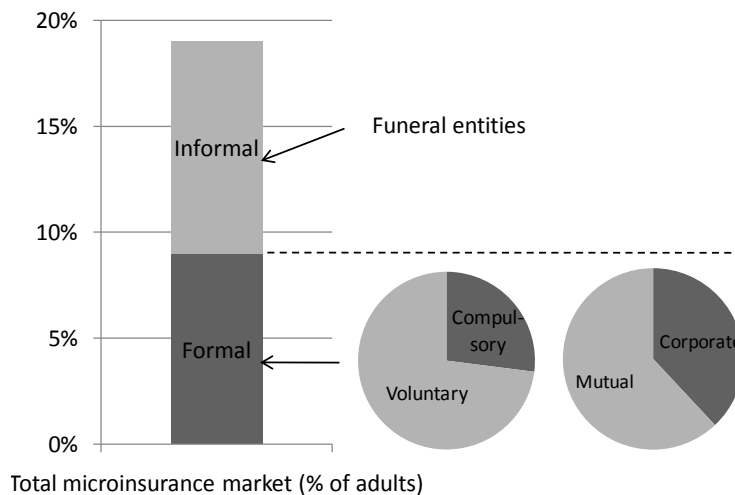


Figure 5: Estimated composition of the Colombian microinsurance market.

Source: Compiled from Cáceres & Zuluaga, 2008. Unpublished country report

Players: There are 43 registered insurers in Colombia, of which 41 are corporates and two are co-operatives. Though 17 insurers provide some form of microinsurance products, the two insurance co-operatives, La Equidad and Solidaria, are the microinsurance pioneers. They remain the largest players in the microinsurance market. With 1.7-million insurance policyholders, they are estimated to account for 62% of the total formal microinsurance market. This is, however, still significantly below the total co-operative membership of 3.7-million, implying scope for further co-operative-based microinsurance expansion.

Products: Voluntary microinsurance plays an important role in Colombia compared to international experience. Compulsory credit life insurance is estimated to account for only 27% of all microinsurance clients, though it is growing strongly on the back of credit expansion. The most popular life microinsurance products are funeral insurance, followed by credit life insurance. Innovative new products are also increasingly marketed on the non-life side, including motorbike insurance, insurance tailored to cover the stock of small businesses, repatriation insurance for migrant workers, products providing benefit pay-outs in the form of grocery vouchers or education fee coverage, and cellphone insurance. Fasecolda (the insurance industry association) estimates property insurance to comprise 60% of the microinsurance market. This category is in turn largely comprises cellphone insurance. Thirty-million Colombians (about 64% of the population), 72% of whom are classified as lower income, now own a cellphone.

Distribution: Traditional broker and agent distribution channels do not feature prominently in the microinsurance market. Instead, microinsurance is distributed largely through co-operatives, as well as through micro-credit NGOs requiring compulsory credit life insurance.

Direct sales²¹, bancassurance and distribution through utilities²² are also emerging as important intermediation channels (see Table 2).

Distribution channel	Share in total distribution
Co-operatives	22%
NGOs specialised in microcredit	18%
Direct sales	18%
Bancassurance	11%
Utilities	9%

Table 2: Microinsurance distribution channels in Colombia.

Source: Cáceres & Zuluaga, 2008. Unpublished country report

Additional channels such as hospitals, educational establishments, large retail outlets/networks and funeral homes could also become significant, though such distribution is not found at present, except for a recently launched initiative where life insurance is sold through cashiers at some supermarkets. The potential of cellphones to support distribution in the low-income market is of yet untapped.

3.1.3. The insurance policy, regulation and supervision landscape

Colombia has no dedicated insurance law. Insurance is incorporated with other financial activities under the Fundamental Law of the Financial System (FLFS) and its subordinate decrees and regulations. The Financial Superintendence (FS) acts as insurance regulator and supervisor.

Prudential and institutional regulation: Both public corporations and co-operatives may register as insurers. The minimum upfront capital requirement consists of a standard minimum capital component, as well as additional technical capital requirements per class of product provided. In 2006, the standard component was \$2.7-million for life and non-life insurers, \$1.5-million for credit and export insurers, and \$ 11-million for reinsurers. The technical equity required ranges from \$0.3-million to \$1.2-million, according to the type of product. The total minimum upfront capital requirement therefore depends on the combination of products provided by the insurer. Apart from the FLFS, Law 79 of 1988 on Cooperatives is also relevant. It establishes a framework to develop co-operative activities and allows co-operative insurers to provide insurance to non-members. There is no special

²¹ "Directs sales" refer to insurance products sold directly by the insurer without tied agents or brokers, for example through telemarketing, direct mail, or call centres. Sometimes this involves insurers selling products through their employees without such employees being considered agents or brokers. This is allowed under Art. 5 FLFS and Art 2 Decree 2605, 1993.

²² With the insurance premium added as a separate item to a person's monthly utility statement

dispensation for co-operative insurers and they have to adhere to the full set of regulatory requirements for insurers.

Product regulation: On registration, insurers are authorised to provide various classes of policies (group life, health, vehicle, asset, etc). New products have to be submitted to the FS, but product authorisation is not required. Strict product demarcation applies only to individual life policies. Under Article 38 of the FLFS, insurers providing individual life policies must do so exclusively. Any other life insurers may sell group life, collective life²³, health, personal accident, funeral or education policies, as well as annuities and non-life policies. Non-life insurers may sell collective life, group life and health insurance in addition to asset-based policies.

Market conduct regulation: In Colombia, insurance may be distributed directly by the insurance company, through agents, insurance agencies or by means of insurance brokers. Under the Cooperative Law, insurance co-operatives may sell their own or another insurer's policies without using agents, brokers or agencies. The main difference between brokers and agents is that, while agents are natural persons, brokers must be a limited company or public corporation. They must register with the financial superintendence and are subject to capital requirements. Agents do not have to register and the onus is placed on the insurers dealing with them to ensure that they are compliant and competent. Insurers must certify that they have trained their agents to ensure that they are competent and must make their training programmes available to the FS. In practice, insurers implement this requirement jointly through courses presented by the industry association, Fasecolda.

The direct distribution and agencies channels are interpreted quite broadly to accommodate new channels. New channels (for example, bancassurance or distribution through public utilities) have also been regulated through subordinate regulation on an ad hoc basis. There is no price control on premiums or commissions. Market conduct provisions mostly relate to consumer protection measures such as the right to choose the provider in the case of credit insurance and the establishment of proper complaints procedures.

Financial inclusion policy: Financial inclusion is an important policy objective, specifically the president and government invests much energy in supporting the development of financial services for the poor. A key feature is the Opportunity Banking policy, which seeks to provide access to financial services, including payments, transfers, savings, loans, insurance, pensions and remittances. It does not place regulated inclusion objectives on private financial institutions, but establishes the overall policy framework that guides public and private players to extend access to financial services. Among others, the government has amended banking regulations to allow the establishment of non-bank agents (named "non-bank correspondents") to extend the formal banking network into previously unserved areas. As of June 2007, there were 3 508 non-bank correspondents and between 2006 and 2007 the new channel has enabled almost one-million Colombians to access formal credit for the first time. Non-bank correspondents are not currently allowed to sell insurance, though they may collect premiums.

²³ The only difference between group life and collective life policies is that in the former there is some relationship between the policyholders, for example they belong to the same union. Collective life would for example refer to the policies sold via the electricity utility.

3.1.4. Impact of policy, regulation and supervision on the market

As the FLFS makes no reference to microinsurance, and there is no official microinsurance definition, the Colombian experience illustrates that microinsurance can grow even in the absence of any regulatory concessions to facilitate its development. However, this is only possible because general insurance regulation does not impose an unduly heavy burden on the intermediation of microinsurance; neither is it restrictive on underwriting:

- **Insurance provided by unregulated funeral entities.** Funeral entities serve a large part of the market and have also supported formal market development by increasing awareness and familiarity with the concept of insurance. A 2006 opinion by the FS (based on a 2003 constitutional court judgment) holds that the policies provided by funeral service providers fall outside the definition of insurance in the FLFS. These providers therefore operate on an unregulated and unsupervised basis. Though this “regulatory forbearance” has by and large served the development of the market, it could create the risk of consumer abuse if not carefully monitored by the supervisor.
- **Demarcation rules favourable to market development.** Market development in Colombia is supported by the fact that an insurer is allowed to provide health, non-life and group life policies under a single licence.
- **Flexible market conduct regime.** The Colombian regulatory framework facilitates microinsurance intermediation in a number of ways. It accommodates new channels within the “direct sales” or “agencies” categories or through specific subordinate legislation as they arise. Furthermore, no price controls (in the form of commission caps) apply to the intermediation process. Co-operatives may sell insurance to non-members and may act directly as a distribution channel. Lastly, the FS delegates supervision of agents to insurers. These factors combine to make Colombia one of the sample countries with the most flexible market conduct regime. This gives providers the confidence to pursue distribution innovation, as witnessed in the various new channels emerging.
- **Active government encouragement of low-income market activity.** To date one of the main impacts of the Opportunity Banking policy has been the introduction of “non-bank correspondents” as an intermediary category to support the distribution of financial services in poor and remote areas. The expansion of micro-credit in turn paves the way for credit life microinsurance expansion.

3.1.5. Conclusion: insights and lessons from Colombia

The financial liberalisation and subsequent crisis in Colombia shaped the current state of the microinsurance market in that it increased competition for domestic clients, which prompted a move downmarket by domestic banks and insurers in the quest for new market segments. Microfinance expansion in turn stimulated the growth of the credit life microinsurance market. Despite the growing importance of compulsory credit life insurance, voluntary microinsurance (driven by the co-operative insurers) still dominates, with funeral insurance being the most popular product and non-life insurance, especially cellphone insurance, also growing in popularity.

A relatively open regulatory stance as well as generally low regulatory burden, especially on the intermediation side, has meant that market rather than regulatory forces have been the definitive driver of microinsurance development. Nevertheless, a number of policy and

regulatory aspects have affecting the microinsurance market. Perhaps most significantly, the Opportunity Banking policy represents a significant push by government for the facilitation of financial inclusion. Though current evidence suggests that the absence of microinsurance-specific regulation has generally not hampered the development of microinsurance, overall microinsurance penetration remains low and microinsurance is still largely driven by two large co-operative players. The creation of a microinsurance definition may serve to align policies and efforts for developing the market and close the regulatory gaps that do exist, such as the fact that no intermediate step or tier with reduced regulatory cost is available to smaller or community-based entities who want to enter the microinsurance market.

3.2. India

The sheer scale of the Indian low-income market creates enormous scope and need for microinsurance. Potential voluntary demand is strong, particularly for micro-health cover. A strong political imperative exists for financial inclusion, resonating in regulation that mandates low-income market expansion, as well as a dedicated microinsurance space. Yet the actual extent of microinsurance penetration in India remains very small. The legacy of a state-owned insurance monopoly still looms large. Private insurers as well as the insurance regulatory authority are very new and have found it difficult to prioritise microinsurance in the face of other pressing concerns. The regulatory strategy to compel insurers to reach downmarket has triggered some interest in the low-income market, but rarely beyond that required by law. Furthermore, general insurance regulation as well the specific provisions for microinsurance impose restrictions that have contributed to its limited success so far.

3.2.1. Context

With a population of around 1.1-billion, India is the second-most populated country in the world. In recent years, there has been strong GDP growth. Yet poverty remains high, especially among the 70% of the population living in rural areas. The World Bank (2007) estimates that 88% of the rural population and 61% of the urban population live on less than \$2/day, reducing to respectively 40% and 20% (33.5% of the total population) for \$1 a day.

Government nationalised the insurance industry in the 1950s, monopolising it into one state-owned Life Insurance Corporation and one General Insurance Corporation with four subsidiaries. The insurance industry was only liberalised in 1999 to allow private insurers. Since then insurance premiums have grown rapidly on the back of new entries to reach 3.5% of GDP. The two state-owned insurers remain the largest insurers in the market.

India is unique in that the government plays a proactive role in providing insurance to the very poor (those below the \$1/per day threshold) through various social security programmes and subsidised insurance schemes. Therefore the microinsurance market in India should largely be regarded as the low-income population living on more than \$1/day.

3.2.2. Salient features of the microinsurance market

Usage: Though no figures are available on the exact size of the microinsurance market in India, a rough estimate would place it at around 14-million individuals, or approximately 2%

of the adult population²⁴. Note that India is the only country for which this estimate includes health insurance²⁵. The low take-up can be ascribed to a general lack of awareness of insurance as a financial product, even in the high to middle-income market (a factor that emerged strongly from the focus group findings). Rural financial services infrastructure for distribution is lacking, as well actuarial data²⁶, and these also inhibit the development of the microinsurance market.

Players: Though the state-owned insurers still have the largest market share, there are now a total of 32 licenced insurers. A feature that sets India apart from other countries is the fact that microinsurance is mostly provided by large, corporate insurers. This is due to a cautious regulatory approach – in response to the fact that small and co-operative financial institutions have not performed well historically – that limits the players in the non-bank field to large cap institutions. The co-operative/mutual sector therefore does not feature as a provider of microinsurance, though corporate insurers use it as a distribution channel. Informal insurance is virtually exclusively the domain of formal entities such as health insurance schemes not registered for insurance purposes, rather than community risk-pooling groups, and is estimated to only comprise 20% of the market.

Products: Microinsurance in India is for the most part driven by compulsory credit life insurance on the back of microfinance. Due to the limited reach of the public health system, there is also a high natural demand for health insurance. Many MFIs therefore provide a package of compulsory insurance cover to their clients that are credit linked – this includes life, asset as well as health insurance. The cover is for the term of credit (usually one year). Health cover provided in such packages is not so comprehensive and covers only certain listed diseases which require hospitalisation. Accident cover is a rider with life insurance and is a fixed payout. India is therefore unique in that compulsory insurance cover extends beyond life cover.

It is estimated that only 10% of microinsurance policies are sold on a voluntary basis. Of these, up to 90% are endowment products rather than pure risk products, indicating a preference among the low-income population for financial products that provide some

²⁴ This figure is derived as follows: the main market for microinsurance in India is the MFI clients (clients of both privately run MFIs and the members of Self-help groups (SHGs) promoted under the Government's/NABARD SHG-Bank Linkages Programme). There are about 50m MFI clients, of which 30m are currently served. Of these, 30-40% are poor which means that there are about 10.5m credit life micro-insurance clients. There are about 5m clients served by community health schemes. However, there are some overlaps among the clients of private MFIs/SBLP and also the lives that are covered by credit life and social security schemes. Therefore, assuming an overlap of about 10%, the total number of low-income clients served by microinsurance will be around 14m. This estimation does not include micro-pensions. These figures would have increased by around 20-30% in 2008 as the Microfinance sector in India has grown at this pace for last several years. Note that this estimate differs from for example Roth, McCord & Liber (2007), where it is stated that in excess of 30m lives are covered by microinsurance in India. This can be ascribed mainly to the fact that the emphasis in this study is on the number of *policy (insurance product) holders* rather than the number of *lives covered* (more than one life may be covered per insurance product). In addition, this study did not count micro pensions (noted as an important product in Roth et al) as microinsurance.

²⁵ As agreed in the methodology for the country studies, health insurance would be outside the scope of the study. Due to its important role in the low-income market, India is however the one country for which an exception was made.

²⁶ As private insurers are still young, they have not been able to accumulate enough pricing data.

payout regardless of whether a risk event has occurred. Health insurance (by Yeshasvini and a few other schemes) largely account for the informal part of the microinsurance market. The health insurance cover in this case is quite comprehensive (unlike in credit-linked policies) and covers a number of illnesses as well as out-patient costs. The lack of adequate health care facilities in rural areas, however, undermines micro-health insurance.

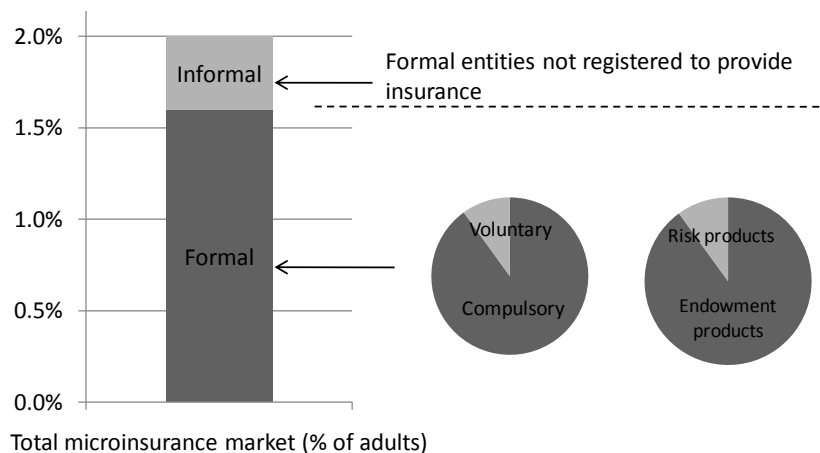


Figure 6: Composition of the Indian microinsurance market.

Source: M-Cril estimates (2008), unpublished India country report.

Distribution: Distribution is an important part of the microinsurance landscape in India. Regulations were issued in 2005 to create a microinsurance agent category for the dedicated distribution of microinsurance. Currently such agents only distribute about 20% of all microinsurance. Instead, distribution mainly takes place through MFIs which either do not qualify as microinsurance agents under the regulations or which find the regulations too restrictive, as partners or agents of formal insurers.

The key features of the microinsurance market are in Figure 6.

3.2.3. The insurance policy, regulation and supervision landscape

Insurance in India is regulated under the Insurance Act of 1938 (as amended). Concomitant to the liberalisation of the insurance industry, the Insurance IRDA Act of 1999 established IRDA as the regulator and supervisor. As its name indicates, IRDA has two explicit mandates: regulating the industry for stability purposes, but also promoting industry development.

Prudential and institutional regulation: The Insurance Act, 1938 defines four categories of insurance: life, fire, marine and miscellaneous. IRDA licenses two categories of insurers: life and general (covering the last three product categories). Applicants must be registered companies. Co-operative insurers are allowed but must comply with the full regulatory load and minimum capital requirements²⁷. No more than 26% of the issued share capital of an insurer may be foreign-owned. All insurers, regardless of type of product offered or institutional type, must hold Rs100 crores (about \$25-million) in minimum start-up capital.

²⁷ Just one co-operative insurer, specializing in agricultural insurance, has been established so far.

Product regulation: One insurer is not allowed to offer both life and general insurance (unless it forms two separate companies for this purpose). Health insurance may however be provided under either a life or a general insurance license. New products are subject to a file-and-use approval approach. General (non-life) insurance premiums have traditionally been regulated, i.e. were subject to price control. In an effort to improve efficiency, IRDA however started to “detariff” the sector in 2007, with full premium liberalisation as of 1 January 2008. As a result property insurance rates are reported to have fallen by as much as 75%-80%, though health insurance rates are expected to rise²⁸.

Market conduct regulation: IRDA recognises four types of insurance intermediaries: brokers, agents, corporate agents (that can for example include rural banks or MFIs) and microinsurance agents. Intermediaries have to undergo a minimum number of hours of training and (with the exception of microinsurance agents) have to pass an examination before they can register. From 2008, IRDA’s approach has been to concentrate on solvency issues and to delegate market conduct supervision to self-regulatory insurance councils²⁹, for example in administering examinations of prospective insurance agents. Nevertheless, IRDA has set up a grievance cell/complaints office and works with insurers towards the expeditious disposal of complaints. Furthermore, it works towards the standardisation of concepts, simple application forms, acceptable accounting standards, transparency in business operations and disclosure of financial statements.

Financial inclusion policy and regulation: Financial inclusion is an explicit policy objective of the Indian government and various initiatives have been launched to that effect. India is one of only two sample countries with a microinsurance regime in place. Of relevance to microinsurance are two sets of regulations issued by IRDA under its market development mandate:

Regulations regarding rural and social sectors obligations³⁰, 2002: These regulations oblige insurance companies to procure insurance business on a quota basis from pre-defined rural areas and social sectors, with the latter defined as “unorganised workers, (and) economically vulnerable or backward classes in urban and rural areas”. The quotas are phased up over time:

- 5% of all life insurers’ policies must be from rural areas in year 1, phasing up to 16% in year 5.
- For non-life insurers, 2% of total gross premiums underwritten must be from rural areas in year one, phasing up to 5% in year 5.
- In the social sectors, each insurer has to maintain at least 5,000 policies in year 1 rising to 20,000 in year 5, for both life and general insurance.

²⁸ Previously, health and property were combined in one product and property rates cross-subsidized health. With property rates falling, this is no longer feasible.

²⁹ All insurers and provident societies incorporated or domiciled in India are members of the Insurance Association of India. It has two councils, namely the Life Insurance Council and the General Insurance Council, funded by industry. Both councils act as self-regulatory bodies by developing codes of conduct, setting disclosure standards, developing compliance programs, etc.

³⁰ Full name: The Insurance Regulatory and Development Authority (Obligations of insurers of rural social sectors) Regulations

An insurer failing to reach the targets incurs a financial penalty. Repeated violations could prompt IRDA to revoke such an insurer's licence.

Microinsurance regulations, 2005³¹: These regulations embody IRDA's commitment to extending the reach of the insurance sector. They create a specific category of microinsurance agents to distribute microinsurance products on behalf of registered insurers. Microinsurance products are defined as both life and general insurance products. The definition is set according to minimum and maximum benefits, the minimum/maximum term of the insurance policy and minimum/maximum age of entry, as well as certain simplicity requirements. The specifications vary according to the type of cover provided. The Table 3 compare the Indian definition of microinsurance with that used in the other relevant sample countries.

	India	Philippines	South Africa (proposed)
Max. premium	n/a	\$25.5 per month (set as max. % of daily minimum wage)	n/a
Benefit limits	<u>Non-life</u> : max. \$740; min. \$123 (exception family health & accident: \$247) <u>Life</u> : max. \$1230 (exception endowment & health: \$740) ; \$123 min. (family health & accident: \$247)	\$4256 (set as max. % of daily minimum wage) - limit defined <u>for life only</u>	\$1245 funeral \$623 friendly societies \$6226 MI recommended
Age of entry	Life: >18, <60 Non-life: n/a (exception personal accident: >5, <17)	n/a	n/a
Term limits	Non-life: 1 year Life: >5, <15 years (exception health insurance: >1, <7)	n/a	max. 1 year
Product features	Simplicity, available in vernacular language	Product must clearly set out details, be easy to understand, with simple documentation requirements. Premium collection must coincide with cash flow/not be onerous to target market	Simplicity & disclosure requirements, including recourse channel
Demarcation	Composite life & non-life MI products allowed, but separate insurers must underwrite the risk.	Life and non-life MI policies possible; only life has max. benefit limits	Life/non-life demarcation removed for MI
Institutional aspects	No prudential tier for MI; distribution through qualifying non-profit MI agents	MI concessions only apply to registered Mutual Benefit Associations with more than 5,000 members and that provide exclusively microinsurance	Public companies, co-operatives and friendly societies may become micro-insurers

Table 3: Definition of microinsurance across the sample countries.

Source: country reports

³¹ Gazetted in November 2005. Available at: www.irdaindia.org/regulations

So far, 12 life and eight non-life microinsurance products have been filed with IRDA. All sales of microinsurance products will count towards insurers' rural and social sector obligations (though rural and social insurance do not necessarily constitute microinsurance). Providers of such products do not receive any prudential or institutional concessions. The demarcation requirement between life and non-life insurance is relaxed for microinsurance in that the regulations allow for the bundling of life and non-life elements in one single product, provided that a life and non-life insurer must respectively underwrite the life and non-life risks underlying the product³².

Microinsurance agent category: Microinsurance agents must enter into a "deed of agreement" with one life and/or one non-life insurer. Until recently such agents were limited to NGOs, self-help groups and non-profit MFIs with a minimum of three years experience in working with low-income groups. In March 2008, the category was extended to all non-profit entities³³. For-profit entities such as rural banks and for-profit MFIs remain excluded as they are classified as corporate agents. Agent categories other than microinsurance agents may sell microinsurance but do not benefit from the concessions microinsurance agents are allowed. However, a microinsurance agent cannot distribute any product other than a microinsurance product.

Concessions for microinsurance agents: While all types of intermediaries may distribute microinsurance, only microinsurance agents are granted certain concessions to do so. Once registered as a microinsurance agent, lower training requirements apply (25 rather than 50 hours of mandatory training). Microinsurance agents may levy commissions of between 10% and 20% of premiums a year, depending on the type of product. These commission caps are more liberal than those applying to the rest of the industry (where upfront structuring of commissions is allowed). Nevertheless, the general market sentiment is that commissions are still too low to make microinsurance sales viable. For group insurance products, the insurer may decide the commission subject to the overall limits specified by IRDA.

Other relevant regulation: The Reserve Bank of India (RBI) imposes stringent restrictions on the collection of "deposits" in any form. In 2002, it issued regulations stating that certain types of non-bank finance companies (NBFC), including most MFIs, may not route any premiums through their books. The implication is that the NBFC intermediary must pay individual transactions over to the insurer, rather than processing all payments through their systems and making a single payment to the insurer. This introduces inefficiencies and increases cost. This restriction is, however, waived for registered microinsurance agents, enabling them to route premiums through their books.

Furthermore, tax legislation is of relevance in that all insurance policies and commissions earned, with no exception for microinsurance policies or microinsurance agents, are subject to a service tax. The fact that insurers pay 12.36% service tax on microinsurance agents' commissions has direct implications for pricing and hence affordability of premiums.

³² This requires two such insurers to enter into a contractual relationship for the provision of the composite microinsurance product via a microinsurance agent.

³³ Refer to www.irdaindia.org

Submissions have been made to the Ministry of Finance for the removal of service tax on microinsurance sales, but no action has been taken yet.

3.2.4. Impact of policy, regulation and supervision on the market

High regulatory burden undermines dedicated microinsurance provision. The high minimum statutory capital requirement is a deliberate entry barrier imposed by IRDA. As there is no concession for dedicated microinsurance providers, this policy could impede the growth of the microinsurance industry since it precludes mutual groups and other community-based entities from formalising into registered insurers. Likewise, market conduct regulation, for example the price controls on commissions, increases the burden on insurance provision to the low-income market, as does the service tax.

Rural and social sector quotas force a move downmarket, but do not necessarily improve the livelihoods of the poor. The impact of the quotas has been ambivalent. While it has prompted some insurers to experiment with new distribution channels through NGOs, MFIs and the rural banking network, many insurers still do not regard this as a profitable market opportunity beyond the quotas. The quotas furthermore do not specify that policyholders need to be poor, and it is reported that many insurers meet the quotas by focusing on higher-income individuals within the rural and social sectors.

Microinsurance regulations open space for microinsurance distribution, but the impact undermined by restrictions. The concessions granted to microinsurance agents bring down intermediation costs and allow enhanced functions such as the routing of premiums. This is, however, undermined by the fact that these concessions are available only to a limited category of agents. The implication of the exclusion of for-profit entities from the microinsurance agent definition is best illustrated in the case of NBFCs that are for-profit companies, often MFIs, registered by the Reserve Bank of India. NBFCs account for more than 80% of the clients served by microfinance and are a ready base for microinsurance distribution. Excluding them from the microinsurance agent definition means that insurers are forgoing this cheaper distribution opportunity. It is estimated that, largely as a result of this restriction, only 20% of microinsurance products are currently distributed through microinsurance agents.

Despite the relaxation in the demarcation requirement for microinsurance, and despite the high potential demand indicated in the focus groups³⁴, no composite microinsurance products have yet been registered. It is argued that this is due to reluctance on insurers' part to bind themselves to any one other insurer. Furthermore, the fact that the microinsurance regulations restrict microinsurance agents to partner with one life and one non-life insurer exclusively makes it impossible to combine the best products from different companies into a bouquet that would suit the needs of particular types of clients within the microinsurance space.

³⁴ Focus group participants indicated a high preference for composite products, particularly if there was a health component attached to it.

3.2.5. Conclusion: insights and lessons from India

Despite large microinsurance potential and policy measures for low-income market expansion, the reach of the Indian microinsurance market remains limited to 2% of adults. Where microinsurance uptake has grown, this has been linked mainly to the growth of the microfinance sector rather than of microinsurance per se. This can be explained by a number of factors, including a lack of awareness among the public and perceived low affordability. Furthermore, while self-help groups and other low-income groups play an important role in microinsurance distribution, underwriting through informal mutual groups has not played a significant role³⁵, with the informal insurance market largely comprised of health insurance schemes. Low usage, however, is also, linked to a distinct regulatory aspect.

The history of government involvement has meant that the private insurance market and the regulatory authority are very new, making low-income expansion all the more difficult. Though IRDA has implemented a number of measures to expand the reach of the insurance market, the approach followed has often been quite prescriptive and restrictive. Thus far, rural and social sector obligations have triggered only limited interest in the low-income market beyond what the quotas require. Likewise, the microinsurance space has not achieved significant success. It must, however, be noted that the regulations are still fairly new and may take some time to take effect. The fact that the space does not allow for a separate prudential tier implies that minimum capital requirements remain a significant barrier to entry. On the market conduct side, the restrictive definition has contributed to the fact that microinsurance agents have by and large not yet been able to become a vehicle for accelerated outreach to low-income clients.

3.3. Philippines

The Philippines has a strong mutual/co-operative tradition and informal risk pooling and underwriting is common. This, together with the growth of the microfinance industry, has been the driving force behind the development of microinsurance. Besides India, the Philippines is the only sample country where microinsurance is explicitly provided for in the insurance regulatory regime. However, whereas India created concessions for microinsurance on the intermediation side, the Philippines created a special prudential tier (with significantly lower minimum capital requirements) for the underwriting of microinsurance policies and linked this to the allowance for Mutual Benefit Associations (MBAs) in their Insurance Code. Filipino insurance regulation allows a great deal of institutional flexibility for formal insurers – they can be stock companies, co-operatives or MBAs, the latter having to be non-profit in nature. The microinsurance regulations also contain an innovative mechanism to facilitate formalisation of informal insurance operators: microinsurance MBAs which are unable to meet the minimum capital requirements upfront, are allowed to increase their capital over time without having to forfeit their registration. Through these regulations, and some public awareness campaigns, the Filipino Insurance

³⁵ Self-help groups are prevalent in India. They normally are a mechanism for about 10-20 women to pool savings and obtain loans. The country report did not find significant in-house risk-pooling among such and other mutual groups. They often distribute insurers' products, however, explaining why self-help groups have been defined as one of the categories eligible for microinsurance agent status.

Commission triggered a move to formalise the informal sector. However, much informal activity remains.

3.3.1. Context

The Philippines has a population estimated at about 88-million people, spread over more than 7 000 islands – 48% of the population lives in urban areas. The World Bank (2007) estimates 44% of the population to live on less than \$2 a day and 14% on \$1 a day or less. During 2007, GDP grew by 7.3%. The Philippines has a relatively sophisticated banking sector and the country has been a pioneer in mobile payments that are accessible to the low-income market³⁶. The insurance sector is less developed, with insurance premiums representing only 1.2% of GDP.

The private microfinance industry has only recently started to grow, after having been crowded out by three decades of government-subsidised directed credit programmes. Since the introduction of a National Microfinance Strategy to encourage increased private sector participation in 1997 the market has grown from less than 500 000 to more than 3.6-million clients, provided through more than 1 400 MFIs.

3.3.2. Salient features of the microinsurance market

Figure 7 captures the key features of the microinsurance market in the Philippines.

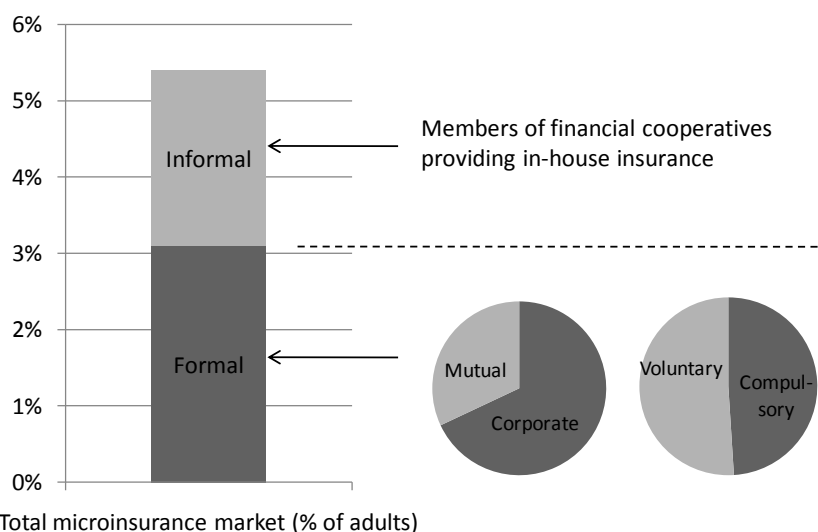


Figure 7: Composition of the Philippines microinsurance market.

Source: Various estimates based on consultations and research for country study.

The diagram indicates:

Usage: Formal insurance penetration in the low-income market is estimated at about 3.1% of adults. Informal “in-house” insurance is very common within the co-operative sector.

³⁶ Its two m-payments platforms, G-Cash and Smart Money, have between them achieved uptake of an estimated 5.5m customers. In total, Globe Telecom and Smart Communications have more than 45 million cell phone subscribers (about half of the population) (CGAP, 2008).

Such informal microinsurance is estimated to amount to 2.4% of adults, bringing the total microinsurance penetration to 5.4%³⁷.

Players: There are 33 life, 94 non-life and three composite insurers in the Philippines. Commercial insurers play only a small autonomous role in microinsurance. Their low-income market activity is mostly limited to credit life insurance provided via the MFI sector. Insurance distributed by MFIs and rural banks³⁸ (denoted as “corporate insurance” on the diagram) accounts for 68% of formal microinsurance use. Mutual insurance, provided by MBAs also plays an important role. MBAs are intricately linked to the MFI sector. There are currently 18 MBAs, six of which are registered as microinsurance MBAs. All of the latter and most of the former were established by MFIs to serve as a vehicle for providing microinsurance to their clients.

Of the 22 000 operational co-operatives in the Philippines (80% of which are financial co-operatives), about half are estimated to provide some form of insurance to their members through “mutual fund schemes”. These schemes are not licensed by the Insurance Commission. There are only two co-operatives that currently provide insurance formally, both of them registered simultaneously as co-operative service providers with the Cooperative Development Authority, and as life insurers with the Insurance Commission. One, CLIMBS, is registered as an MBA with primary co-operatives as members. These two co-operative insurers therefore act as insurers to networks of co-operatives that essentially serve as distribution agents. The other, CISP, has been put under curatorship by the Insurance Commission because of financial difficulties – symptomatic of the generally poor condition of prudential risk management pervasive in the co-operative sector.

Other groups, such as *damayan* funds, also provide risk-pooling. However, as they do not provide guaranteed benefits, their activities fall beyond the definition of insurance.

Products: Compulsory credit life is estimated to account for 49% of microinsurance use. Within the voluntary market, life insurance³⁹ and “casualty insurance” (including disability and health insurance related to accidents⁴⁰) are the most important products. MBAs only provide life and credit life insurance. In the informal (self-insured co-operative) market, life

³⁷ No definite statistics exist on the size of the microinsurance market. Therefore an estimate was derived based on the estimated number of microfinance clients with credit life insurance, plus members of microinsurance MBAs, plus an assumption that microinsurance provision outside of the MFI market would amount to the equivalent of 10% of existing microfinance clients (which totalled 3.1m in August 2007). This renders a total figure of 1.7m adults (3% of the population). The informal market was estimated by assuming that it will total 50% of the members of financial co-operatives. This renders an informal market of 1.2-million, bringing the total market to 2.9-million, or 5.4% of the adult population.

³⁸ Note that the largest commercial insurer involved in microinsurance, Country Bankers, was formed by the rural banks to underwrite their credit life policies.

³⁹ Note that these life insurance policies are “traditional” life insurance policies, not funeral insurance as found in some other jurisdictions. In the Philippines setting, products targeted at funeral costs are generally provided by pre-need companies.

⁴⁰ This health insurance entails a capital pay-out in the case of a health contingency, rather than covering medical expenses incurred (the traditional meaning of health insurance). The latter is provided outside of the jurisdiction of insurance regulation, by health maintenance organisations regulated by the Department of Health and defined as juridical entities organised “to provide or arrange for the provision of pre-agreed or designated health care services to its enrolled members for a fixed pre-paid fee for a specified period of time” (Department of Health Administrative Order No. 34 dated July 30, 1994).

insurance, sometimes with added hospitalisation or accident coverage, is the most common insurance product offered.

Distribution: Microinsurance is distributed mainly through MFIs (including rural banks), MBAs, co-operatives and other groups. Individual sales through traditional broker and agent channels are rare. It is only the two co-operative insurers that apply agent-based sales directly to individuals. As they are also registered as co-operative service providers under the Cooperative Development Authority, they target people belonging to their co-operative member networks for such sales. They have their own set of Insurance Commission-licensed agents assigned directly to a partner co-operative to market insurance and process the documentation. In the case of CLIMBS, commission is shared between the agent (called an “assurance manager”) and the primary co-operative, which is considered a marketing arm of CLIMBS. For claims processing, however, the primary co-operative may deal directly with CLIMBS and opt not to go through the assurance manager. This cuts the claims processing time (CLIMBS promises to pay the claims within seven days).

Three main market factors drive the development of the microinsurance market:

Microinsurance mainly driven by microfinance development: The growth of the microfinance industry demonstrates the viability of the poor as financial services clients. Increased competition among MFIs has led to providing better and expanded services to members. Realising their clients’ need for protection against risks (e.g. death in the family, illness, loss of assets by small businesses, etc), many MFIs started to offer or facilitate the provision of insurance services to clients beyond just credit life insurance. Microcredit also served to create awareness of financial services among the poor, and compulsory credit life insurance has familiarised the market with insurance to the extent that spontaneous demand for other types of insurance, such as health and life, is emerging. Moreover, MFI staff and credit processes provide an existing and cost-effective channel for selling insurance, premium collection and claims payments.

Role of groups in microinsurance: Microfinance provision in the Philippines is mostly initiated and facilitated through client groups, many of whom are clients of MFIs. The group mechanism is used to grant loans and collect repayments. This group-based mechanism, and clients’ familiarity with it, has lent itself to the formation of MBAs for providing insurance to MFI clients.

The role of CARD MBA: The MBA has become the vehicle of choice for insurance provision by MFIs, largely due to the experience of CARD MFI, one of the MBA pioneers in the Philippines. CARD initially offered informal insurance to its members. With time, however, it realised that this was unsustainable and could bankrupt the organisation. On advice from the regulator, CARD registered an MBA to rehabilitate its insurance operations and bring it within the formally regulated space. CARD MBA’s subsequent success provides an example to other MFIs that want to cater for the risk protection needs of their members and has been instrumental in the establishment of a tiered regulatory regime for microinsurance MBAs. CARD furthermore plays an important development role in the MFI-MBA sector. Under the Insurance Commission Circular 9-2006, an MBA is only recognised as a microinsurance MBA when it has a minimum of 5 000 clients. As most MFIs were not yet large enough, CARD MBA implemented a programme called Build Operate and Transfer

(BOAT). Under this programme, small MFIs' members are initially insured with CARD MBA, though enrolment, documentation and processing of claims are lodged within the MFI. CARD also provides technical assistance. When the necessary scale is reached, the MFI can register an MBA and fully handle its own insurance.

3.3.3. The insurance policy, regulation and supervision landscape

Insurance in the Philippines is regulated under the Insurance Code (Presidential Decree No. 1460) of 1978, with the Insurance Commission as regulator and supervisor. Insurance is, however, also provided outside of the regulatory mandate of the Insurance Commission, through guaranteed-benefit pre-need plans⁴¹ and health insurance contracts. Pre-need plans are regulated by the Securities and Exchange Commission, whereas health insurance contracts are provided by health maintenance organisations (HMOs) regulated by the Department of Health. There are discussions in Congress to bring these institutions under the authority of the Insurance Commission.

Prudential and institutional regulation: The Insurance Code identifies four types of insurers: life insurers, non-life insurers, composite insurers and mutual benefit associations. The Code allows co-operatives providing insurance (registered under the Cooperative Development Authority but not extensively supervised in practice) to also register for insurance purposes, but only two co-operatives (out of thousands providing in-house insurance) have done so. A life insurance provider may organise itself either as a stock corporation or a mutual life company⁴².

An important characteristic of prudential and institutional regulation in the Philippines is the fact that it allows for a tiered minimum capital regime. In effect, five tiers are created:

- Under Circular 2-2006, minimum capital requirements were raised to Php 1-billion (\$24-million) for new life and non-life insurers and double that for composite insurers. This is up sharply from the \$1.2-million previously required of commercial insurers.
- The Insurance Commission has the discretion to reduce this requirement by up to half for co-operatives, but thus far no co-operatives have applied for registration under this condition, as specific guidelines for implementing this provision of the co-operative code have not yet been formulated.
- Existing MBAs must hold capital of \$305 000 (Php12.5-million), an extremely sharp increase from the minimal capital requirement previously in place (Php10 000).
- This increase is even more pronounced for new MBAs. They must now hold capital of about \$3-million (Php125-million).
- Microinsurance MBAs (see the discussion of this category below) must hold capital of \$122,000 (Php5m) that must be phased up over time to the level of existing MBAs. It is the only category for which such graduation is allowed⁴³.

⁴¹ "Pre-need plan" is the term used in the Philippines for an endowment insurance product, for example an education savings plan that promises to pay out a certain amount at a certain time in future in exchange for a monthly premium.

⁴² A stock corporation is owned by shareholders while a mutual life company is owned by policyholders.

⁴³ The graduation option is allowed for under Circular 9-2006 (microinsurance circular), rather than Circular 2-2006 as the rest of the tiers.

Type of insurance provider	Minimum capital requirement
new life or non-life insurers	\$24m (double for composite insurers, up to half for co-operative insurers)
new MBAs	\$3m
Existing MBAs	\$305,000
all microinsurance MBAs	\$122,000; to be phased up to \$305,000 over time

Table 4: Capital requirements under the Philippines Insurance Code.

Source: Insurance Commission Memorandum Circular 2- 2006 and 9-2006

Product regulation: Insurance is demarcated into life and non-life, but composite products are allowed under certain circumstances, depending on the institutional form:

- Commercial insurers (stock companies) may either provide life or non-life exclusively, or apply for a composite license, in which case they can provide both categories. As discussed, health care plans fall outside the jurisdiction of the Insurance Commission. Yet life and non-life insurance can include health insurance related to accidents
- Co-operative insurance societies registered with the Cooperative Development Authority and also licensed by the Insurance Commission may provide both life and non-life products.
- MBAs may provide only life insurance. It is counterintuitive that MBAs, even though they are the main vehicle for microinsurance and the microinsurance regulations define both life and non-life microinsurance products (see below), are indeed subject to the strictest demarcation. This may be because the Microinsurance Circular could not override the Insurance Code that was passed long before microinsurance came on the horizon.

Market conduct regulation: Insurance may only be distributed through licensed agents or brokers. They could be individuals or companies/organisations (in which case the company has to provide the specific list of persons or individuals who may act on its behalf). Brokers and agents are required to take a written examination prior to authorisation and are required to explain the nature and provisions of the contract to their clients, particularly the minimum disclosure requirements printed in the insurance policy contract. No commission caps are imposed. Under banking regulation, an insurance company allied with a bank is allowed to sell insurance products to that bank's clients within the premises of the bank (bancassurance)⁴⁴. This is however not allowed for rural banks. In practice, the traditional broker and agent channel is not applied in microinsurance. Only the two co-operative

⁴⁴ Section 20 of Republic Act No. 8791, otherwise known as the General Banking Law (GBL) of 2000, allows a bank, subject to prior approval of the Monetary Board, to use any or all of its branches as outlets for the sale of other financial products, including insurance, of its allied undertaking. Under BSP Circular No. 357, Series of 2002, this is applicable only to universal and commercial banks, not to rural banks.

insurers use individual agent selling, and even there, they only do so within their own network of member co-operatives, in partnership with such member co-operatives. For the rest, the MFI either enters into a partnership with an insurer for the distribution of insurance to its members, or a licensed agent of the commercial insurance company sells a group insurance policy to the MFI or rural bank.

Financial inclusion policy and regulation: In line with government's financial inclusion objective, the Insurance Commission in 2006 issued Memorandum Circular No. 9-2006 to encourage the provision of microinsurance. It defines microinsurance as insurance (life and non-life) aimed at mitigating the risks of the poor and disadvantaged. It is defined in terms of maximum premium (of about \$25.5⁴⁵ per month) and maximum benefits (of approximately \$4000) for life insurance only (no benefit caps apply to non-life microinsurance policies that are included in the microinsurance category). It also stipulates that policies must clearly set out all relevant details, must be easy to understand and must have simple documentation requirements. Premium collection must coincide with cash flow of/not be onerous to the target market. Although any registered insurer can offer microinsurance products, the regulatory concessions created in the circular apply only to microinsurance MBAs. An MBA can be recognised as microinsurance MBA if it only provides microinsurance and has more than 5,000 member-clients. As described above, microinsurance MBAs are allowed to hold reduced minimum capital vis-à-vis new MBAs (the same as existing MBAs). If they are unable to comply with this, an even lower amount is allowed, but they must increase their capital at a rate of 5% of gross premium collections per year until they reach the required minimum capital. Furthermore, the Circular requires the establishment of a set of performance standards, tailored to the capacity and activities of microinsurance MBAs, to evaluate, amongst others, their solvency, governance and risk management.

3.3.4. Impact of policy, regulation and supervision on the market

Regulation shapes the microinsurance market in the Philippines in a number of ways:

A "market-following" approach of monitoring market trends and tailoring regulation accordingly: The Insurance Code confers wide powers on the Insurance Commissioner to issue circulars in response to changing market conditions. This allows the Commission to provide the insurance industry sufficient latitude to innovate and to issue regulatory measures that consider and accommodate such innovations. This is in line with the stance taken in Filipino financial sector regulation more broadly.

Impact of financial inclusion policy: The National Microfinance Strategy has had a dramatic impact on the growth of the microfinance industry. This triggered credit life expansion and the growth of the MBA vehicle that in turn paved the way for the implementation of the Insurance Commission circular defining microinsurance and setting out a tiered prudential structure favouring microinsurance MBAs. However, to date, unlike the approach in India and South Africa, government's financial inclusion policy does not extend to the encouragement of large commercial insurers to reach into the low-income market, except to sell group credit life policies to MFIs and rural banks. Commercial insurers enjoy neither

⁴⁵ Exchange rates taken from www.oanda.com on 11 March 2008. Actual limits for the microinsurance definition are set not in absolute monetary terms, but relative to a multiple of the daily minimum wage.

capital nor market conduct concessions to market microinsurance products and the Philippines has therefore seen only a few instances of innovation by large insurers focused on the low-income market⁴⁶. On the contrary, the dramatic increase in their minimum capital requirements (from \$1.2-million to \$24-million) has arguably discouraged experimentation in the low premium market.

Tailored regulatory space facilitates microinsurance, but with limitations: The microinsurance circular (Circular 9-2006) carved out a space for dedicated microinsurance MBAs in the Philippines. This approach has proven conducive to microinsurance development (with six microinsurance MBAs already registered and more being prepared for registration). The provision allowing MBAs who cannot meet the minimum capital requirements to register and then grow their capital over time, is proving useful to formalise insurance operations that were previously conducted in an informal and unsupervised manner. Microinsurance MBAs, however, remain unable to underwrite non-life and health products, thereby limiting their ability to extend their product range in line with the needs of their clients, unless they obtain underwriting by large commercial insurers.

A lack of effective supervision over all insurance-type products undermines microinsurance market development: Though two popular product types in the Philippines, pre-need and health care plans, both constitute “insurance”, these products fall outside of the jurisdiction of the Insurance Commission. This implies that differing rules and regulations are applied to various insurance products. This has created confusion in the market, as was apparent from the focus group interviews, where people indicated that they were hesitant to buy any insurance due to a recent failure of a large pre-need company to meet its obligations. Furthermore, a lack of enforcement of the provisions of the Co-operative Code has led to the proliferation of “in-house” insurance schemes among co-operatives not licensed to provide insurance under the Insurance Code. These in-house insurance schemes are not subject to actuarial evaluations and therefore create risks for their members. More than 65% of total co-operatives registered with the Co-operative Development Authority are no longer operating due to mismanagement, governance issues and more importantly, the lack of rules and regulations.

Inability of rural banks to sell insurance products within bank premises: Most rural banks are situated in the countryside and about 25% of these banks are engaged in the delivery of microfinance services to poor clients. Given their proximity to the poor, rural banks have the potential to be effective channels for widespread delivery of micro-insurance products. However, this potential cannot be exploited at present since only universal and commercial banks (that are usually situated in urban areas) are allowed to sell other financial products (that includes insurance products) on their premises. As a result, rural banks resort to taking group credit life insurance policy contracts with commercial insurers to cover their loan exposure to bank clients. At present, very few microfinance clients of rural banks have therefore availed of insurance products other than credit life.

⁴⁶ It is reported that the Insurance Commission has to date approved five microinsurance products provided by commercial insurers. Therefore, the definition of microinsurance in terms of premium and benefit limits did to some extent provide a benchmark for commercial insurers to create innovative products that would be affordable to the poor.

3.3.5. Conclusion: insights and lessons from the Philippines

Microinsurance in the Philippines is fundamentally group-based and largely microfinance driven. It illustrates how MFI-based microinsurance can evolve beyond the provision of credit life insurance to also provide life, accident and capital health insurance to members. The provision of microinsurance by commercial insurers outside of the MFI realm however remains underdeveloped and the fact that total microinsurance penetration is estimated at less than 6% of adults indicates much scope for further expansion.

Despite some remaining obstacles (such as the proliferation of in-house co-operative insurance, the fact that pre-need and health plans fall outside of the Insurance Commission's jurisdiction and the inability of rural banks to provide bancassurance), a number of policy and regulatory aspects bode well for the growth of microinsurance. Financial inclusion policy, in the form of the National Microfinance Strategy, has contributed to the development of the microfinance and hence microinsurance sectors. The Insurance Commission takes a reactive, "market-following" approach that encourages innovation. In this way, it has adopted a risk-based supervision approach. The challenge to such an approach is that it requires ongoing management to monitor risks, which may imply challenges to the capacity of the regulator. Most importantly, the Philippines present one of only two current examples where microinsurance has explicitly been included in the insurance regulatory regime. The microinsurance concessions are however limited to MBAs that are willing to exclusively provide microinsurance and have reached a certain level of scale. Whilst commercial insurers may also offer products that fall within the definition, there are no regulatory concessions applicable to them.

3.4. South Africa

South Africa has one of the highest insurance penetrations in the world. At the same time it is characterised by a history of inequality and poverty. In the financial sector this has created a distinct divide between the intensively served high-income end of the market and the low-income market, the latter largely excluded from the formal sector. Where the formal providers would not go, informal markets developed. Following the end of apartheid, the government has pursued a policy of financial inclusion with agreed targets for insurance outreach by commercial insurers into previously marginalised markets. The combination of formal and informal provision has created the biggest microinsurance market (relative to population) in the five sample countries. Funeral insurance dominates the low-income market, showing the importance of the demand for the underlying service in triggering insurance uptake. Due to a history of abuse, South Africa also places strong emphasis on consumer protection. Extensive market conduct legislation was promulgated for the entire financial sector. It increased the cost of insurance intermediation to such an extent that the individual marketing of microinsurance policies became too costly. To ensure the continued growth of microinsurance the government is now in the process of designing a dedicated microinsurance space.

3.4.1. Context

South Africa is a middle income country with a population of around 47m, of which 59% live in urban areas. The country has recently experienced an economic upswing, with GDP growth averaging around 4% since 2000. South Africa has a well developed, sophisticated

financial sector. Usage of financial services has risen to 60% of adults. The payment system infrastructure is strong, with in excess of 15,600 Automatic Teller Machines and a multitude of POS (Point of Sale) devices spread across the country (PWC, 2007). With a premium to GDP ratio of among the highest in the world (16%)⁴⁷, the insurance sector is well developed.

The industry traditionally largely served the high-income end of the market and only recently started to focus on ways in which to innovate (in terms of products and especially distribution) to penetrate the low-income market. In the traditional formal vacuum, a robust informal risk-pooling market has developed, almost exclusively for funeral insurance.

3.4.2. Salient features of the microinsurance market

Figure 8 captures the key characteristics of the microinsurance market in South Africa:

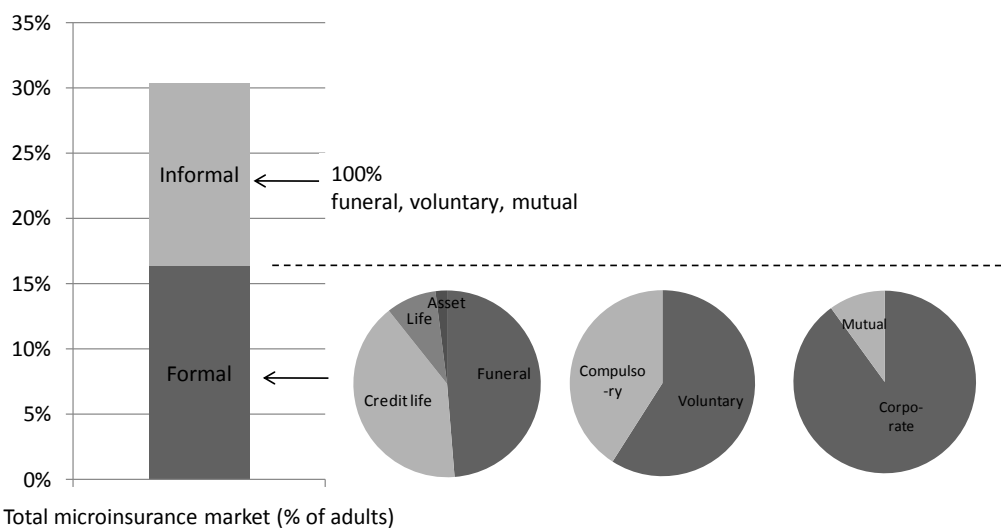


Figure 8: Composition of the South African microinsurance market

Source: FinScope (2006); National Credit Regulator consultations and authors' estimates (for credit life).

The diagram indicates:

Usage: Microinsurance usage in South Africa is estimated at 30% of adults – the highest among the sample countries. Formal insurance accounts for just more than half the market, with the rest being informal risk-pooling via burial societies as well as self-underwriting by funeral parlours not authorised as insurers. Table 5 compares the size and composition of the microinsurance market with the other countries.

⁴⁷ Swiss Re, 2007.

		Colombia	India	Philippines	South Africa	Uganda
MI policyholders: % of adults		19%	2%	5.4%	30%	5%
Share of formal market in total MI		48%	80%	59%	54%	up to 100%
Share of informal market in total MI		52%	20%	41%	46%	Negligible
Formal MI market composition estimates	Mutual/coop share	62%	Distribution only	32%	<10%	n/a
	Compulsory credit life share	27%	90% (about 12.3m)	49%	41%	100%

Table 5: Total size and composition of the microinsurance markets across the sample countries

Source: country consultant estimates. Note: "MI" denotes microinsurance

Players: There are 75 commercial long-term (life) and 97 short-term (non-life) insurers. No composite insurers are allowed. The formal market is dominated by corporate insurers. Though the two largest insurers originally developed as mutuals, they demutualised to become public companies towards the end of the 1990s. Today, there is only one mutual insurer⁴⁸. In addition, there are a number of burial societies providing funeral insurance formally (as friendly societies), within a limited-benefit space provided for them under the insurance legislation. On the informal side it is estimated that there are between 80,000 and 100,000 mutual burial societies serving between 4 and 8 million individuals⁴⁹, as well as between 3,000 and 5,000 funeral parlours providing funeral cover – of which we estimate 50% to do so formally, i.e. with underwriting by registered insurers, and 50% informally. All in all, almost two thirds of the demand for funeral insurance is met informally.

Products: Lately, formal insurers have started to move down-market, focusing on innovations for more appropriate products. This is partly due to industry associations' efforts to create product standards for the purpose of complying with the Financial Sector Charter (see regulatory discussion below). The criteria for these standards include fair charges, easy access and decent terms (so-called CAT standards). As a result, various products are now available that provide cover at as little as \$3-7 per month and that are characterised by simple and flexible terms.

The South African microinsurance market is distinguished from most of the international experience in that voluntary insurance accounts for the majority of the microinsurance market. Compulsory credit life insurance accounts for only about 22% of the total microinsurance market. This figure moves up to 41% when only focusing on the formal market⁵⁰. The increasing prominence of credit life insurance is largely the result of the development of the micro-credit market in South Africa. Funeral insurance however still

⁴⁸ Mutual insurers are not allowed unless a special act of parliament is passed to provide for them.

⁴⁹ Of these burial societies, only 180 are registered friendly societies. Under the Friendly Societies Act, only friendly societies with a turnover of more than R100,000 (about \$1,300) need to submit annual financial statements and adhere to the requirements of the act. Only 74 out of the 180 registered friendly societies resort in this category.

⁵⁰ Note that this is a conservative estimate and that the share of credit life insurance may therefore be higher.

clearly dominates (at 72% of the total microinsurance market and 93% of the voluntary market). The cultural necessity for a dignified (and thus costly) funeral drives the demand for funeral insurance.

Non-life and non-funeral life insurance have achieved limited take-up among the poor, despite recent innovations and the introduction of housing, cell phone, personal accident and other types of insurance targeted at the low-income market. Focus group insights indicate this to be a function of affordability and a lack of awareness of the value proposition offered by such products. The only asset-based insurance product starting to achieve some voluntary take-up is cell phone insurance. This reflects the rapid adoption of mobile telephony and the very important role played by the cell phone as personal and business communication tool in the lives of the poor – a phenomenon strongly supported by the focus groups.

Distribution: In all successful microinsurance products, intermediation innovations have played an important role. These include the use of the cell phone as communication and sales tool, as well as joint ventures with retailer chains and even with low-income groups such as church networks or sports clubs as distribution channels. Innovation in microinsurance distribution has been made possible by the availability of a large, well developed retail network in South Africa, as well as a sophisticated payment system. Due to the restrictive market conduct regulation, all these products are sold in a passive, “off the shelf” way, with no or limited advice and verbal disclosure of product terms. Rather, insurance policy contracts are filled out using a “tick-of-the-box” approach that requires minimal insurer or sales person engagement. This is a feature that only characterises models aimed at the lower-income market. High-income individuals tend to be served via the traditional broker/agent model. Low-income market products are also sold on a group basis and with contract periods of no more than one year (with the norm being one-month contracts renewable with the payment of each premium). All of this has assisted in bringing down the risk, both from an underwriting and a market conduct point of view, of insurance products sold to the low-income market and the implicit emergence of a “microinsurance” category of products. A regulatory review process has been launched with the intent to formalise the definition of microinsurance in order to tailor regulation to its specific risk characteristics.

3.4.3. The insurance policy, regulation and supervision landscape

Insurance in South Africa is primarily regulated by the Long-Term Insurance Act (52 of 1998) and the Short-term Insurance Act (53 of 1998), governing respectively the life and non-life insurance industries. The Financial Services Board (FSB) is the statutory body in charge of supervision. Health insurance (in the form of indemnity benefits covering medical expenses) is regulated separately under the Medical Schemes Act (131 of 1998) and does not fall under the supervision of the FSB. In addition, certain elements of the Friendly Societies Act (25 of 1956) and the Co-operatives Act (14 of 2005) are of relevance. Market conduct is regulated primarily through the Financial Advisory and Intermediary Services (FAIS) Act (37 of 2002). Below, the main aspects of the regulatory scheme are discussed.

Institutional and prudential regulation: Only public companies with insurance as their main business are allowed to register as insurers under either the long-term or short-term act. No

company may have more than one insurance license and no composite licenses are possible. Registered friendly societies may provide insurance without registering under the insurance acts, provided that their policy benefits do not exceed R5 000 (just more than \$600). Under the Co-operatives Act, registered financial co-operatives may provide insurance but must register under the long or short-term act to do so. In effect this implies that they must convert to a public company, undermining the intent of the Act to facilitate the delivery of financial services by co-operatives. Prudential regulation requires minimum upfront capital of approximately \$1.3m for life and \$0.7m for non-life insurers.

Product regulation: Upon registration, each insurer is authorised to provide a number of classes of policies as defined under each act. No product pre-approval is required, though insurers are required to report separately to the FSB on each class of policies they provide. In the case of the Long-term Act, it is possible to register as an “assistance business” (funeral insurance) provider only, with assistance business policies defined as policies not exceeding R10 000 (about \$1,300) in value. Though no prudential or institutional concessions are made for assistance business-only insurers, assistance business is granted special regulatory treatment in a number of instances: it is the only class of product for which no commission caps are imposed and its intermediaries are temporarily exempted from the education requirements under the FAIS Act. Insurers are required to give assistance policyholders the option of a monetary benefit, even in cases where the terms of the policy contract specifies that payment will be in kind (i.e. the provision of a funeral). Assistance business is the only product subject to this requirement.

Market conduct regulation: Market conduct regulation is primarily contained in the FAIS Act. It sets the conditions for the intermediation of insurance (and other financial services) to the public in order to enhance consumer protection. Amongst others, it requires all intermediaries providing advice or intermediary services (defined as actions requiring the person to exercise judgment that leads the client to enter into a transaction; in the case of advice, this includes the recommendation of a product choice) to be authorised to do so by the supervisor. Authorisation in turn entails various education, experience, fit and proper, reporting and other requirements⁵¹. FAIS does not require advice to be provided on all transactions, but where furnishing advice, the financial service provider is obliged to conduct an analysis of client’s financial needs, identify the products that will be appropriate to the clients’ needs and take reasonable steps to ensure that the client understands the advice and makes an informed decision. Furthermore, records of client interactions and advice should be kept for a minimum of five years. In terms of a guidance note issued by the FSB, financial products may be sold by non-authorised intermediaries as long as they do not provide advice or intermediary services, that is, as long as they do so in a passive, clerical way that does not require the exercise of judgment. This has opened the space for “tick-of-the-box”, advice-less sales models, which in turn have found application in the various innovative models currently on the market.

⁵¹ Including: the need to appoint a compliance officer; the need to maintain externally audited accounting records; an annual levy; the duty to supply factually correct information to the client and to confirm this in writing upon request; and the duty to disclose the nature and extent of any remuneration.

In addition to FAIS, commission levels payable to intermediaries are capped under the regulations to the Long-term and Short-term Acts (with the exception of assistance business, as indicated above).

Financial inclusion policy and regulation: Since democratisation in 1994, South Africa has been characterised by a drive towards black economic empowerment. As part of this process industry, labour and other stakeholders within the financial sector in 2003 negotiated and signed the Financial Sector Charter as a commitment by the formal industry to implement black economic empowerment that includes the extension of financial access to the low-income market. The charter also commits government to provide a facilitative regulatory framework for the achievement of the charter targets and goals. The access targets for insurance require that 6% of the low-income⁵² population have effective access to short-term and 23% to long-term insurance by 2014. This equates to 1.2m short-term and 4.5m long-term policyholders (FinScope, 2006). “Effective access” is defined in terms of the distance to the nearest service point, the range of products and services available, their appropriateness to the needs of the low-income market, and whether they are affordably priced as well as structured and described to customers in a simple and easy to understand manner. In addition, industry is committed to spending 0.2% of post-tax profits on consumer education.

Other regulation of note includes the implementation in 2007 of the National Credit Act of 2005: This has implications for the credit life insurance industry, in that it reiterates the client’s right to choose the provider of insurance, should the credit provider compel them to take out credit life cover, as well as for transparent sales and pricing of credit life insurance.

Current reconsideration of insurance legislation as it pertains to micro-insurance: Concerns about potential consumer abuse in the low-income market, combined with government’s commitment under the Charter to remove regulatory barriers to market development, have prompted the National Treasury (the policy-making body for the financial sector) to reconsider the insurance regulatory framework in South Africa. The aim is to create a microinsurance regulatory space to (i) bring down regulatory unit costs in order to facilitate outreach into the lower income market by formal insurers and (ii) provide formalisation and graduation options for the informal market. The details of the proposed regime are discussed in Box 9, p.90.

3.4.4. Impact of policy, regulation and supervision on the market

Financial inclusion policy drives low-income market expansion and triggers innovation: The access targets contained in the Financial Sector Charter have been the main driving force in formal sector expansion over the past few years. In this quest, it has proven essential to bring down transaction costs. The intermediation innovation described above has emerged as the most viable avenue for achieving lower transaction costs and larger scale reach.

⁵² Defined as the LSM (Living Standards Measure) 1-5 population. The LSM measure uses location (urban vs rural), ownership of household assets and access to services to group individuals into one of ten potential LSMs. The average income across LSM1-5 is about \$300 per household, or \$100 per individual per month. The average individual income in LSM 5 amounts to about \$140 per month (FinScope, 2006).

At the same time FAIS Act increases intermediation costs: The greater drive towards consumer protection embodied in the FAIS Act increases the per transaction cost of intermediating financial services, creating a disincentive to serve lower-income (and hence lower revenue-per-premium) clients. This is especially true where advice is provided as part of the sales process. However, since the regulation allows financial products to be sold by non-authorized intermediaries as long as they do not provide advice or intermediary services, this has opened the space for “tick-of-the-box”, advice-less sales models that in turn have found application in the various innovative models currently on the market. The result of (i) the need for low-income market expansion under the Charter, (ii) the increased transaction costs under FAIS and (iii) the space for advice-less sales, is a split of the market into a high-income end served with detailed financial advice, versus a low-income market served through advice-less selling techniques. The implication is that the low-income market receives no advice in the insurance products that they buy.

Regulation inhibits the formalisation of the large number of informal providers: Current institutional regulation inhibits the formalisation of mutual groups by requiring registered insurers to be public companies. Given the important role of burial societies in the funeral insurance market, this undermines formal microinsurance development. Furthermore, existing prudential regulation, set at a uniform level for respectively the life and non-life category, is not commensurate to the risks inherent in microinsurance products.

Strict demarcation undermines the development of short-term microinsurance: Demarcation between short-term (non-life) and long-term (life) insurance implies that short-term insurers are not able to offer funeral insurance, which is classified as a long-term insurance product. In practice, however, the product characteristics of funeral insurance as provided in South Africa correspond to that of short-term insurance rather than long-term insurance, as these products tend to be written on a one-month or one-year at most renewable contract basis. Given the dominance of funeral microinsurance, an inability to provide funeral insurance is a serious disadvantage to low-income market expansion.

3.4.5. Conclusion: insights and lessons from South Africa

South Africa is characterised by a large voluntary market for funeral micro-insurance, driven by the cultural significance attached to a dignified funeral in African society. Whereas informal social risk-pooling mechanisms and funeral parlours account for a large proportion of total demand, the highly sophisticated formal insurance market is also increasingly expanding down-market, partly as a result of Financial Sector Charter commitments. In addition, credit life insurance remains an important and growing market.

Effective market provision of microinsurance requires the distribution of products with low value premiums. Although the cost of distribution can be substantially increased by regulation it can also be substantially reduced through distribution innovations, as the application of “tick of the box” models has shown. This has however only been successful in funeral insurance, due to the high awareness of and natural demand for it that makes it possible to sell it as a “commodity” without active sales effort. Now the market faces the challenge of also selling other life and non-life insurance to their funeral insurance clients. Beyond funeral insurance the awareness amongst low-income persons of the value of insurance remains low, implying that such products need to be actively sold. Active, advice-

based selling to the low-income market has however thus far been inhibited by onerous market conduct regulation.

The proposed regulatory reform with respect to microinsurance is encouraging in that it suggests an active engagement of the regulatory authorities to address the challenges highlighted. Should the proposal for regulatory reform be accepted and implemented, it will provide a valuable case study on the impact of regulatory change on the development of a microinsurance market.

3.5. Uganda

Uganda has a small, relatively young insurance market. The country faces many challenges in the expansion of microinsurance, especially the voluntary, non-credit life market. The extremely low and irregular average household incomes in Uganda mean less disposable income to pay for insurance. Moreover, the limited footprint of formal sector activity, such as banks and national retailers, imply that there are few channels for low-cost insurance distribution. Though focus groups indicated a strong need for the mitigation of risk, especially health risk, the understanding of insurance amongst the population is limited and widespread mistrust of the insurance industry exists. Adding to these market factors is the fact that the insurance regulatory framework in Uganda is very young. However, the passing of an insurance law and the establishment of a supervisor has brought greater certainty, triggering significant entry of foreign insurers over the past ten years. At the same time, regulatory gaps remain. The first priority of the supervisor must of necessity be to cultivate a compliance culture. This leaves little time and resources to be spent on microinsurance.

3.5.1. Context

Uganda is a small, very low-income country. In the 1980s it was subject to a period of hyperinflation, followed by a large currency devaluation⁵³, from which the country took a long time to recover. Of the total population of 29m (of which 13m are adults) 87% still reside in rural areas (this presents a key complication for the distribution of financial services), 96% live on less than \$2/day, and 82% live on less than \$1/day (World Bank, 2007). Uganda thus faces many development challenges, one of which is the development of its relatively underdeveloped financial sector. Only 21% of the Ugandan adult population use any type of formal or semi-formal⁵⁴ financial service, and 17% use informal financial services only. This implies that 62% of the adult population do not use any type of financial service (FinScope Uganda, 2006). The insurance sector is even more underdeveloped than the financial sector at large, with gross premiums totalling less than 1% of GDP.

⁵³ After the devaluation, a life insurance policy would only pay out 1% of its original value.

⁵⁴ The banking sector is tiered by regulation into 4 types of financial services, the first three of which are classified as "formal" and the latter as "semi-formal": banks; credit institutions; microfinance deposit-taking institutions; and co-operativeco-operatives & MFIs. Banks (tier 1) may mobilise deposits, extend credit and perform foreign exchange transactions; tier 2 may do everything as tier 1 except perform foreign exchange transactions; tier 3 may do the same as tier 2, except operate cheque accounts; tier 4 may mobilise savings only from its own members, not the general public, and may extend credit.

Until recently, the insurance industry in effect operated in an unregulated domain. Formal insurance sector legislation, regulation and supervision have only been implemented over the last decade.

3.5.2. Salient features of the microinsurance market

Usage: The insurance market currently serves no more than 8% (1m) of the adult population. Only 3% (0.4m) of adults use traditional (non-micro) insurance (FinScope Uganda, 2006), while an estimated 0.6m (4.6%) use microinsurance⁵⁵. Uganda is therefore unique amongst the sample countries in that the share of microinsurance exceeds that of the higher income insurance market. The low penetration overall is due primarily to the low and irregular incomes of the Ugandan population that leaves little disposable income to pay insurance premiums. Focus group interviews also show that there is limited understanding of insurance and widespread mistrust of the insurance industry among the population. Interestingly, no informal risk-pooling is picked up in the usage data, though focus groups indicate that some community-based informal risk pooling activity does exist and people also appeal to family networks to mitigate funeral and health risks.

Players: The insurance sector is fragmented, with 20 relatively small players. There is a strong foreign presence and 12 out of the 20 insurers are foreign-owned. In the microinsurance sphere, some of the underwriting is done by commercial insurers, some by MFIs providing credit life insurance themselves. There is little if any co-operative or mutual insurance activity.

Products: The life insurance sector is much smaller than the non-life sector and constitutes only 4% of gross insurance premiums. This small share is often attributed to the currency devaluation of the 1980s that undermined consumers' trust in the life insurance sector. 41% of all non-life insurance is "miscellaneous accident" insurance, the category under which credit life insurance is traditionally written. It is therefore an anomaly that most of credit life insurance is not written under a life license. Microinsurance is virtually exclusively comprised of credit life insurance sold through micro-finance institutions (MFIs).

Distribution: Uganda has limited infrastructure available for the distribution of microinsurance. For example, it does not have a formalised retailer network. The infrastructure that is available, e.g. the bank network and cell phone platforms, is currently not actively utilised to distribute insurance. Bank branch infrastructure is concentrated mainly in urban areas, thereby excluding the majority of the population. The payment system is also weak and cash dominates as a means of transacting.

Poor value proposition: Insurance as currently provided in Uganda offers clients a poor value proposition, with insurers spending a large portion of premium income on administration costs. At 35% of net premiums, the average claims ratio is very low (compared to about 60% in South Africa), indicating that little money is paid back to policyholders as benefits. There are several reasons for this, including a lack of efficiency and competition in parts of the industry, and the high costs associated with relatively weak and expensive communications and payment infrastructure. Insurers are small by international

⁵⁵ This estimate is based on an AMFIU (Association of Microfinance Institutions of Uganda) estimate that there are between 500,000 and 800,000 micro-credit borrowers with credit insurance countrywide.

standards, making it difficult for them to spread their fixed costs. A lack of actuarial and other insurance skills also hinders development. The entry of foreign insurers into the Ugandan market is however triggering product innovation and a more competitive marketplace, as seen in a steady reduction in premiums on credit life insurance.

3.5.3. The insurance policy, regulation and supervision landscape

Before 1996, the insurance industry was effectively unregulated, with nominal supervision by the then Department of Insurance within the Ministry of Finance. Insurance regulation was introduced in 1996 with the promulgation of the Insurance Statute, converted to the Insurance Act (Cap 213) in 2000. The Insurance Act governs all insurance business and is supplemented by the Motor Vehicle Insurance (Third Party Risks) Act (Cap 214 Laws of Uganda, 1989) that makes third party insurance compulsory for all vehicle owners. The Co-operative Societies Statute, 1991 and the Companies Act (Cap 110 of 1961) establish the institutional framework for respectively co-operatives and companies. The Insurance Commission was established as supervisor in 1997. The recent nature of the regulation has meant that trust in the industry and a compliance culture is still developing.

Prudential and institutional regulation: The Act does not contain a substantive definition of insurance. It is defined as simply including “assurance and reinsurance”, with no further definition of these terms. By convention rather than definition it seems that provision of benefits without any guarantee falls under informal risk pooling rather than insurance. The act restricts the institutions that may provide insurance to companies, insurance corporations, co-operative insurance societies and mutual insurance companies. The latter is restricted to having between 25 and 300 members, which creates a risk pool too small for responsible underwriting. Consequently no mutual insurance companies have been registered.

Capital requirements are currently about \$580,000 for either a life or non-life license, double that for a composite license, and \$1.4m for a reinsurer. These requirements were instituted in 2002. Previously, local insurers were only required to hold \$115,000, while foreign insurers were required to hold the present \$580,000. This sharp increase for local insurers has been described as a deliberate attempt by the Commission to reduce the number of insurers in the market (subsequently the insurers reduced from 30 to the current 20). Lower capital requirements apply to mutual insurance companies (but not to co-operatives). They are not required to provide any upfront capital, but must hold a surplus of not less than 15% of assets over liabilities, or such other percentage to be determined by the commission.

Product regulation: The Insurance Act demarcates life and non-life insurance and reinsurance, but does not specify a category of medical insurance or how insurers should treat medical insurance. As a result, the Commission interprets it as residing under “miscellaneous” non-life insurance. Composite insurance products may be provided by composite insurers only. The act provides for a scale of minimum premium rates for non-life product lines to be agreed between the industry association and the regulator. The first finalised set of minimum premiums was agreed upon in 2007 and is now being implemented⁵⁶. Furthermore, all new products must be submitted to the Insurance

⁵⁶ Determined according to different products and expressed as a rate per 1000 Ugandan Shillings sum assured.

Commission for approval. Before granting approval, the Commission considers issues like the experience of the insurer in writing the particular type of business, the data and the calculations underlying the pricing. A number of possible micro-insurance products have been rejected by the Insurance Commission for failing in these respects.

Market conduct regulation: The distribution of insurance is limited to registered brokers and agents. A broker is an independent contractor working for commission, while an agent is appointed by an insurer to solicit applications for insurance in exchange for commission. Brokers are required to be bodies corporate or companies incorporated under the Companies Act. Legally, companies may be agents but in practice most agents are licensed in their capacity as individuals. The Act expressly prohibits employees of insurance companies from being insurance agents. Two limited exceptions apply: (i) bancassurance is allowed for banks and micro deposit-taking institutions, but they are only allowed to distribute products covering their own credit exposure; (ii) compulsory third party vehicle insurance, as a commoditised product, may be bought directly at petrol stations. Although direct sale of products by an insurer to the public is not prohibited by legislation, this distribution channel is used on a very limited basis. As there are currently no call centre distribution channels, clients have to approach an insurance company and ask to purchase a product directly.

The Act does not contain any prescriptions on how the sales process should be conducted and whether the client is entitled to advice or product disclosure and what this should entail. It however establishes an obligation for the Insurance Commission to provide a bureau where members of the public can submit complaints related to insurance. It also explicitly prohibits misleading advertising.

Only registered brokers (not agents) may collect premiums on a credit basis. This implies that if an insurance policy is sold by an agent or directly, and the policy is written for a period longer than a month, clients will not be allowed to pay premiums on a monthly basis. The Act furthermore stipulates that a scale of maximum commission rates is to be agreed between the intermediary and insurer associations and the supervisor. Different maximum commission levels are determined for different classes of insurance and these levels vary between 25% for consequential loss and 5% for motor third party insurance. Overall, commissions account for about 24% of net premiums received by insurers in the Ugandan non-life market. Maximum commissions are not set for life insurance.

Financial inclusion policy: Financial policymakers have paid some attention to promoting access to credit or microfinance. The Poverty Eradication Action Plan (PEAP) of 2004 identifies rural financial services (defined as credit or microfinance) as a focus area for the elimination of poverty, though no specific regulations have been issued in this regard. Microinsurance is not included in the scope of the PEAP, but the fact that virtually all microinsurance is credit life means that the development of the rural financial services industry could lead to microinsurance expansion.

3.5.4. Impact of policy, regulation and supervision on the market

Despite introduction of regulatory framework, some regulatory uncertainty continues to plague the market: Regulatory certainty was greatly improved by the establishment of the Uganda Insurance Commission and the introduction of the insurance regulatory framework. Only once such certainty was achieved did foreign insurers start to enter the market.

Therefore the introduction of a regulatory regime was fundamental to the development of the Ugandan insurance market. Unclear regulation and ad hoc enforcement have however meant that some uncertainty has persisted in the low-income market. For example, though insurance is demarcated into life and non-life, some grey areas remain, with common practice being to write credit life insurance under a non-life license. This creates difficulties for those insurers not willing to interpret the law in this way. The absence of explicit health insurance regulation has furthermore created uncertainty for players in this space or interested in entering the market⁵⁷. At the same time it has however also opened a space for market development, with new entrants and product innovation occurring around the regulatory gap. The effects of the introduction of the regulatory regime and the remaining uncertainties are discussed further in Box 4, p.67.

Market conduct regulation inhibits market development: Uganda is judged to have high intermediation costs relative to the other countries included in this study. This can partly be ascribed to the fact that such a large proportion of the population live in hard-to-reach rural areas with poor bank and payment infrastructure that makes premium collection expensive. There is however also a strong regulatory driver behind this phenomenon. Despite limitations, the strongest distribution network remains that of the banking sector. By not allowing bancassurance apart from credit life insurance on the bank's own loans, regulation effectively neutralises the single most important alternative distribution footprint available in a poorly served nation. Furthermore, the fact that minimum premium rates are set stifles competition in the market and the commission caps can make it uneconomical to distribute insurance to lower income consumers. Lastly, the fact that the provision of credit on premium payments is restricted to brokers makes direct distribution unattractive, thereby further limiting potential distribution channels.

Institutional limitations on the market: Whilst the inclusion of a mutual insurance company institutional category in the Insurance Act with lower capital requirements indicates a willingness on the part of the authorities to facilitate insurance provision by smaller mutual entities, the limit placed on maximum membership (300 members) is not high enough to facilitate the creation of a large enough risk pool to write insurance. The mutual option that could encourage community-based insurers to emerge is therefore an option in name only.

3.5.5. Conclusion: insights and lessons from Uganda

Uganda illustrates the challenges of expanding access to microinsurance in a very poor country with a relatively underdeveloped formal financial sector. This is amplified by a lack of well developed informal risk pooling mechanisms – implying that the overwhelming majority of the population is vulnerable to financial shocks. Insofar as it has achieved some take-up, microinsurance has been limited to credit life insurance. As the market develops, it is therefore important for non-credit life insurance to be established in the low-income market. To achieve this, low-income individuals need to be “won over” through positive

⁵⁷ Note that, while health microinsurance is not explicitly part of the scope of the study, this was a particular gap in the insurance regulatory framework that emerged in Uganda. Health insurance was also shown by focus groups to potentially be the product with the highest likelihood of spontaneous demand among the low-income population. This is due to a distrust in the life insurance industry (due to past hyperinflation experiences) on the one hand, and indicative of a poor public health system on the other hand.

experiences in credit life insurance and insurance in general to break the prevailing mistrust in insurance.

The introduction of a new regulatory regime offers the architects thereof a unique opportunity to pre-empt potential pitfalls and ensure a framework that will facilitate financial inclusion – an objective especially important in a country with such high poverty levels as Uganda. While the Ugandan case has shown the impact that the introduction of greater certainty can have, it also illustrates the potential pitfalls to be avoided – namely the creation of an overly restrictive regime designed without explicit regard for financial inclusion, and that leaves certain important market segments with an inconclusive regulatory regime.

4. Factors that impact on microinsurance market development

This section summarises the key factors that were found to impact on microinsurance development in the sample countries and present some hypotheses on how these factors may combine to impact the development of the microinsurance market. Although our ultimate focus is on understanding the impact of regulation, this needs to be considered in the broader country context. We therefore consider four different categories of factors in this section: demand-side (insurance decision), supply-side (particularly emerging channels of distribution), regulatory factors (using the structure of the regulatory framework) and macro-economic conditions (including general infrastructure). We commence with a summary of the salient features common to the microinsurance markets in the sample countries.

4.1. Salient features of microinsurance markets in the sample countries

The microinsurance markets in the five sample countries share a number of key features:

Low insurance and microinsurance take-up: Total insurance take-up (microinsurance and other insurance) is very low in the sample countries. With the exception of South Africa, insurance penetration is consistently below 5% of GDP. Within this, the take-up of microinsurance among adults is even more constrained with only South Africa and Colombia achieving take-up of more than 10% of adults (much of this provided by informal insurers). Microinsurance take-up and insurance penetration for the sample countries are shown below:

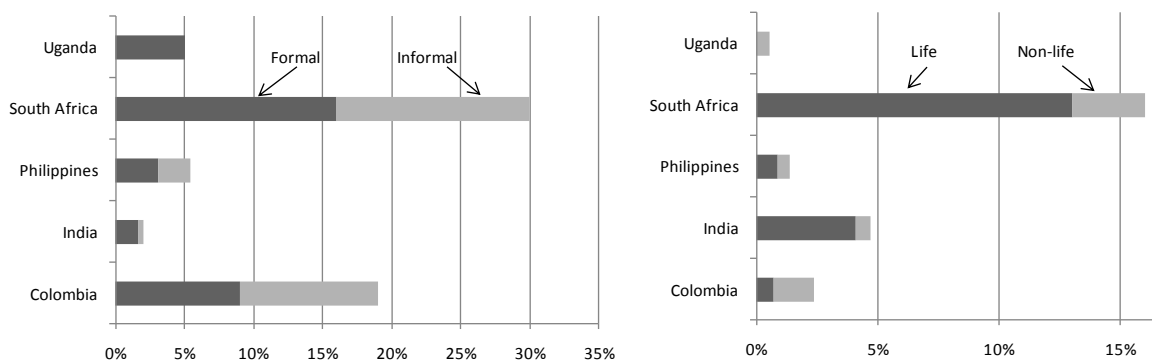


Figure 9: Estimated microinsurance take-up (% of adults) compared to insurance penetration (premiums as % of GDP) across the sample countries⁵⁸

Source: country reports.

Large proportion of population in low-income categories: A large proportion of the population in the sample countries (ranging from Colombia at 19% to Uganda at 96%) live on less than \$2⁵⁹ per day. The ultra-poor (less than \$1⁶⁰/day) population is also significant. Low income levels have two immediate implications: Firstly, it suggests that microinsurance is not a peripheral topic but the appropriate insurance category for a substantial proportion of the population and should, therefore, be a priority for the insurance sector. Secondly, low income levels also imply limited disposable income to allocate to insurance products and a high opportunity cost of doing so. The reality is, therefore, that there will always be a proportion of the low-income population who may simply be too poor to be reached by the commercial insurance market where they are expected to pay the premium. Care should be taken by regulators when designing regulation aimed at encouraging insurance provision at the ultra poor levels. These groups may have to remain the responsibility of government falling in the market redistribution zone as depicted in the access frontier in Section 2.2. In Uganda the low level of insurance take-up (even of informal products) may in part reflect the very low income profile of the population. Though microinsurance expansion is definitely possible, growth will at some stage become constrained by high levels of absolute poverty.

High informality: In all of the countries barring Uganda, estimates have shown that the informal sector accounts for a sizable proportion of the total microinsurance market ranging from 20% in India to 52% in Colombia. Such informal mechanisms may take various forms. In Colombia this is largely made up of funeral insurance provided by funeral parlours that are not regulated for the purposes of providing insurance⁶¹. In South Africa informal insurance is

⁵⁸ Note that India is the only country for which indemnity health insurance is explicitly included in the microinsurance data. This is due to the intricate link between microinsurance and health insurance in India. In the Philippines, some health cover, in the form of an insurance policy that can be claimed in the event of for example an accident, is also included, but indemnity health insurance as a dedicated field, provided by health maintenance organisations is excluded, as it falls outside the jurisdiction of insurance regulation.

⁵⁹ Adjusted for purchasing power parity.

⁶⁰ Adjusted for purchasing power parity

provided by funeral parlours⁶² in similar fashion to Colombia but also on a much larger scale through completely informal burial societies⁶³. For India, this is made up of formal entities providing insurance without being registered for insurance purposes and largely consisting of health insurance schemes. In the Philippines informal provision is largely made up of co-operatives offering insurance but not registered or the purpose of doing so. In the case of Uganda, no quantitative evidence is available to suggest that there is significant informal insurance activity. The focus groups did note the presence of informal risk-pooling groups, but this was not reflected in the available data. This may be more the result of limitations to the available data than a lack of risk-pooling. The apparent low level of informal insurance may, however, also indicate that, given the extremely low levels of income in Uganda, the nature of the risk-pooling mechanisms are largely ad hoc (i.e. no premium collection by a structured society of some kind). Hence it was not picked up in the demand-side survey.

Large reliance on compulsory credit-based insurance: Formal microinsurance is largely comprised of compulsory credit life policies sold on the back of microcredit. Even in the countries where credit life does not make up a majority of the microinsurance market it is still significant and credit life expansion on the back of micro-credit growth remains an important driver of microinsurance growth.

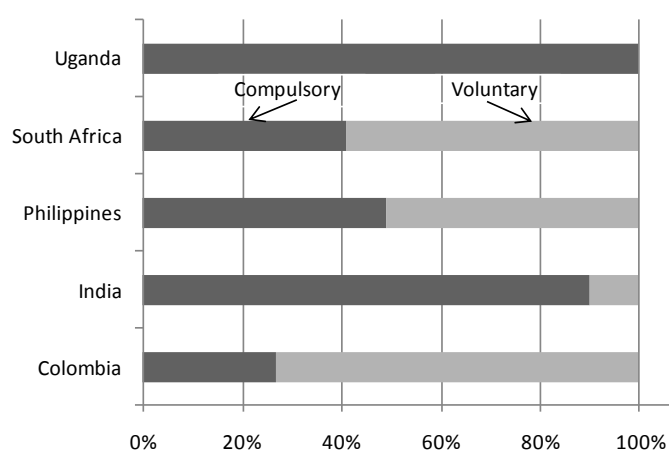


Figure 10: Estimated share of compulsory insurance (number of policyholders) in total formal microinsurance

Source: country reports

Voluntary sales bundled with other products or services and/or through mutual/co-operative channels. Where voluntary take-up does occur, it tends to be funeral insurance

⁶¹ As noted in Section 3.1.4, funeral parlours have managed to obtain an exemption from insurance regulation which allows them to provide in-kind funeral service benefits without having to register or comply with insurance regulation.

⁶² Different to Colombia, these activities are not covered by an exemption to insurance legislation and are, therefore, illegal.

⁶³ As noted in Section 3.4, it is estimated that 80-100,000 burial societies are estimated to provide funeral cover to between 4m and 8m people. This is provided on a non-guaranteed basis so it is not deemed to be insurance.

policies (South Africa and Colombia) or other policies bundled with other products and services. For example: micro-life policies purchased in addition to credit life coverage via the credit provider in the Philippines and accident and health policies added to compulsory credit life in India. To a lesser degree, this can also include non-life insurance policies often purchased via a credit retailer to replace a specific asset such as a mobile phone when lost or stolen as was found in Colombia and South Africa. The overwhelming majority of voluntary products are sold via client aggregators such as co-operatives/mutual associations, MFI networks, retailer networks (in the case of South Africa) or even utility companies (in the case of Colombia). Co-operative/mutual associations play a particularly dominant role in Colombia, the Philippines and in South Africa (if informal provision is included). In India, they do not play an important role in the underwriting of microinsurance, but nevertheless present an important distribution channel for formal insurers.

Microinsurance definitions vary but share low-risk features. The bulk of microinsurance products offered in the sample countries share features that help to limit the risk (prudential and market conduct) of these products, such as:

- Limited benefits: Microinsurance benefits across the sample countries tend to offer low benefit values in line with the needs of low-income households even where regulation does not impose a limit. For the same type of risk and geographical distribution a larger number of smaller benefit policies have a lower risk profile than a smaller number of higher benefit policies.
- Term of contract: For the reasons outlined in Box 2 overleaf, microinsurance tends to be underwritten on a short-term basis. As it is easier to forecast and manage the claims experience on a short-term product than is the case for a long-term product, such products hold lower technical risk.
- Complexity: Complicated products with various components are more difficult to manage than simpler products. Such products are also more complicated for the consumer to understand increasing the risk of mis-selling. Although not done to a sufficient degree across all countries, microinsurance products tend to be simpler in design in order to be understandable to a market with lower levels of financial literacy. This serves to limit the risk of these products.
- Nature of event covered and ability to predict (including availability of data): Although the shorter contract term reduces the risk, it does not remove the risk completely. Insurers still require sufficient data to forecast likely claims experience and price their products. The ability to predict risk experience varies significantly across different product categories. Life risks are often supported by better data that allows for accurate forecasting. Other risks such as weather risks may be more complicated to forecast and the size of the risk event also makes it much harder to manage for an individual (and particularly smaller) insurer. Based on the evidence in the country studies a large proportion of current microinsurance products offered cover high frequency, low impact risk events that are easier to manage. The exceptions like weather insurance, however, remain.

These features are reflected where regulatory definitions have been developed to define a separate space for microinsurance underwriting. For example,

- India defines a maximum and minimum contract term, maximum benefit values and requires availability of the insurance policy documents in the vernacular language.
- The Philippines defines maximum premiums as well as maximum benefit values for life microinsurance and sets simplicity requirements.
- South Africa is proposing a definition that sets maximum benefits, requires simplicity and sets a maximum contract duration (12 months) for the insurance policy. It also limits the types of risk events that may be covered by micro insurers (e.g. excluding weather index insurance).

Box 2. Underwriting methodologies define microinsurance as short term.

Long-term policies require individual underwriting: Traditional life policies are sold and underwritten⁶⁴ on an individual basis. Such policies tend to have a long or whole-life term and the insurer typically cannot cancel the insurance policy without the consent of the policyholder. The premium may also be fixed for the contract period. The insurer is, therefore, tied to the risk of the policyholder necessitating the detailed individual risk assessment to be able to predict risk adequately and assign each individual to a risk pool or category. To manage this risk, insurers require individual underwriting for such policies where the applicant has to fill in a detailed form with biographical and health details and in most cases has to undergo a health examination (or make a health declaration). Successful underwriting will ensure that the actual experience of a specific policyholder corresponds as closely as possible to the expected experience of the risk category to which it was allocated.

Microinsurance mostly based on group underwriting: The individual underwriting process is expensive and therefore simply not feasible for low-income, low-premium policies. As a result, insurers targeting the low-income market often assess the profile of groups rather than of individuals. Combined with the fact that these are new markets on which data is often not available, this implies that insurers do not have as accurate understanding of the risk profile of the group (or the individuals in the group) as they would have had in the case of individual underwriting. Due to this uncertainty, they are generally not willing to commit to a long-term price guarantee or contract and, therefore, group policies tend to be written on a short-term contract basis, with policies sold on a one year or even one month renewable basis. In such a set-up the insurer has the option not to renew the contract or to adjust the price on each renewal in line with the risk experience of the group.

Group underwriting requires short contract terms for risk management: Given that individual underwriting is unlikely to be viable for small premium policies, the conclusion is that microinsurance will by default be short-term. This is also the experience that was observed in the sample countries. Any regulatory restriction on minimum insurance policy contract duration, for example the minimum term of 5 years contained in the life microinsurance definition in India, may however influence insurers' ability to manage risk in this way.

⁶⁴ Underwriting refers to the process of assessing, rating and pricing the risk of an individual policyholder or group of policyholders.

In the next section we explore the demand-side insights gained from the focus groups and combine this with the usage trends noted in this section to consider the reasons for individuals to decide to use insurance without being compelled to do so.

4.2. Understanding the insurance decision

This section looks at the demand-side of the take-up equation. We commence by noting the cross-cutting findings from the respective country focus groups and then synthesize these findings into a potential model to explain the insurance decision for low-income households.

The value of accurate demand-side data: Before proceeding, it is important to note that initiatives to expand the market are greatly aided by the availability of accurate data. In South Africa and Uganda detailed demand-side survey data are supporting policymakers and insurers in defining ways of achieving low-income market expansion. Although not comprehensive, recent surveys of the insurance sector in Colombia has catalysed an increased level of interest in this market. The absence of detailed demand-side data for the other countries has meant that this project had to rely on estimates triangulating from the limited sets of data that are available. While this is sufficient to derive high level market figures, it provides little help to, for example, insurers that have to conduct more detailed analyses for product development, pricing and market sizing.

Focus groups such as those conducted as part of this project, although not providing quantitative data have also proven to be very useful to gain a qualitative understanding of the needs and financial behaviour of low-income households. It is these results that we discuss in the next section.

4.2.1. Insights from focus groups

Methodology: Qualitative focus group research, where groups of low-income people are encouraged to discuss their risk experiences, their perceptions and understanding of insurance, were conducted for each of the country studies. Participants are typically not informed beforehand that the topic of discussion will be insurance. In this way people from a similar background interact to share their perceptions and experiences. Different participant recruitment methodologies were applied in the different country studies:

- In Colombia, six focus groups were held of 10 lower-income people each, three in Bogota and one each in three other cities.
- In India, participants were selected from respectively the clients and non-clients in the target area of various NGOs/MFIs. Interactions were had with 115 clients through 10 focus groups and 75 non-clients through another 9 focus groups.
- In the Philippines, discussions were held with 73 participants in nine groups selected from current and potential clients of MBAs and MFIs that offer microinsurance.
- In South Africa, six groups of between 6 and 8 participants each were conducted on asset insurance – three male and three female. Groups were selected to represent the poorest and next-poorest levels of the income spectrum. All participants were urban (from the greater Johannesburg area), but some had rural links. In addition this was combined with earlier focus groups on funeral insurance (12 groups covering rural and urban, male and female as well as different age groups).

- In Uganda, 12 focus groups discussions were held in the rural and urban areas of Uganda. These groups included males and females classified as very low-income (earning US\$1-3 per day), lower-income (earning US\$3-9 per day) and middle to higher-income (earning more than US\$9 per day).

The focus group research revealed a number of cross-cutting demand-side insights⁶⁵ into the state of the microinsurance markets which we summarise below:

- The poor face various material risks: In all the focus groups, the poor indicated an awareness of being exposed to risk. Health risks, in particular, were emphasised. Also the risk of the death of a breadwinner, or of becoming disabled or unemployed was often cited as of particular importance. Generally, the risk that assets will be damaged or lost, though acknowledged as important, was afforded less priority in the minds of respondents:
- In Colombia, the death of a breadwinner was stated as the most important risk (combined with the need for funeral expenses), followed by accidents, illness, hospitalisation, disability and natural catastrophes
- Risk of death, unemployment or sickness was stressed in South Africa.
- Health was the top priority for more than 60% of participants in the Indian focus groups.
- Illness in the family was the only risk for which respondents in the Philippines indicated a spontaneous need for risk mitigation.
- “Well, it is sickness because you are not sure and it is your life. You can forego a wedding but you cannot forego sickness. You have to attend to it immediately.” (Ugandan respondent)
- Low knowledge and awareness of the insurance value proposition was one of the main findings across all the focus groups. Though some respondents did indicate that they are familiar with insurance as a form of protection that gives one “peace of mind”, uncertainty remained around the working of insurance. For example, in the Philippines, some focus group respondents indicated that they have never had any explanation or introduction to insurance. Without such an introduction to insurance, they have not considered buying an insurance product. Furthermore, the fact that there is no pay-out if no risk event occurs was raised as an issue in several of the focus groups. These points to a lack of understanding of the value proposition of insurance as protection against risk events, rather than as a savings vehicle providing a return regardless of risk. The following responses from the Ugandan focus groups underline the limited knowledge and awareness:
- “There is one reason why I would not go for insurance, even if it is charging me one shilling, you say you have insured me for let us say burglary, no burglar comes even close to my house to take anything. At the end of the year I would have given the insurance company free money.”

⁶⁵ All such insights are to be regarded as qualitative only and are not statistically representative of the low-income population.

- "Sincerely this community knows nothing about insurance. Most of the insurance companies are based in the city. Those that we know, we see adverts as we go to Kampala."
- "I don't trust insurance companies because I cannot trust something I don't have full knowledge about. I need to be educated fully about it and therefore I can decide whether to trust it or not."
- **The importance of trust to achieve insurance take-up:** The introduction to insurance is greatly facilitated where there is trust in the provider or intermediary. This can be, for example, trust of community or member-based groups, trust attached to a particular brand (retailers, utility companies and banks are examples of this) or trust derived from word of mouth of positive claims experience. Conversely, the insurance transaction is complicated where trust is undermined where, for example, institutions fail and cannot meet their obligations under the insurance contracts; claims are rejected without proper cause, etc. The focus groups revealed a general mistrust of the formal sector and the insurance sector in particular:
 - In India, the lack of trust and low perceived benefits were only outstripped by lack of awareness and affordability issues as reasons for not taking up insurance.
 - "I do not trust them. They are profit making companies. They do not benefit people..." (Ugandan respondent).
 - In the Philippines many of the focus groups participants indicated that they do not want to purchase any type of insurance products due to past bad experiences with a big commercial insurance provider and, more recently, some pre-need companies who defaulted on their commitments. This damaged the reputation of the insurance industry in the minds of the low-income market.
 - The same experience occurred in Uganda when hyperinflation eroded the value of life insurance policies two decades ago: "Previously insurance was okay. Government used to honour claims but eventually they failed and people completely lost the idea of insurance." (Ugandan respondent).
- **The importance of quick and reliable claims payment:** Claims payment emerged as an important factor in determining people's perception (and trust) of insurance. The need exists for speedy claims payment with little administrative hassle. A past negative or slow claims experience, or hearing about the negative claims experience of others, may lead to a negative perception of insurance:
 - "They take long to compensate their customers when risks occur. That is what I have heard but I don't know whether it is true" (Ugandan respondent).
 - "I have seen the bad experience my grandmother had with her cell phone insurance. When it was faulty, they kept on fixing it without replacing the phone. ... It cost us transport money to take it in. From there on, I hate everything and anything about cell phone insurance, as they will not replace the cell phone. The process was tedious and annoying. Moreover, in the meantime you suffer as you have no other phone to use and you are paying" (South African respondent).
 - This also emerged outside of the focus groups. The long delay in claims payments was the main motivation for CARD MBA to move to their own insurance license. Also

most of the complaints received by the Ugandan Insurance Commission are related to delays in claims settlement.

- **Affordability and spending priorities:** Even where respondents acknowledge that insurance could offer value, affordability is a problem given other spending priorities. This is especially relevant for those participants with irregular incomes or persons who cannot commit to a fixed premium amount every month. It must be noted, however, that this may relate to perceived affordability as respondents were not always informed on the actual cost of insurance:
- Affordability was listed as second only to lack of awareness as reason for not taking up insurance among focus group participants in India. It was however noted that this is correlated with a lack of awareness. Even should products be available that are actually affordable, respondents tended to perceive insurance as unaffordable.
- In Colombia, some participants indicated that they did not have insurance because they perceive it to be expensive and because they believe only high-income people can buy insurance.
- In the Philippines, focus group discussions revealed that participants spend 50%-70% of their total income on food and the education of children, leaving little if any room for insurance
- "...it is very expensive to afford it is usually big organisations and the rich" (Ugandan respondent)
- Price sensitivity may vary for different product categories. A surprising observation from the South African focus group discussions was the relative insensitivity towards the price of funeral cover, with no concern expressed by one respondent upon finding out that another respondent in the same group is paying much less for the same amount of cover. This is however not the case for asset insurance products: "... a cellphone insurance may cost R35. If I have R50, I cannot spare R35 to pay insurance because I need to use the same money to pay transport to go and pay the insurance. As it stands now, I do not have a bank account where insurance money can be debited." (South African respondent)

Conclusion: The focus group insights indicate that, though affordability is perceived as a significant access barrier, trust and low levels of knowledge and awareness dominate in the explanation of low insurance demand despite high levels of need. Low levels of awareness also reflect the often limited sales effort that has been invested in the low-income end of the market.

4.2.2. Towards a model of the insurance decision

Based on the experience in the sample countries we have modelled a behavioural pattern which could help us to understand individual clients' decisions to obtain insurance or not. Whilst this framework is consistent with the observations across the respective country studies, it requires further research to substantiate.

The model of the insurance decision by an individual is shown in Figure 11:

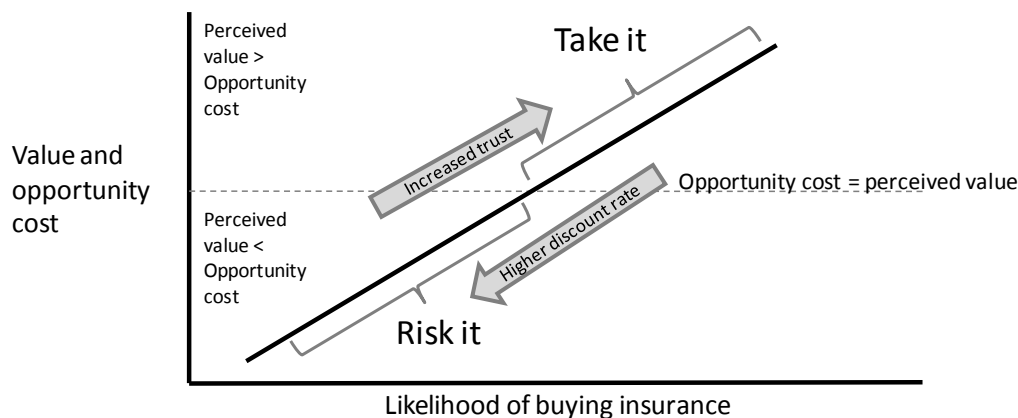


Figure 11: Model of the insurance decision

Source: Chamberlain, 2008

The basic premise is that, unless compelled, an individual will only buy insurance if the perceived value of the insurance product exceeds the perceived opportunity cost of purchasing it. The fact that this is ‘perceived’ is important as consumers are not always fully aware of the cost or able to assess the value of the benefit. The insurance decision can then be analysed in terms of the various factors that determine perceived cost and perceived value. If the perceived cost exceeds the perceived value, the consumer will not buy the product and “risk it”, i.e. accept the risk of a particular event happening rather than insure against it.

Perceived cost is determined by both the value of the premium and the opportunity cost of paying that premium. A low-income consumer who has to give up other consumption to pay an insurance premium will attach a much higher opportunity cost to this than a higher-income consumer who does not have to sacrifice any consumption to pay for the premium. This correlates with the general finding of the study that income levels correlate with take-up and that growth in take-up correlates with economic growth.

Perceived value is influenced by at least the following three factors:

High cash discount rate and the nature of the benefit: The phenomenon of over-discounting by low-income households⁶⁶ would seem to be a strong driver in the decision of low-income households to purchase insurance. The discount rate refers to the rate at which a person discounts (reduces) the value of any future benefit to reach a current or “now” value. Experience shows that low-income households place a disproportionately high value on current consumption relative to deferred consumption in favour of a future benefit (i.e. over-discounting the future benefit when comparing to current opportunity cost or benefit). The experience of insurance products found in this study suggests that the phenomenon of over-discounting may be exacerbated for financial benefits (a cash pay-out) in comparison to

⁶⁶ Behavioural economics challenges neo-classical theories such as the life cycle hypothesis and the permanent income hypothesis by posing a hyperbolic discounting theory that argues that people over-discount future needs in favour of current consumption. See for example Deaton, 2005.

tangible benefits (e.g. the funeral service, or replaced mobile phone). Another example is the accident insurance products in Colombia that offer life or disability cover that pays out in the form of a cash amount combined with a coupon to purchase groceries, plus a monthly fee for one year's educational expenses for every child in the family under 18, plus the funeral service. Low income clients are therefore likely to choose a microinsurance product which promises to deliver a tangible benefit rather than a product which promises a cash payment only.

- **Levels of trust:** The perceived value of an insurance product is higher where the consumer has a higher level of trust in his/her ability to be able to lodge a successful claim. Several factors impact on the level of trust. A complex product with a lengthy contract document containing much fine print may lead the consumer to distrust his/her ability to successfully claim compared to a simpler or commoditised product with more understandable terms and disclosure. In the same way insurers that have demonstrated that they are willing to pay legitimate claims promptly will be trusted more and their products will achieve a higher perceived value. As mentioned in Section 4.1, specific categories of entities such as mutual/co-operative associations or trusted clothing retailers have also been able to achieve a higher level of trust. That is why member-based groups are consistently more successful at distributing microinsurance than individual agents or brokers unknown to the customer.
- **Probability of the risk event occurring:** Products covering risk events such as health and life risks with high frequency and/or probability of occurrence will achieve a higher perceived value than products that cover assets risks, where the risk event may not occur at all.

The model of the insurance decision described here goes some way to help us understand the dynamics driving the demand for microinsurance. The next section seeks to categorise the supply models observed in this study.

4.3. Making a market for microinsurance

A variety of models are being used to intermediate microinsurance with varying degrees of success. In this section we categorise the models that were found in the sample countries and describe their relative success in achieving insurance take-up. The experience is remarkably consistent across the five countries allowing us to draw conclusions on the features required to achieve microinsurance take-up. This section does not present an exhaustive discussion of all the possible models⁶⁷, but seek to highlight key categories of models and their salient features that may help us to understand their success or failure to intermediate microinsurance. Such an understanding will also help regulators to design an appropriate regulatory space.

Evaluating success: Before proceeding it is important to consider the criteria against which to assess the models. As noted in Section 2.1, financial inclusion means that people not only have access to appropriate and affordable products, but that they actively choose to use

⁶⁷ We also note that, in practice, business models may combine some of the features that we present as distinct categories. Models do, however, exist for each of these categories and even if combined, the assessment of the specific category features will remain valid.

them to mitigate their risks. Ultimately our interest is in facilitating increased take-up of insurance products that are affordable and appropriate to the needs of the poor. However, take-up by itself is not a sufficient objective. Consumers may, for example, be forced to take out insurance without being aware of the cover or how they can claim. Alternatively, mis-selling may result in take-up but the consumer may not be able to claim due to exclusions that were not made clear to the client at the time of the sales transaction. The objective is, therefore, to increase take-up of appropriate insurance products in manner that the client can actually claim.

Positive market discovery: Based on the country experience, we propose that this objective can be achieved where a particular business model ensures *positive market discovery*.

- Market discovery means that the consumer must be introduced to the product in a manner that allows them to understand the value that insurance may hold for them. This is in line with the old adage that insurance has to be sold (i.e. you need a “market maker”) and is also supported by the finding in Section 4.2.1 that low levels of knowledge and awareness are a key barrier to inclusion.
- Positive discovery means that they should not only be sold the product but must be able to claim on it thereby resulting in a positive demonstration of the value of the product.

No discovery will take place if the client is not aware that they are covered by insurance and the discovery will be negative if a claim is rejected for reasons that were not explained to the client at the time of purchase. Once the market for a particular microinsurance product has been made through this process of positive market discovery, it allows other less expensive models to extend the market.

Below, we assess five categories of models emerging from the country case studies based on their ability to achieve positive market discovery.

4.3.1. Compulsion

Dominant microinsurance channel: Compulsory insurance in the form of credit insurance on the back of loans is the single biggest category of microinsurance across the sample countries. It represents the vast majority of microinsurance policies in India and Uganda and is estimated to account for about half of the microinsurance market in the Philippines. In South Africa, it is outstripped only by funeral insurance. In Colombia, compulsory credit life is the fastest-growing segment, driving the overall growth of microinsurance. This product category has evolved on the back of credit expansion and was initially driven by lenders seeking to manage their risk of default. As result, this product is still sometimes seen as covering the risk of the lender rather than the risk of the borrower.

Compulsion and captive markets: This product is compulsory as the lender can insist on the consumer buying the insurance product (normally life insurance or insurance against default in payment) as a pre-condition to obtaining a loan. In some cases (e.g. South Africa) such compulsion is officially sanctioned by legislation allowing the lender to insist on such cover but giving the borrower the right to choose the provider of insurance. In some cases the cover may not be disclosed to the consumers who remain unaware that they are covered, what the cover costs and even that premiums are deducted as part of their loan repayment

(or even funded in advance out of the loan in some cases). In jurisdictions such as South Africa where legislation gives consumers the right of choosing the provider of the insurance policy, consumers are however often not informed of this right. In practice, therefore, this provides the lender a captive market to sell its own or preferred insurance policies often resulting in overpriced premiums as there is little threat of competition.

Positive discovery depends on disclosure: While some jurisdictions, such as South Africa, compel the credit provider to disclose the existence of the credit life insurance policy and provide the customer with a choice as to the insurance provider used, some countries place no obligation on the creditor to provide a choice or to disclose the existence of the insurance policy. Even where disclosure is required by law, limited enforcement means that lenders who are not incentivised to disclose details to the client are not forced to do so. This can lead to abnormally low claim ratios and poor value to the client. The potential of the compulsory model to lead to positive discovery of microinsurance therefore requires that the existence of the policy and its terms be disclosed to the credit client.

Potential to offer value to consumers: The compulsory model is attractive as it reduces the cost of intermediation significantly. The same network and staff are used to market the credit and sell the insurance policies, and premium collection is conducted via the loan repayment mechanism. In some cases, these policies have evolved to be more client centric offering additional benefits of value to the consumer and ensuring that the client is in a position to utilise these benefits.

Compulsion can facilitate positive discovery: Although the compulsory models described above run the risk of negative or no insurance discovery, with appropriate regulation it can be a powerful tool to extend insurance in the low-income market. A positive experience with credit insurance may encourage consumers to utilise insurance for other risks without being compelled to do so.

4.3.2. Re-invention

Spontaneous informal risk-pooling: In the absence of formal insurance provision or simply because they are unable to afford it, low-income communities often develop informal risk pooling mechanisms as a means of coping with risk events, thereby effectively re-inventing insurance. For example, burial societies or co-operative insurance societies are formed to provide support to members who have lost a loved one and need to incur the cost of a funeral. Such informal schemes may evolve over time into formal insurance programmes or remain informal providers of risk cover. Sometimes risk pooling is not the primary reason for the existence of a community-based institution. For example, many co-operatives evolve to provide other services, financial or otherwise, and only start to offer in house insurance or risk pooling at a later stage.

Trust in the mutual mechanism: In contrast to the lack of awareness and trust in formal insurance, focus groups highlighted the role of community and member-based organisations (such as co-operatives or mutuals) as a trusted source of risk mitigation. This is the case even where member-based institutions may be unregulated and much weaker than commercial institutions and the trust may, therefore, be misplaced. Nonetheless this inherent trust allows mutuals to overcome some of the demand-side barriers presented in Section 2.1.

There is evidence of such member-based activities in all the sample countries⁶⁸ and they play a particularly prominent role in Colombia and the Philippines where the bulk of microinsurance is provided by member-based channels, as well as in South Africa if the informal market is included.

Box 3. Co-operatives and mutuals as member-based organisations

Mutual or co-operative entities may take different forms in different jurisdictions, often with important institutional distinctions between them. For example, the various country studies refer to co-operatives, co-operative insurers, mutual insurers, mutual benefit associations, mutual fund schemes, co-operative societies and friendly societies, to name just a few. There is no general consensus on the difference between co-operatives and mutuals and the two types of organisations share many basic characteristics. It can be argued that the following conceptual distinction applies:

- **Mutuals:** In an insurance context, the members of a mutual insurer are the owners of the insurer. Individuals become members of a mutual when they purchase an insurance policy. Thus all members are also policyholders and all policyholders are members. Votes are generally proportional to the number of policies held or the value of the insurance policies. As owners, policyholders/members are responsible for the governance of the organisation. The surplus is redistributed to members. While mutuals may be member-managed to a varying extent, the norm is for mutual insurers not to be member-managed, but to outsource the function to professional managers. Mutual organisations may however also exist more informally than mutual insurers, for example the friendly society or the mutual benefit association. In all instances, however, the principle of mutuality of interest among members remains.
- **Co-operatives:** The co-operative can be defined as a distinct type of organisation based on the principle of mutuality/common interest among members. Unlike mutual insurers, the co-operative's *raison d'être* is usually broader than the provision of insurance which is often a secondary activity of the organisation. The members of the co-operative do not necessarily have to purchase an insurance policy, i.e. membership does not necessarily imply policyholder status. Member-management is furthermore proportional to membership rather than number of policies, with each member generally being assigned one vote. Co-operatives can however also grow into larger networks or become co-operative insurers, where the main purpose does become insurance provision. The principle of member-ownership and governance however remains core.

Member-based entities. Both mutuals and co-operatives can be defined as member-based entities to be distinguished from corporate entities. A number of characteristics mark the member-based form:

- **Ownership/governance/benefit:** The member-based organisation is owned and

⁶⁸ While co-operativeco-operatives are present in Uganda, there are currently no co-operative insurers. Focus groups do, however, indicate some level of informal risk pooling.

governed by its members, for their mutual benefit, and with the surplus accruing to the members (that are in most instances the policyholders).

- **Management:** Small mutual/member-based organisations usually start out by being managed by the members themselves. This may progress to professional management being appointed by the members. As long as members own and govern the organisation, the delegation of management does not undermine the member-based/mutual nature.
- **Membership character:** How membership is obtained may also define the organisation. In some cases, all members are also policyholders (mutual insurers), in others all members are not necessarily policyholders (some co-operatives) and sometimes (as is the case in Colombia) policies may even be sold to non-members. This is however not a central defining characteristic of whether an organisation is member-based or not.
- **Nature of risk carried:** In many smaller/informal mutual-type organisations, risk is pooled informally, for example the burial society – sometimes on an ex post basis (i.e. all members contribute to support the one who has suffered a loss), sometimes on an ex ante basis (all members make regular contributions to a pool, which is then used to compensate members incurring a specific loss). In other organisations there has been a progression to guaranteed benefits. While entities can be distinguished on the nature of the risk carried, they remain part of the overarching member-based organisation category.

In this document, co-operatives and mutuals (in whatever way they manifest and are defined in each of the countries) are regarded in their capacity as member-based organisations.

4.3.3. Derived demand

Voluntary insurance uptake is most often the result of demand for another product or service: Derived demand for microinsurance occurs where the client does not set out to purchase insurance and may not even be aware of the existence of insurance products, but is induced to buy an insurance product based on his or her demand for another product or service. The secondary demand for insurance is therefore derived from the primary demand for another product or service. Examples include the following:

- In South African culture, an expensive funeral is regarded as an “unavoidable expense”, forcing people to plan ahead by taking out funeral insurance. It is therefore the demand for funeral services that drives the demand for insurance, rather than the need for life insurance in general. This is supported by the fact that 40% of formal funeral cover in the low-income market is bought via funeral parlours. This is also the case in Colombia, where funeral service providers selling funeral cover (albeit outside of the formal definition of insurance) account for more than half of the total microinsurance market.

- In India, voluntary insurance, where it exists, often relates to the need to take out insurance to cover health expenditures – a service that people know that they will not be able to afford when needed.
- For non-life products, the South African focus groups revealed that, even where a person deems non-life insurance to be important, they will only buy it in practice when related to the credit purchase of a household good or a cell phone, generally regarded as an essential asset for social and business/employment purposes. Colombia is also experiencing increased demand for cell phone insurance among the poor, as well as for motorbike insurance (with motorbikes being a vital transport and business asset to many).

Distribution through same channel as underlying product or service: Insurance based on derived demand is most often distributed through the service provider (for example funeral parlour) or product distributor (seller of mobile phones) of the product or service which the client set out to purchase in the first instance. This reduces distribution costs. Trust in the insurance product may be supported by the credibility of the service or product provider.

4.3.4. Passive aggregators

Innovative new models are emerging to intermediate microinsurance at a low cost without attaching it to any other product or service. These models may leverage existing client bases (e.g. retailers) or reach out to a large number of people through clever marketing combined with low-cost passive sales strategies. This requires products to be sufficiently simplified to be sold through such channels. Examples of this model include:

- Retail client bases: In this model insurance is sold to the existing client base of a retailer focused on the low income market. The target market consists of the clients of the retailer (who serves as the aggregator) to whom insurance products are sold either passively or actively by the sales personnel of the retailer.
- Public utilities: In Colombia Codensa, an electricity utility company in Bogota, succeeded in converting the majority of its electricity clients to funeral insurance using a tick-box option on the utility bill.

Low cost but limited success: While the low cost distribution of these models are appealing the experience to date shows limited success beyond funeral insurance that can be easily commoditised and where other players such as funeral parlours have “made the market” as described in the introduction to this section (using the derived demand model described in Section 4.3.3 above). While passive aggregators are, therefore, able to extend existing markets at lower costs, the evidence suggest that they are unable to make a market for products that low-income clients may be less familiar with.

4.3.5. Individual agent-based outbound sales

Greenfields sales of insurance: This refers to the traditional model where an individual agent sells insurance (without being attached to another product) typically through face-to-face interaction with the client (but it can also be done through out-bound call centres). Agents also distinguish themselves from the other channels in that they usually provide advice on the appropriateness of the insurance products which they sell. Although sales to groups, for example the members of a religious group, labour union or employer, and

innovative use of technology can reduce the cost, this remains an expensive channel. As the insurance has to be sold on its own merit, much time needs to be spent with the client to inform them of the benefits. This is particularly challenging where the client has not been exposed to insurance before.

As result, this model is unlikely to make significant inroads into the low-income market, unless it moves away from the traditional agent model described here to more non-traditional models such as MFIs or other groups (and their staff) acting as agents (channels 1-4 above). This is particularly the case where market conduct regulation increases the regulatory burden on advice-based sales as is the case in South Africa.

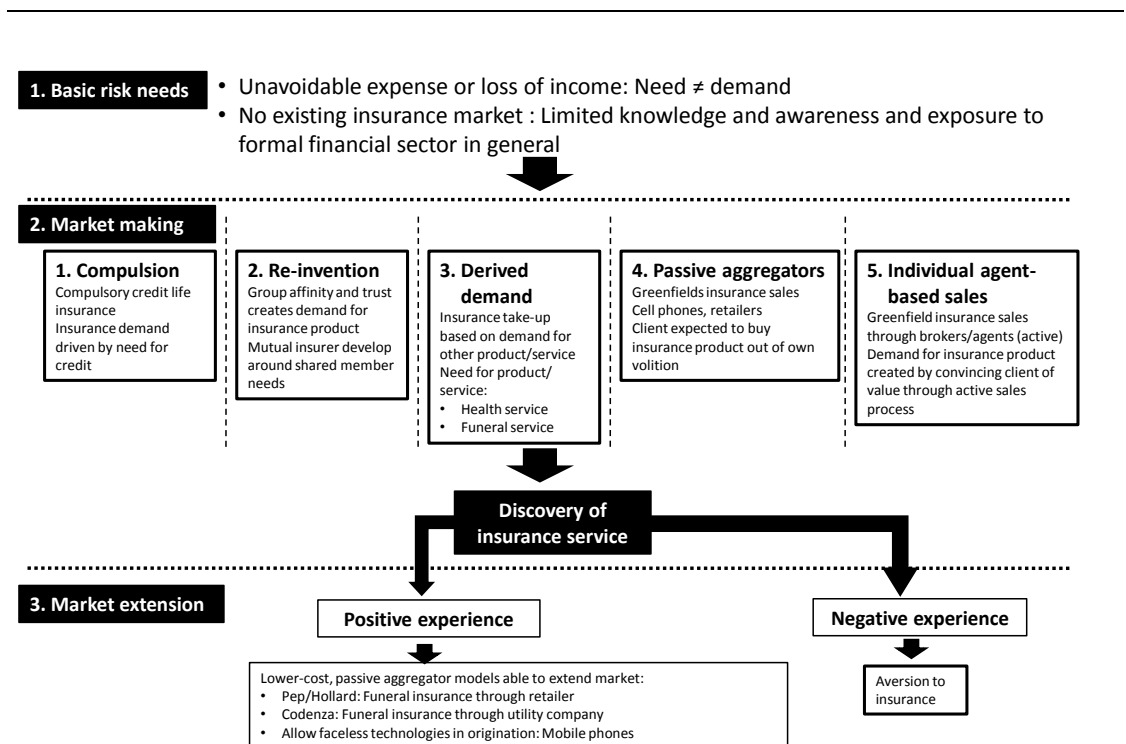


Figure 12: The evolution of the microinsurance market.

Source: Bester & Chamberlain, 2008.

The insurance discovery process and the channels through which people are introduced to insurance are depicted in Figure 12 above. Channels 1-3 are in-bound but for reasons not relating primarily to the purchase of insurance. Channel 4 is in-bound purely on the merit of insurance and Channel 5 is outbound providing the means to sell insurance on its own merit.

The experience of the country case studies is that the bulk of microinsurance is sold through channels 1, 2 and 3. However, regulatory models often favour channel 5 as it is, in theory, able to provide advice. In some cases regulatory systems may even restrict distribution to a particular model (typically channel 5). In practice, however, advice-based distribution by brokers and agents may be too expensive for low-premium products, making this model unattractive.

Regulation may (sometimes unintentionally) also facilitate channel 1 by allowing compulsion but few regulators consider the consumer protection concerns arising from the captive client

base and limited competition. While this channel may be efficient in achieving take-up, it is clear that the incentives are not always in place to ensure positive market discovery. Regulation needs to ensure that efficient channels such as credit life do not only achieve take-up but also provide value to clients. Disclosure of the existence of the insurance policy and its terms is crucial to this process.

The low-cost and innovative passive aggregator models (channel 4) hold great potential to support market development, but current evidence suggests that they are unable to create a market for a new product, that is: they rely on prior discovery through another channel before they can achieve success.

These categories over-simplify the picture and, in reality, a large variety of models exist that may combine features of different categories. 10 years ago few would have predicted the innovative use of mobile phones in various distribution models and in various ways. Regulatory systems that restrict intermediation to traditional agent models may, therefore, exclude these new innovations and undermine market development.

4.4. Impact of policy, regulation and supervision on market development

The country studies have shown that regulation does indeed influence the development of microinsurance markets both by its presence and its absence. Moreover, it is not only the details of legislation that are relevant, but also the general approach followed by policymakers and regulators and how policy-making in the insurance space relates to other spheres of policy and regulation.

In this section we summarise the impact of various features of regulation on microinsurance market development as observed in the sample countries. We commence this discussion by noting three general features of a regulatory framework that may have a significant impact on market development and then proceed to explore the impacts of specific aspects of regulation and its enforcement by using the structure of the regulatory framework discussed in Section 2.8. In each case the impacts are illustrated with reference to experience in one or more of the sample countries.

4.4.1. General features of the policy, regulatory and supervisory framework

Regulatory approach impacts on market development. The basic approach followed by a regulator in the design and implementation of regulation under its control may have a significant impact on the nature and level of market development. There are particularly two characteristics of the regulatory approach that we have identified to impact on market development:

- **Pro-active or re-active:** The Philippines and India have proactively developed a microinsurance policy and South Africa is in the process of doing so. In different ways all three of these actively encouraged or even pushed providers to enter into the microinsurance space. Uganda and Colombia, on the other hand, have not created a special dispensation for microinsurance and, instead, have followed a market-led approach where the initiative was taken by the providers and no pressure was exerted by the regulator and supervisor for them to do so.
- **Facilitative versus exclusionary approach:** A facilitative approach accommodates market-led developments, allowing new models to evolve except where explicitly

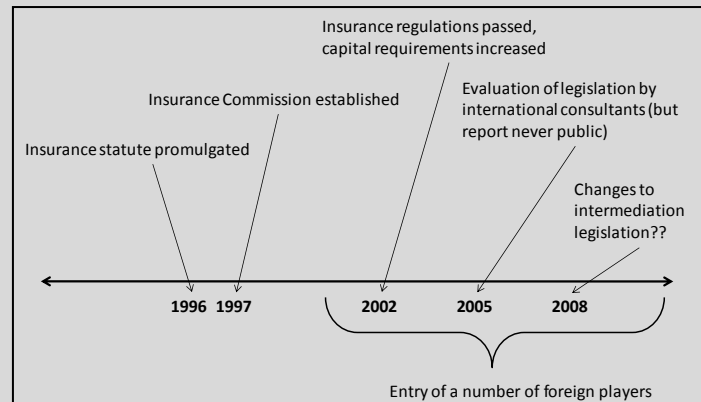
prohibited and choosing to intervene only when the risks posed become material enough to justify intervention. Financial regulation in the Philippines generally follows this approach where new business models are allowed to enter (with careful monitoring) even if no explicit regulatory space exists for them. Regulation is then gradually adjusted to accommodate them where relevant. The exclusionary approach seeks to dictate what form development should take prohibiting new models except if explicitly allowed in regulation. Regulation in for example India follows more of an exclusionary approach. In an environment of fast changing models and technologies it is increasingly difficult for the regulator/supervisor to lead market development and “pick winners” as the exclusionary approach requires. The result is that innovative new models are frustrated by the long process of opening the regulatory space to operate.

Regulatory uncertainty may undermine microinsurance development. Regulatory uncertainty disincentivises the entry of legitimate players into a specific market due to the risk that regulation may change or be introduced that may close down a specific model or space. If not appropriately monitored, models that operate in the grey areas of regulation may raise the reputational risk for legitimate players to enter into the same space. Ironically the impact of both regulatory certainty and uncertainty is best illustrated by the same country, Uganda. After decades of having no insurance regulation at all, the regulatory certainty provided by the introduction of an insurance law encouraged a number of foreign insurers to enter the market. However, the new regulatory framework had some critical gaps creating uncertainty, for example, on the exact treatment of health insurance under the new law. This uncertainty has discouraged a number of potential providers of health insurance from entering the market (refer Box 4) while leaving the room for other models to operate unregulated.

Regulatory certainty can also be achieved under a facilitative approach and does not necessarily require detailed regulation in all areas before market development can proceed. Clear policy in favour of market development may, for example, provide new entrants with sufficient certainty that their models are in line with government’s view on market development even if regulation on a specific aspect remains uncertain.

Box 4. The impact on market development of the recent nature of the insurance regulatory regime in Uganda

Recent regulation: Insurance regulation is fairly new in Uganda. The insurance statute was promulgated in 1996, the Insurance Commission was established in 1997 and the insurance regulations were passed in 2002:



Prudential issues addressed first. Before 1996, the insurance industry had no insurance regulator and no effective supervision other than being nominally supervised by the Ministry of Trade. Even insurers unable to fulfil basic operational functions were allowed to operate and there was no compliance culture. Post-1997, the newly established Insurance Commission focused on developing a culture of compliance and on achieving its mission, namely a sound and stable insurance industry. Its focus was therefore on stabilising the existing industry rather than extending the insurance frontier and it is only now starting to consider financial inclusion issues.

The fact that the regulatory regime is so recent has had a number of impacts on the microinsurance market:

The presence of regulation has encouraged entry of foreign players: 12 of the 20 insurers currently active in the Ugandan market are foreign-owned and entered after insurance legislation was introduced. Even though foreign ownership was not prohibited before, foreign insurers were reluctant to enter given the regulatory uncertainty and risk they would face.

Remaining uncertainties undermine market development: Despite the greater certainty created by the implementation of the insurance regulatory regime, the fact that the regulation is still so new has meant that some regulatory uncertainty remains. This uncertainty relates especially to two major areas: the demarcation of health versus other categories of insurance; and the demarcation lines between life and non-life insurance.

- **Lack of health insurance definition distorts market:** The Uganda insurance law does not refer to health insurance. It is therefore usually written under a short-term insurance license. The fact that it does not explicitly appear in regulation has however been exploited by some operators, most notably Health Management Organisations that provide health insurance outside of insurance regulation. On the formal sector side, the loophole has led to some reluctance on the part of registered non-life insurers to enter the health space, should they thereby open themselves up to regulatory risk and face an unlevel playing field having to compete with the unregulated HMOs. This is a phenomenon that could also be preventing innovation in health microinsurance.
- **Life vs non-life demarcation loophole creates unlevel playing field:** Though

insurance is demarcated into life and non-life insurance and an insurer that does not have a composite license must register as either the one or the other, some grey areas remain. One insurer, for example, is providing credit life insurance under its non-life license. It justifies this on the basis that it only provides a pay-out to the client in the case of accidental death, which is a risk that may be written under a non-life license. However, it provides a payout to the MFI for the outstanding account balance of the client irrespective of the cause of death. This creates an unlevel playing field for those insurers reluctant to engage in such grey area activities (that could strictly speaking be regarded as illegal insurance practices even though the supervisor has not put an end to the practice) and in this way could be undermining competition in the credit life market.

Overall regulatory burden determines the need for microinsurance dispensation:

Ultimately regulation dictates who may operate in a specific market and how they must conduct their business. Both intentionally and unintentionally, compliance with regulation imposes costs on businesses and may also exclude some (e.g. by preventing foreign ownership of domestic insurance firms, or prohibiting legal persons other than public/stock companies from conducting insurance operations). Together the degree of compliance costs and exclusions determine the ultimate regulatory burden of a particular system. There is also a natural tendency for this burden to increase over time as the sophistication of incumbent market players and products increase.

If the overall regulatory burden is low, formal microinsurance (as opposed to informal market development) may be able to develop without any further regulatory interventions as the regulatory burden is not prohibitive. This is for example the case in Colombia where a low overall regulatory burden combined with general inclusion policy meant that no explicit intervention around microinsurance was required in order to catalyse the development of this market. In contrast, where the overall regulatory burden is high it increases the need for special policy or regulatory exemptions to encourage the development of formal microinsurance. In the sample countries such regulatory initiative has manifested in two forms or in a combination of these: (i) a dedicated (exempted) microinsurance space; or (ii) in some form of regulatory coercion pushing providers to enter this space (e.g. quotas or charters such as the case in India and South Africa).

It must be noted that the absence of such special dispensations does not necessarily prevent the development of microinsurance but simply keeps this development in the informal sector.

Box 5. Why does the regulatory burden tend to increase over time and to differ between countries? The phenomenon of regulatory drift⁶⁹

Regulatory drift refers to the tendency over time for regulatory systems to increase in

⁶⁹ Note that the phenomenon of “regulatory drift” is a hypothesis based on our observations across countries. The hypothesis will need to be tested through an analysis of the historical evolution of regulatory regimes – an investigation which falls beyond the scope of this study. Nevertheless, it is highlighted here given its pervasive impact on the development of microinsurance.

complexity and burden and, in particular, the tendency to gradually exceed the requirement of risk.

Regulation is not a static concept. It continually evolves as the insurance market develops, new players come to the fore and new technologies are implemented. In many jurisdictions, insurance regulation originated in response to social groups coming together to pool risk. Often, insurance was originally the domain of lower-income groups coping with adverse impacts through mutual risk pooling, rather than of the rich. As these groups grew, “insurance” emerged – an action that the financial authorities realised could have stability and consumer protection implications if not provided through sound structures and following sound business practices. Insurance regulation therefore started out on a simple basis, often aimed at regulating informal mutual activities amongst lower and middle-income consumers.

The following diagram illustrates the initial low sophistication of insurance markets and regulation, as well as the initial low-income market focus (bottom left):

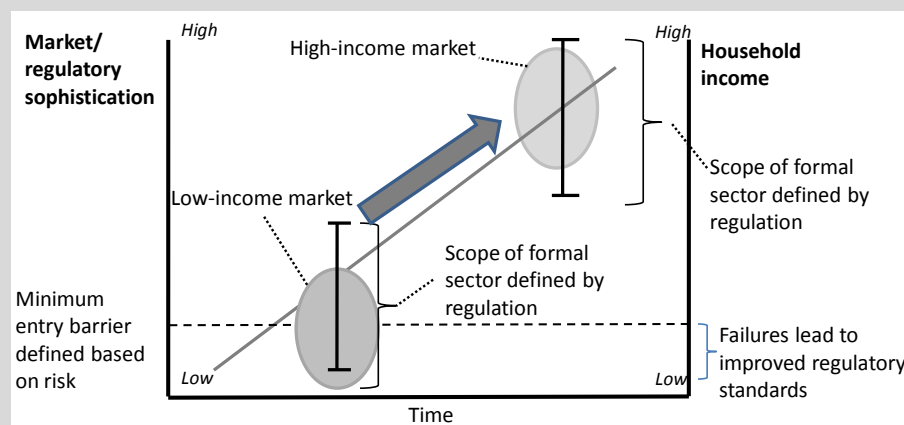


Figure 13. Illustration of regulatory drift: initial position and drift over time

Source: Bester & Chamberlain (2008)

Over time, insurance markets increase in complexity and sophistication. While entry barriers and regulatory requirements may have started off simple and low, experience and failures gradually lead to better risk analysis and more sophisticated and complex regulation (moving to the top right of the diagram). The scope and level of regulation and regulatory burden also becomes tailored to the sophisticated incumbent insurers who themselves tended to migrate to the high end of the market. Incumbent insurers may, in fact, lobby for and support aspects of increased regulation as the higher burden limits entry and competition. Increased sophistication and complexity also meant an increasing regulatory burden and compliance costs, which went largely unnoticed due to the traditional focus of regulators on stability rather than market development.

The increasing burden has meant that it gradually became more difficult for new insurance providers to enter, particularly in the small premium market where cost sensitivity is higher. The high regulatory burden thus undermines the entry and evolution of potentially legitimate players. Combined with limited supervisory capacity, this has created the space

for informal insurance to fill the gaps. As result a special dispensation may now be required to accommodate microinsurance products and to support the formalisation of informal providers, as indicated in the diagram below:

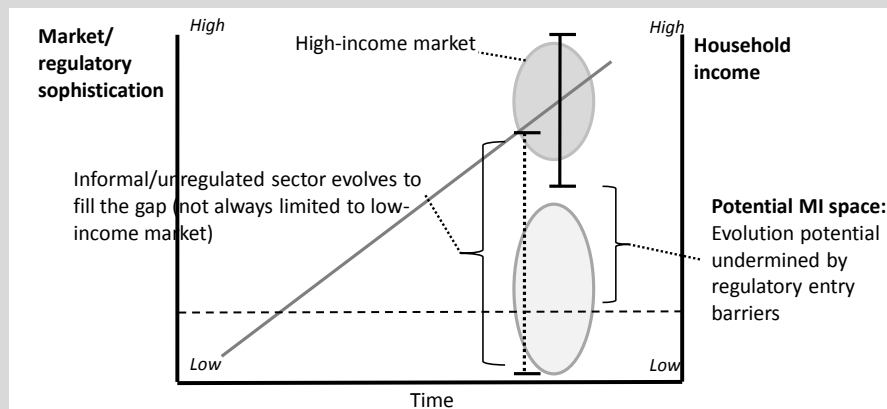


Figure 14. Illustration of regulatory drift – the consequent gap filled by the informal/unregulated sector

Source: Bester & Chamberlain (2008)

The following sections consider the impact of the details of specific aspects of regulation.

4.4.2. Financial inclusion policy and regulation

Financial inclusion policy and regulation can push microinsurance development but long-term growth and scale depends on viability. Financial inclusion is becoming an increasingly important policy objective for governments around the world. Four out of five sample countries have some form of financial inclusion policy, in various stages and forms of implementation. Although not all of these policies (e.g. the National Microfinance Strategy in the Philippines or the Opportunity Banking Policy in Colombia) make specific or detailed reference to microinsurance it nonetheless provides important support for the development of the microinsurance market. Increased financial inclusion in other financial sectors such as microcredit and transaction banking has a beneficial impact on the growth of microinsurance. Also the clear support provided to inclusion in general sends a positive signal to entities looking to enter and extend into the low-income market.

Two main approaches to financial inclusion: Two categories of inclusion regulation were found in the sample countries:

- **Push interventions:** Both South Africa and India have implemented explicit financial inclusion interventions. In South Africa, this took the form of the Financial Sector Charter, a commitment negotiated between industry and various role players to achieve certain access targets that were then adopted in regulation and committed government to providing the regulatory space supportive of inclusion. In India, it took the form of regulated rural and social sector quotas. In both cases these interventions led to the development of a special regulatory dispensation for microinsurance to support the quest for inclusion.

- Supportive policies/pull interventions: In Colombia, the Opportunity Banking policy does not place any obligation on financial institutions to pursue inclusion. Rather, it seeks to facilitate the provision of financial services to the currently unserved through committing to creating a supportive regulatory environments and removing obstacles to inclusion. This, for example, led to the introduction of non-bank correspondents providing a low-cost channel for insurance premiums collection. Likewise, the Philippines government facilitates financial inclusion and microinsurance through its National Microfinance Strategy and public awareness campaigns in support of microinsurance.

Limits of inclusion policy: Inclusion policy is usually premised on the assumption that if commercial insurance providers are introduced to the low-income market they will discover its potential which will in turn lead to market development beyond that which is compulsory. However, inclusion policy cannot indefinitely force providers to pursue unviable markets at any significant scale. While push regulation can force providers to enter a specific market space, its impact will therefore be limited if initiatives are not put in place to also support the viability of the market. In South Africa, access targets for non-life insurers have proven problematic, as non-life products priced to achieve large scale take-up among the poor are in many instances simply not viable from an insurer's and, especially, an intermediary's point of view. In India, the rural and social sector policy has thus far achieved limited microinsurance take-up beyond what is required in the relatively modest quotas suggesting that insurers "cross-subsidise" policies in these sectors to reach the quotas and have not yet shown that expansion beyond the quotas is viable. In both these cases adjustments also had to be made to create a more supportive regulatory environment. Push and supportive initiatives could therefore be seen as complementary interventions.

Regulators require mandate to support development: Even in the absence of explicit or comprehensive inclusion policy, financial inclusion can be supported by extending the regulator's mandate to support market development. Regulators are bound by the statutes under which they operate. This means that they can only operate and apply their resources based on what their official mandate allows them to do. If market development or financial inclusion is not part of that mandate, the regulator could be found to be acting outside of the law should it pass regulations or implement administrative actions that seek to develop the market.

Traditionally, most financial sector regulators' statutory mandate was limited to stability and to some extent direct consumer protection. Increasingly regulators' mandates are extended to include other objectives including market development⁷⁰. India's Insurance Regulatory and Development Authority provides a good example of a regulator that was given an explicit development mandate. On the other extreme the Ugandan Insurance Commission is an example of a regulator that has no explicit development mandate and therefore does not have the scope to consider financial inclusion as part of its policy obligations.

⁷⁰ Other objectives may include market conduct regulation and consumer education as additional means of consumer protection.

4.4.3. Prudential and institutional regulation

High regulatory barriers undermine formalisation and entry: Prudential regulation seeks to ensure that insurers are able to meet their contractual obligations to their clients. This is done by setting minimum entry requirements such as minimum levels of capital and requiring compliance with a set of prudential regulations governing the functioning of the insurer. One of the outcomes of prudential regulation is, therefore, to limit entry into the market to those providers who are able to manage insurance business appropriately. Unnecessary high regulatory barriers, however, undermine the entry and formalisation of potentially legitimate providers.

Using regulatory barriers to compensate for limited capacity may be counterproductive: Regulatory barriers may be the result of general conservatism, unintentional regulatory drift (see Box 5 on page 69) as well as deliberate regulatory strategies to address specific concerns of the regulator. For example, due to limited capacity regulators and supervisors may be concerned about their ability to effectively supervise the sector and about the risk that insufficient supervision will introduce. Such supervisors may take a conservative approach by explicitly restricting entry into the sector through artificially high capital requirements. In isolation, however, limiting entry does not necessarily stop informal insurance activities for the very same reason that motivated this approach: the supervisor does not have the capacity to monitor and control these informal activities. Increasing entry barriers into the formal sector where the supervisor has limited capacity may, therefore, simply result in a larger informal sector, rather than a more limited insurance sector. India, for example, has the highest minimum upfront capital requirement of the sample countries (\$25m), with no second tier, exceptions or opportunity for smaller players to graduate to this level. This is a deliberate requirement by IRDA aimed at restricting the market to a few large commercial insurers. Entry and formalisation of smaller (but potentially legitimate) players is, therefore, explicitly discouraged. The result of these high entry barriers was not to close down these activities but to keep them in the informal sector.

	Colombia	India	Philippines	South Africa	Uganda
Minimum upfront capital requirements	\$3-4.2m min (depending on business line)	\$25m	* \$24m - new insurers * \$3m - new MBAs * \$122,000 - all MI MBAs; to be phased up to \$305,000 over time	\$1.3m life \$0.7m non-life	\$580,000 (double for composite)

Table 6: Comparison of capital barriers across the sample countries.

Source: Country reports

Regulatory barriers particularly affect microinsurance: The development of formal microinsurance is particularly affected by such deliberate entry barriers, as informal providers are unable to formalise and new entry is discouraged. The larger incumbent insurers may also not be particularly interested or able to enter the microinsurance market and with the limited competition as result of barriers to entry they are in no hurry to do so.

Box 6. The merits and means of achieving formalisation

While financial inclusion tends to focus on extending the formal sector, it also recognises that informal services often play an important role in the microinsurance landscape servicing the critical needs of consumers who are unable to access the formal system. Where low risk is posed by such providers (e.g. burial societies in South Africa), the formalisation of informal providers may not be a regulatory priority. However an insurance regulatory framework should provide formalisation options for those informal organisations that are able to grow into formal insurance providers. If there is no platform on which they can formalise and compete with formal insurers, community based risk-pooling and insurance schemes will remain in the realm of the informal, without any guarantees of protection for customers. Numerous examples of the need for formalisation are evident in the sample countries:

- In South Africa, the government is concerned about allegations of consumer abuse in funeral parlours that self-insure. In order to protect consumers, it is important to bring such providers within the insurance regulatory net. Formalisation is therefore regarded as a strategy required to limit consumer abuse. At the same time this is proposed to be combined with active support for such parlours to make the difficult transition to regulatory status. Most of them would also have to cede their insurance portfolios to registered insurers as they will be unable to comply with even the second tier of regulation proposed for microinsurance.
- Co-operatives that provide in-house insurance in the Philippines are not currently supervised by the Insurance Commission unless specifically registered for insurance purposes. This implies that risk is created for the consumer and formalisation would therefore serve the goal of consumer protection.
- The importance of member-based entities with informal origins is powerfully illustrated in the transition of informal insurance schemes into the regulated MBA insurance market in the Philippines. These member-based entities are trusted by clients making insurance take-up easier to achieve than for commercial insurers. As is the case with funeral parlours in South Africa, formalisation is not a simple matter and it requires the support of a dedicated back-office and actuarial resource (provided by Rimansi) and additional regulatory changes to incentivise formalisation (e.g. reduced capital requirements and the ability to build this up over time).

It must also be noted that informal providers are often outside of the regulatory scope due to the limited capacity of the supervisor to enforce regulation and not the absence thereof. It may, therefore, simply be beyond the capacity of a supervisor to formalise these entities through supervisory effort or decree. An alternative approach is to design the regulatory environment to encourage and support formalisation while gradually targeting enforcement to high risk areas.

Tiering and graduation supports entry, formalisation and growth of microinsurance-friendly providers: Tiering and graduation have been used in the sample countries to facilitate entry while still maintaining prudential standards.

Tiering: This approach creates a lower tier of insurer subject to reduced regulatory burden but limited to lower-risk products. In the Philippines a separate tier was created for MBAs (and within that for microinsurance MBAs) that are subject to lower capital requirements than commercial insurers. In South Africa, Friendly Societies are allowed to write funeral insurance up to R7500⁷¹ (approximately \$940) under a lower-tier license with reduced requirements. South Africa is also in the process of designing a dedicated microinsurance regulatory tier (see the case study in Box 9, page 90). In India tiering was only implemented for intermediaries and not for insurers.

Graduation: In this approach providers (usually informal providers seeking to formalise) who are not immediately able to comply with the full regulatory requirements are allowed to stagger or graduate their compliance over a set time period or according to a set formula or procedure. Microinsurance MBAs in the Philippines may, for example, start with a lower capital requirement and build up their capital to the required level over time. This allows regulators to reduce entry barriers while still maintaining appropriate prudential standards. As noted above, take-up of the MBA license was only achieved when this graduated capital requirement was implemented. Graduation between tiers is also critical to ensure that successful smaller providers are able to evolve to full insurers. In the case of friendly societies in South Africa graduation to full insurer status is undermined by the fact that the insurance legislation does not accommodate the member-based legal structure of a friendly society. This has resulted in cases where successful friendly society insurers have stagnated as they were unable to graduate out of the restrictive regulatory environment for such societies.

Discretionary approach may be difficult to manage: In addition to explicit graduation, discretion can also be given to the supervisor to allow entry for specific players/categories of players at a lower capital level and allow them to build this up over time. Although possible, the ad hoc nature of this process makes it difficult to manage with limited supervisory capacity. This option is technically available to the insurance supervisor in South Africa, but not used in practice due to concerns over the capacity to manage such an ad hoc process. In the Philippines the Insurance Commission also has the power to reduce upfront capital requirements by up to half for co-operative insurers. There has however been no instance of such graduation thus far, as no co-operative insurers have applied for it.

Unlevel playing field introduces a bias against provision by potentially legitimate players: While tiering may be a useful tool to manage entry requirements, it can also create unlevel playing fields if not carefully designed based on risk. Following a risk-based approach, entities writing the same kind of risk should face a similar regulatory burden. This is not the case in South Africa where friendly societies are allowed to write funeral insurance policies up to R7,500 (approximately \$940). Dedicated funeral insurers may write benefits up to R18 000 (approximately \$2 250) but with regulatory requirements similar to that of a full life insurance license. This is too onerous relative to the limited product portfolio they write. While the benefit caps on friendly societies reduce the risk compared to full funeral insurance licences the regulation applied to friendly societies are reduced to such an extent that it may be too low to manage the level of risk that remain at this benefit level. At the

⁷¹ This was recently increased from R5000 (approximately \$625).

same time, the differentiated benefits mean that these societies cannot compete with formal insurers and are losing ground in the market. The current tiering system, therefore, creates an unlevel playing field neither achieving appropriate risk management nor supporting competition.

In Colombia, funeral parlours have obtained an exemption from insurance regulation based on legal technicalities around the definition of insurance (see Section 3.1). This means that although they write products with similar risk features to funeral policies offered by insurers, they are not subject to the same regulation. This places commercial insurers at an unfair disadvantage and may discourage them from competing for this market.

Unnecessary restrictions on institutional types may exclude legitimate providers: Where regulators follow an exclusionary approach (see Section 4.4.1) they may limit underwriting (and intermediation) to specific and predetermined institutional types making it difficult for new business models with different legal identities to enter the market. This approach effectively requires the regulator to be able to ‘pick winners’ by deciding which entities will be better placed to serve the market. Such institutional restrictions also do not always add value as it is not based on clear risk considerations. This affects member-based entities as well as commercial insurers.

Member-based insurers: As noted in Box 3, page 62, where these entities are a feature of society, member-based entities such as mutuals and co-operatives may play an important role in the development of microinsurance. Regulatory environments, however, do not always provide the space for such entities to formalise their insurance operations restricting them to informal markets.

- The Philippines have created an explicit regulatory framework to accommodate both co-operative insurers and MBAs. The overwhelming majority of formal microinsurance in the Philippines is provided by member-based entities. This is not without problems as at least one of the co-operative insurers are under curatorship. Instead of excluding this category, the government’s approach has been to support the improvement of management and governance of these entities.
- In the case of Colombia, co-operative insurers have evolved to the point where they are able to compete with commercial insurers on an equal footing and subject to the same regulatory requirements. 62% of formal microinsurance in Colombia is provided by these insurers.
- In the case of South Africa, informal member-based insurers also play a significant role in the microinsurance market (63% of the combined formal and informal funeral insurance market). However, current regulatory structures do not provide a suitable route for such entities to grow and formalise themselves into insurers.

Commercial insurers: These restrictions also impact on commercial insurers. In the Philippines the microinsurance regulation only benefits member-based entities and does not provide space or incentives for commercial insurers to enter this market. While commercial insurers may not currently be interested to serve this market there is no reason to exclude them in regulation, thereby disincentivising potential interest.

Box 7. The mutual approach as a strategic option for sustainable microinsurance – the case of CARD MBA in the Philippines.

CARD instrumental in choice of MBA as microinsurance vehicle: The Mutual Benefit Association (MBA) is the Insurance Commission’s vehicle of choice for the formalisation and development of microinsurance in the Philippines. As it is regarded as the most suitable organisational structure for microinsurance, it is the only institutional entity eligible for micro-insurer status and enjoys a lower tier of minimum capital requirements⁷². It is argued that this decision is based partly on the success of CARD (Centre for Agriculture and Rural Development) MBA, one of the MBA pioneers in the Philippines. CARD MBA showed how the MBA approach can use microfinance social networks, payment flows, financial information and management systems to reach a critical mass of members, reserves and capital. As of December 2007 it had about 470,000 active members and US\$16.5m in assets. It paid out US\$1.1m in claims over the year. This robust current position is however the result of a turbulent history.

Unsustainable practices and consequent rehabilitation into the MBA form: In 1994, CARD, an MFI, established a Members Mutual Fund (MMF) among its members to cover its exposure on the loans of members in the case of death. In addition, it started offering basic life insurance. In 1997, it responded to the need to broaden the product offering by including a monthly pension for members older than 65 based on a minimal weekly contribution. All of this was done without registration for insurance purposes although registration was mandatory under the Insurance Code. The possible impact on the institution of these in-house insurance services was however not adequately assessed. When eventually such an assessment was done, CARD realised that two years of a member’s contributions were needed just to cover one month of pension benefits receivable by such a member. This was clearly not a sustainable situation for the organisation. Fulfilling all its obligations would “decapitalise” CARD and could lead to bankruptcy. CARD sought advice from the regulator and towards the end of 1999 formed an MBA to manage/replace the MMF. The MBA is registered as a non-stock, non-profit legal entity owned and partially managed by the members. With the assistance of an actuary, CARD MBA repackaged its existing product lines and developed new ones. It has also started to offer non-financial services.

The MBA was therefore used as a vehicle to rehabilitate CARD’s insurance operations and bring it within the formally regulated space. CARD MBA’s subsequent success (and advocacy in the sector at large – sharing their learning and providing support to other MBAs) has been instrumental in convincing regulators to provide sufficient regulatory space (through tiered capital requirements) for MBAs engaged in microinsurance. The success of CARD provided an example to other MFIs that want to cater to the risk protection needs of its members.

⁷² While the MBA has existed as insurance vehicle since the Insurance Code of 1971, it has only recently started to feature as vehicle for microinsurance provision and the formalisation of MFI in-house insurance. This shows how the mere existence of a regulatory option in itself is not always sufficient to trigger formalisation. Some active work needs to be done by the regulator/supervisor in promoting it.

Sound corporate governance allows regulator to leverage non-traditional institutional types: Weak governance for a particular category of institution means that a much higher regulatory effort is required to ensure compliance. However excluding such institutional types may impede development. Where the regulator has implemented measures to improve governance structures rather than excluding such institutions, a whole new category of entities became available to support market development. This is particularly relevant for member-based entities such as financial co-operatives that, for historic reasons (e.g. where co-operatives first emerged in the agriculture sector), are often regulated under regulators not focused on or geared for prudential regulation.

- In the Philippines weak governance of co-operatives has been problematic, with 65% of co-operatives registered with the Co-operative Development Authority no longer operational due to mismanagement. Under the insurance code co-operatives are allowed to write insurance but no additional governance requirements are placed on those who do this. There are two co-operatives currently offering formal insurance of which one is under curatorship.
- In Colombia, improved co-operative regulation secured the continued existence of the co-operative environment even through the financial sector crisis of the late 1990s. In fact, financial crises often trigger more appropriate regulation to strengthen the financial sector, among others through better corporate governance standards. As noted co-operative insurers are the dominant providers of microinsurance in Colombia.
- Better governance can also be incentivised by market-driven mechanisms. In India MFI rating agencies and standards have ensured that MFIs also providing insurance improve their management and governance. This led to these entities obtaining underwriting for previously informal insurance portfolios (or risk being downgraded on their credit rating).

Demarcation shapes provider models: In all five of the sample countries insurance regulation distinguishes to a greater or lesser degree between life, non-life and health insurance products. Composite insurers are allowed (with concomitant increases in capital required) in all but India and South Africa, but with some exceptions for microinsurance. The degree and certainty of demarcation has shaped the nature of insurance provision in these countries. For example, In Colombia, insurers may combine policies from the three categories (with concomitant increase in capital required), with the exception of individual life policies, under a single license⁷³. This has allowed insurers to design products that cover both assets and life (including disability and health) risks in one “family protection⁷⁴” policy.

Relaxed demarcation supports low-cost provision meeting market needs. Strict demarcation increases the cost of offering a product that combines life, non-life and health elements and also restricts the cost efficiencies that may be gained from combined products. The

⁷³ Individual life policies can only be provided under a life license. Both life and non-life insurance companies may however sell group life and health insurance.

⁷⁴ Insurance co-operativeco-operatives and companies have designed products that cover both assets and life risk (including disability and health) as an integral family protection plan. In this way, one insurer offers a so-called family protection policy at a premium of \$4/month, providing \$5,200 in life and disability cover respectively, as well as cover of \$10 for daily hospital fees and \$2,600 for serious illness. Clients of an NGO specialised in microcredit are targeted for this policy.

microinsurance experience and focus group findings in the sample countries have indicated a need for composite microinsurance products combining different risk categories. For example, the Indian focus groups indicated a preference for composite life and health products. As a result of the need for composite products, countries are moving away from strict demarcation in the microinsurance environment. This is already the case for Colombia, Philippines and Uganda. India's microinsurance regulations are also allowing composite products but separate underwriting of the product by respectively a life and non-life insurer is still required. In South Africa, the proposed microinsurance regime recommends a dedicated microinsurance license that will allow life and non-life risks to be underwritten by the same microinsurer. The rationale is that both life and non-life products meeting the microinsurance definition are of a short-term nature and, therefore, underwritten on a similar basis. There is also an explicit recognition that composite products may be required to ensure viability of low-premium products.

4.4.4. Product regulation

Weak insurance definitions result in regulatory avoidance and arbitrage: In several of the sample countries weaknesses and gaps in insurance definitions have been exploited to avoid regulation, illustrating the need for clear definitions of insurance business:

- **Colombia:** Funeral parlours have used the legal system to exploit weaknesses in the definition of insurance and to avoid insurance regulation.
- **Philippines:** Health and pre-need companies have avoided insurance regulation.
- **Uganda:** As health insurance is not defined in the insurance legislation, some Health Management Organisations are using this to provide unregulated insurance arguing that they do not fall within current regulatory definitions of insurance.

Regulatory definitions seek to utilise low-risk features of microinsurance products. As noted (with some clear exceptions) in Section 4.1, the bulk of microinsurance products offered in the sample countries share features that help to limit the risk (prudential and market conduct) of these products. These features include: short-term contracts underwritten on a group basis, simplified products, generally predictable risks and limited benefit values. These features are reflected where regulatory definitions are used to create a separate space for microinsurance underwriting (see also discussion on tiering and graduation in Section 4.4):

- The Philippines use limited product definitions to create the space for MBA microinsurers.
- In India the microinsurance definition is based on the same low-risk features but it is not utilised to create a second tier of insurers (for reasons explained in Section 4.4). These parameters of the definition are however used to create a second tier of intermediaries dedicated to microinsurance.
- South Africa has utilised these features to create a space for friendly societies and funeral insurance products. The microinsurance definitions proposed in a recently issued discussion paper on the future regulation of microinsurance explicitly seeks to create a second tier of insurers and intermediaries with reduced regulation.

4.4.5. Market conduct regulation

The following drivers related to market conduct regulation emerge from the country experience:

Allowing multiple channels facilitates innovation and low cost distribution: Section 4.3 highlighted the importance of innovative, non-traditional models in the development of low-cost distribution channels- a prerequisite for microinsurance development. Where facilitative regulatory approaches (see Section 4.4.1) have been able to accommodate such new models, it has supported innovation. In contrast exclusionary regulatory approaches limiting intermediation to specific and usually traditional models have undermined market development.

Country experience has shown that cross-selling with other financial services, such as those provided by banks or MFIs, facilitates market discovery and low-cost distribution.

- In the Philippines, India and Uganda (in the latter virtually exclusively) the MFI sector is a large distributor of microinsurance and the growth of the micro-finance sector has been a direct driver of the growth of microinsurance (primarily through compulsory credit life).
- Bancassurance is allowed in Colombia, the Philippines and South Africa.
- In Uganda, restrictions on intermediation prohibit banks and MFIs from receiving a commission where they intermediate insurance products to their clients. The result is that these channels are either not incentivised to distribute insurance or it results in costly legal structuring to avoid regulation, ultimately limiting the value that the client may have received. This undermines one of the few available distribution networks in the country that could be harnessed for microinsurance distribution.
- In India the distribution opportunities are limited by the fact that the definition of microinsurance agents (despite recently being broadened to include all non-profit entities) excludes key for-profit organisations (see Box 8) with potential as distribution channels to low-income clients. Such entities often have a broad customer base among the poor and in rural areas that could be leveraged for low-cost insurance distribution. Furthermore, bancassurance is an important distribution channel for insurance in general, but also does not qualify for microinsurance agent status.

Cross-selling with non-financial services is also an important way of creating (derived) demand for microinsurance. The insurance policy is sold with the underlying service (e.g. a funeral service) or product (e.g. a cell phone) that creates the demand for the insurance. The person who sells the insurance policy is therefore not an employee of a financial institution and would normally not be a registered insurance agent or broker. Whether the regulatory system allows such intermediary models will shape the development of the market.

- In countries where insurance distribution is limited to registered brokers/agents, such as Uganda, the scope for cross-selling with non-financial services to facilitate market development is limited.
- South African regulation does not limit intermediation to specific models but instead focuses on the functional requirements that any intermediary model should fulfil. This has supported the development of innovative models utilising, for example, clothing retailers and cell phones as distribution channels.

- In Colombia, alternative distribution is allowed as part of the ‘direct sales’ and ‘insurance agencies’ categories of intermediation (the definitions of which are defined fairly broadly). Co-operative insurers are also allowed to use non-traditional intermediation channels and subordinate regulation allows distribution via non-traditional structures such as utility companies whose payment infrastructure can be used for premium collection.

Box 8. Regulations for microinsurance intermediation in India

Microinsurance regime: In the quest to facilitate low-income market expansion in line with its development mandate and in light of the rural and social sector quotas placed on insurers, IRDA in 2005 issued a set of Microinsurance Regulations. These regulations define general and life microinsurance products according to minimum and maximum benefits, minimum/maximum term of the policy and minimum/maximum age of entry, as well as certain simplicity requirements. For this category of products, the demarcation requirement between life and non-life insurance is relaxed in that a composite microinsurance product may be provided as long as a life and non-life insurer respectively underwrite the life and non-life risks underlying the product. All sales of microinsurance products will count towards insurers’ rural and social sector obligations.

The regulations then create a specific category of microinsurance agents who may only distribute microinsurance products on behalf of registered insurers. Until recently such agents were limited to NGOs, self-help groups and non-profit MFIs with a minimum of three years experience in working with low-income groups. In March 2008 the category was extended to all non-profit entities. Microinsurance agents are subject to lower training requirements and higher commission caps than traditional agents. They may also perform certain functions, such as the routing of premiums and claims through their books, not allowed for traditional agents. Each agent may only enter into a relationship with one life and one non-life insurer.

Restricted space limits market expansion: Despite the concessions granted to microinsurance agents, the microinsurance regulations have thus far had a limited impact on market expansion. This can partly be ascribed to the fact that the space opened up for microinsurance is relatively restricted:

- The concessions mostly relate to intermediation requirements and do not address the minimum capital constraint to the entry of dedicated micro-insurers;
- The definition of microinsurance agents, despite the recent adjustment, still excludes for profit MFIs and rural banks that are large potential aggregators of microinsurance clients;
- The fact that microinsurance agents may only distribute microinsurance products may act as a disincentive for existing intermediaries to enter into this market;
- The limit on the number of insurers that a microinsurance agent can work with has undermined their ability to offer the best combination of products to clients; and
- Commission capping, while at a higher level for microinsurance agents than for other agents, provides limited incentive for selling to such a low-premium market.

Therefore, even though the microinsurance regulations have served (together with the quotas) to draw the attention of the market to microinsurance and even though the training requirement relaxation and the enhanced functions granted to microinsurance agents go some way in facilitating this category, the limited scope has meant that the regulations have by and large not yet been able to become a vehicle for accelerated outreach to low-income clients. IRDA has therefore declared itself willing to adjust the regulations over time as the true market need is revealed.

Where enforcement capacity is limited, price controls may be counterproductive:

Commission caps are typically motivated by consumer protection objectives. In practice, however, such caps are difficult to enforce leading to various forms of legal structuring to get around them rather than reducing the cost to the consumer. Commission caps also only control one aspect of the cost of the product rather than the total cost to the client. With the blurring of various institutions and intermediaries it is furthermore becoming increasingly difficult to distinguish between commission and other charges. With increasingly complicated group structures that may extend beyond the jurisdiction of the supervisor, it may be very difficult to enforce the caps (e.g. international groups can make transfer payments within the group but outside the country). At the same time, realistic commission levels are required to incentivise the intermediation of low-premium products. Even though it may look like a high percentage, commissions on low-premium products may still amount to a small fee for the intermediary.

In Uganda, South Africa and India caps are placed on the level of commission that may be paid to intermediaries for selling insurance policies, including microinsurance. The experience of these countries show that price limitations may be circumvented in various ways (e.g. by loading the “administration” component of the premium) thereby undermining its intended effect while penalising compliant players. Furthermore the one insurance product in South Africa that has achieved success in the microinsurance market – funeral insurance – is also the only product exempted from commission caps. While this is not the only reason for its success, it has certainly contributed to the provision of microinsurance by formal players.

Market conduct regulation impacting on transaction costs may distort intermediary models:

Microinsurance, even more so than other insurance products, requires large volumes to be sustainable. Market conduct regulation is a relatively new category of regulation aimed at regulating the intermediation process. In doing so it risks adding costs to every transaction that undermines the scale benefits achieved by larger volumes. South Africa and to a very limited extent the Philippines⁷⁵ are the only sample countries where the insurance sales process (as opposed to the intermediary itself) is directly regulated. In the other sample countries, stipulations on who should register to intermediate insurance, or what fit and proper requirements they should meet may apply, but the way that products

⁷⁵ Where agents or brokers are required to explain the nature and provisions of the contract to their clients, in particular the minimum disclosure requirements printed in the policy contract.

should be sold, the information to be provided in the sales process and the type of advice to be provided to prospective clients are generally not specified.

In South Africa the design of market conduct regulation, in the form of the Financial Advisory and Intermediary Services Act of 2002, has increased the cost of advice (as defined in the Act) and had a major impact on the development of intermediary models in the microinsurance market. Essentially it has split the market into high end advice-based models and a low end tick-box models.

Compulsion without disclosure and appropriate protection risks abuse: While there are risks to market development where market conduct regulation increases costs of intermediation, there are also risks of abuse where market conduct regulation is completely absent. This is particularly the case for compulsory insurance models. As noted in Section 4.3.1 compulsory insurance linked to a loan or to the sale of a good purchased on credit provides a powerful opportunity for low-income consumers to discover the value of microinsurance. It often provides the first point of contact with insurance for many consumers and, if applied properly, can act as a springboard for the development and distribution of additional products suitable to the low-income market. However, insufficient disclosure and limited incentives to ensure value to the client due to the compulsory nature of the transaction have undermined the value that this channel may offer and have also led to consumer abuse.

- In South Africa credit life is the biggest microinsurance category next to funeral insurance. Concerns about consumer abuse and opaque selling practices in credit life insurance have, however, led to an enquiry into practices in the sector. This revealed several problems including that premiums on compulsory credit life products are significantly higher than that of voluntary equivalents and very few people are aware that they have cover. These problems manifest in claims ratios of less than 10% in some cases, reflecting poor value to the consumer.
- In India and Uganda, the microinsurance market is dominated by compulsory credit life insurance where the focus is still on the risk of the lender being insured rather than the risk of the borrower (partly due to the unintended consequences of regulation as described in Section 3.5.4). The result is that there is limited incentive to disclose this cover to the client or develop additional products and features to meet consumers' needs.
- The extent to which credit life succeeds in triggering voluntary uptake of other insurance products also depends on the extent to which the credit provider is interested in cross-selling insurance products to the clients. The Philippines is a good example of the growth of voluntary uptake off the back of credit life. This is driven by the fact that MFIs and MFI-MBAs who are sensitive to the needs of their clients started to develop new insurance products to ensure continued client loyalty.

4.4.6. Other regulation

Regulatory provisions other than those contained in the insurance regulatory framework can also have a far-reaching impact on the development of microinsurance markets. The country studies reveal the potential impact of tax laws, anti-money laundering controls and the regulation of national payment systems.

Taxation can undermine the attractiveness or viability of microinsurance: Taxation may impact on microinsurance through its impact on costs as well as through differentiated levels biasing for or against specific models or products.

- In the Philippines, insurers claim to be the most heavily taxed financial entities. All insurers are subject to 35% corporate income tax (to be reduced to 30% in 2009). MBAs and co-operatives are exempted from such tax. In addition to the income tax, all life insurance premiums are taxed at 5% and non-life insurance premiums are subject to 12% VAT. Furthermore documentary stamp taxes apply.
- In India, insurance agents have been subject to a 12.36% service tax since 2001. In practice however it is passed to the client by adding it to the premium.
- In South Africa, friendly societies will be encouraged to move to the proposed new microinsurance space that offers them several benefits. However, this will not happen unless the preferential tax treatment of friendly societies is not removed or at least mirrored under the new microinsurance regime.

Anti-money laundering controls may create barriers and increase transaction costs: Microinsurance typically presents low money laundering or financing of terrorism risk. As a financial service, microinsurance may, however, be subjected to a country's general anti-money laundering regime without recognition for its potential low risk profile. This increases transaction costs and may create barriers to the take-up of insurance.

- In India, microinsurance agents have expressed concern at the difficulties of obtaining know-your-client (KYC) documents from prospective clients in rural areas, including the electoral identity card, ration card or electricity bill required as "proof of residential address".
- In some jurisdictions, regulators however recognise the low Anti-money laundering/Combating the financing of terrorism (AML/CFT) risk posed by insurance and implement measures that ensure that AML/CFT legislation does not negatively impact on insurance market development. This is the case for example in the Philippines. Though insurance is subject to the Anti-money Laundering Act of 2001, the Insurance Commission Circular Letter No. 15 of 2007 lifted or reduced many of the KYC requirements for low-value insurance contracts. In South Africa, life insurance is exempted from the AML duty to identify clients and keep records⁷⁶. In Colombia, KYC stipulations up to recently required a face-to-face interview with a prospective customer as well as the filling out of a detailed form, presenting a barrier to insurance uptake. This stipulation was however changed in June 2008 to exempt insurance from KYC requirements if: the insured value is equal to or lesser than 135 times the minimum monthly wage (approximately US \$35,000) and if the maximum bimonthly premium does not exceed one twelfth of the minimum monthly wage (amounting to approximately US \$21). This recent regulatory development therefore recognised the low money laundering risk posed by insurance and especially insurance targeted at the low-income market.

⁷⁶ Part 2, section 7 of the Regulations to the Financial Intelligence Centre Act, 38 of 2001 (as amended by GNR.456 in GG 27580 of 20 May 2005 and GNR.1595 of 20 December 2002)

Efficient and low-cost payment systems are an important facilitator of microinsurance development: The structure and efficiency of the payment system is usually determined through a combination of bank and dedicated payment system regulation but may also involve other legislation such as that governing the telecommunications industry. It is mostly not within the direct control of the insurance regulator, but nonetheless has an important impact on the development of the insurance market.

Microinsurance agents must enter into a “deed of agreement” with one life and/or one non-life insurer. Until recently such agents were limited to NGOs, self-help groups and non-profit MFIs with a minimum of three years experience in working with low-income groups. In March 2008 the category was extended to all non-profit entities⁷⁷. For-profit entities, such as rural banks and for-profit MFIs remain excluded (they are classified as corporate agents). Agent categories other than microinsurance agents may sell micro-insurance but do not benefit from the concessions allowed for the microinsurance agents. However, a micro-insurance agent cannot distribute any product other than a micro insurance product.

A lack of co-ordination may unintentionally undermine microinsurance development: The development of the microinsurance market is influenced not only by insurance regulation but also by the policies and regulations of several other regulators. Often the best intentions of the insurance regulator can be undone by seemingly unrelated regulations passed by a different regulator, and the development of the microinsurance market is hampered by coordination failure. The country studies have revealed a number of instances of coordination failure:

- In the Philippines insufficient supervision of pre-need companies have led to several failures of these entities, increasing the distrust of insurance in general amongst the low-income population. For this reason, there are pending proposals in the Congress that seek to incorporate pre-need plans under the oversight of the Insurance Commission.
- In India, a lack of coordination between the RBI and IRDA on the receipts of premiums by intermediaries (that is defined as deposit-taking by the RBI) prevents insurance intermediaries from bulking premiums on their books. Not to fall foul of the prohibition on deposit-taking under RBI regulation for entities that do not have a banking license, each premium must be paid over individually. This was never intended to hamper the premium collection activities of non-banks, but it has nonetheless been the unintended consequence. This restriction was lifted for microinsurance agents but given the limitations of the definition of such agents, many potential low-income intermediaries are not benefiting from this exemption.
- Coordination failure also characterises the provision of insurance by co-operatives in South Africa. The Co-operatives Act that came into effect in 2007 was drafted without sufficient engagement with the National Treasury, who is responsible for insurance policy and regulation. As a result, the provisions for co-operatives to provide insurance under the Co-operatives Act require them to register as insurers. This however, under the Insurance Acts, requires that entities be public companies. In effect, co-operatives would therefore need to sacrifice their co-operative form, should they wish to provide insurance. Whereas the intent was (i) to create a new institutional form for community-

⁷⁷ Refer to www.irdaindia.org

based insurers and (ii) to reduce the burden of functional regulation on these community-based insurers, both of these objectives therefore failed since there was a lack of cooperation between the Department of Trade and Industry, who developed the Co-operatives Act, and the Treasury who is responsible for insurance regulation.

A significant coordination challenge also arises when a government wishes to formalise a largely informal sector of insurance providers (e.g. co-operatives in Philippines or funeral parlour insurers in South Africa). Blanket law enforcement is largely beyond the capacity of the insurance regulator. Dealing with recalcitrant operators (even if a conducive regulatory environment has been created for their formalisation) will usually require cooperation between a number of government departments, including criminal law enforcement, revenue authority, local authorities and health authorities (where funeral insurance is involved). This is the challenge faced by South Africa as it seeks to clamp down on its large informal funeral parlour market.

4.4.7. Impacts related to supervision and enforcement

A high regulatory burden combined with limited enforcement capacity incentivise informality: As noted in Section 4.4.3 where high capital or other regulatory barriers that make it difficult for players to enter the formal market are combined with limited enforcement capacity it incentivises the development of an informal market.

- In South Africa, the limited formalisation options for member-based entities as well as the limited capacity of the regulator have spawned the development of a large informal market. There are estimated to be between 80,000 and 100,000 burial societies with only a few registered as friendly societies. Furthermore, a large proportion of funeral parlours are believed to offer insurance products not underwritten by regulated insurers.
- In the Philippines limited enforcement capacity has resulted in the development of an informal co-operative insurance sector despite the options for formalisation of these entities as co-operative insurers being made available in legislation.

Microinsurance often evolves in regulatory and enforcement gaps: The natural consequence of limited capacity in the sample countries is that some parts of the markets (particularly higher-risk segments) receive more regulatory attention than others. Reduced or absent regulation and supervision have (unintentionally) given some components of the microinsurance market the space to evolve. This has allowed the development of new models, but has in some cases also led to abuse.

- **Regulatory forbearance:** Examples include burial societies in South Africa or informal risk pooling societies (referred to as *damayan* funds) in the Philippines that do not provide guaranteed benefits and are therefore regarded as outside the scope of insurance regulation (as it is not deemed to constitute “insurance”). Burial societies make up an estimated 60% of the total market (formal and informal) for funeral cover. Some of the largest burial societies have evolved to the point where they were able to formalise their activities as friendly society insurers.
- In the same way, supervisory forbearance means that entities technically incorporated under regulation are not in practice supervised. This is the case where burial societies act as intermediaries selling formal insurers’ products to their members in South Africa.

Though they should technically fall under the ambit of intermediation regulation, their sheer number and perceived low risk of consumer abuse (as they are small member-managed organisations) have prompted the supervisor to consider them as “client collectives” rather than as intermediaries, thereby exempting them from intermediation supervision. Most burial societies will not be able to comply with the FAIS regulation and the supervisor does not have the capacity to enforce this.

- In India, many MFIs still conduct self-insurance without being supervised for insurance purposes. Ironically, it has been the market, through MFI ratings systems, that has put a damper on this practice, rather than a regulatory clampdown.
- The negative experiences of some of the focus group respondents with pre-need companies in the Philippines have undermined their trust in the insurance sector. It is also estimated that at least half of the 22,000 co-operatives provide some kind of in-house insurance, once again outside the reach of insurance supervision.

4.5. Impact of macro-economic conditions and infrastructure

Finally we need to note that the development of microinsurance is also impacted by the general macro-economic conditions in a particular country. We note the following examples from the country studies:

Growth stimulates insurance take-up: Economic growth can lead to increased income levels that in turn can stimulate insurance activity. For example, in India the recent strong growth in the insurance sector is correlated to high levels of economic growth and increased incomes.

Privatisation/liberalisation may increase competition: Insurance growth in India is also driven by the recent privatisation of the insurance industry. Since 1999 the Indian insurance sector has grown from a single state-owned life insurance company and a single state-owned general insurance company (with 4 subsidiaries) to 15 life insurance companies and 12 general insurance companies. This has led to increased competition that has placed downward pressure on prices and has stimulated innovation and new products. The effect of liberalisation on the insurance industry can also be seen in Colombia, where the financial sector liberalisation efforts of the early 1990s increased competition to such an extent that insurers and banks started to target the lower-income end of the market in search of expansion. It must be noted that privatization and liberalization per se does not necessarily lead to increased financial inclusion as it depends on the broader economic context and the manner in which liberalisation is managed.

High levels of inflation may undermine the insurance value proposition: When policies are not designed to cope with this, high levels of inflation will undermine its value proposition. This was the case when Uganda experienced hyperinflation in the 1980s. The destruction of the value of policies, combined with the devaluation of the currency, undermined trust in the insurance industry leading to very low levels of uptake of insurance. In the Philippines, the failure of pre-need companies to manage the impact of high inflation on school fees has led to several company failures in this market. Apart from the direct loss to policyholders, this has greatly damaged the reputation of the general insurance industry.

Crises destroy trust but may lead to better regulation and increased competition: The financial sector crisis that Colombia experienced at the end of the 1990s illustrates that a

financial crisis can also be a positive force in shaping the microinsurance market by forcing a “regulatory clean-up” and the strengthening of co-operative regulation.

Strong physical, social and commercial infrastructure aid microinsurance development

- Physical infrastructure, such as roads, mobile phone network coverage, the availability of retailer networks, a widespread post office or post-bank network and the general level of urbanisation all provide opportunities for insurance distribution. The sample countries exhibit varying degrees of urbanisation, but with the exception of the Philippines more than 40% of the population in all the countries live in rural areas. As payment system and other financial sector infrastructure tend to be centred in urban areas, the level of urbanisation is an important indicator of the likely distribution challenges faced by insurance providers. This is particularly illustrated in Uganda, where insurance evolution is made all the more difficult by the fact that the overwhelming majority of the population live in rural areas where physical infrastructure is lacking.
- Non-insurance financial infrastructure plays an important role in enabling insurance transactions. This includes the banking sector footprint and the efficiency of the payment system, as well as the micro-finance sector footprint. In India and Uganda premium collection in cash increases the cost of distribution. The Opportunity Banking Policy in Colombia is making it possible to harness small traders for premium collection through its “non-bank correspondent” initiative. Alternative distribution through the payment system of utility companies has also proven fruitful. In South Africa the extensive banking infrastructure, widespread POS device network at retailer chains and deep reach of mobile phones is opening up innovative distribution channels. Alternative distribution infrastructure in turn creates opportunities for microinsurance expansion.
- Social infrastructure can also determine microinsurance market development. The level of cohesion within communities impacts on the spread of mutual organisations. In most of the sample countries, such mutual organisations play an important role: either in the spontaneous development of an informal insurance market (for example burial societies in South Africa), or in the formalisation of microinsurance (e.g. MBAs in the Philippines or the co-operative insurers in Colombia).

5. Approach to carving out a microinsurance space

In this chapter we illustrate how a regulatory space for the provision of microinsurance can be carved out, based on the underlying risk of providing microinsurance. While this study clearly illustrates that the creation of specific microinsurance category in regulation is not a prerequisite for the development of a microinsurance market, the majority of countries covered in this study have migrated to some form of microinsurance definition in their regulation to foster market development.

The approach is illustrated in the figure below. The objective is to limit risk in a step by step approach that will allow supervisors with limited capacity to effectively supervise the microinsurance market.

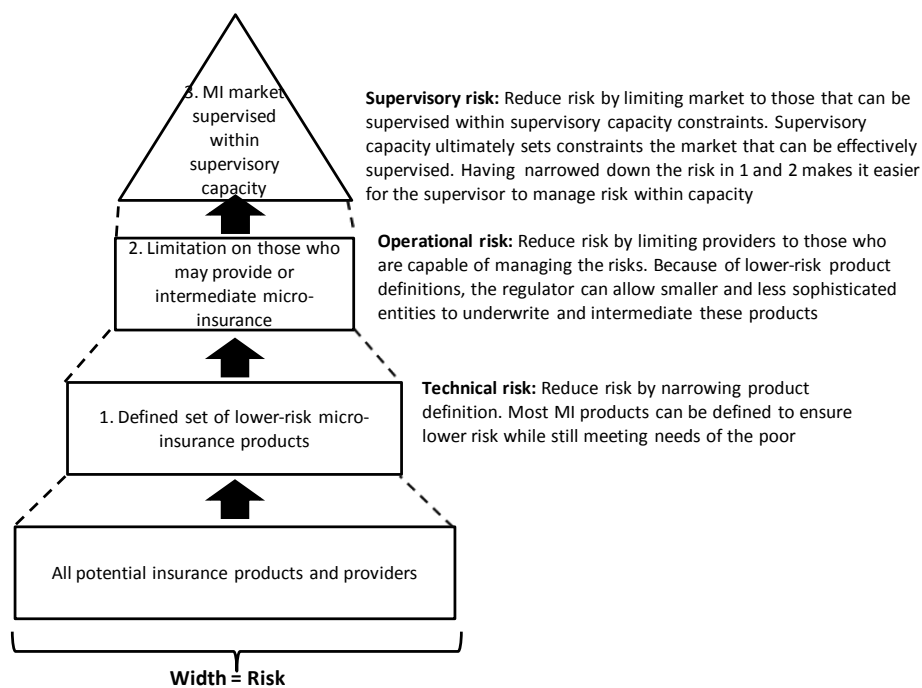


Figure 15: Product-based approach to risk management

Source: authors

The core of the approach is to use a product definition which defines a limited category of lower-risk microinsurance products and thus reduces underwriting and operational risk. This enables the supervisor, to effectively oversee a higher degree of entry and development within its limited capacity. Such product definition could limit both prudential and market conduct risks. We outline the approach below.

Microinsurance can be defined to reduce risk: The evidence from the sample countries suggest that there is a fair amount of consistency in the nature of microinsurance products that have emerged and that the features of these products tend to limit the underwriting risk of these products (see Section 4.1). It is, therefore, possible to utilise these features to develop a set of regulatory definitions for microinsurance that will limit the risk. The fact that these features have evolved without explicit regulatory restriction suggests that

restricting products in this way should still allow insurers to meet the needs of low-income consumers.

Limited product definition reduces operational risk: The limited underwriting risk as result of the restricted product definition reduces the operational risk of managing a portfolio of these products and allows this to be managed in a simplified manner and with lower capacity. Managing the risk of a portfolio of short-term products is, for example, a simpler task than managing the risk of a whole-life portfolio. As result, smaller entities may be able to underwrite such products. However, it must be noted that some level of restriction on entry will remain as minimum standards of risk management would need to be met by the potential insurers.

Reduced underwriting and operational risks in turn reduces supervisory risk: In the same way that the reduced operational and underwriting risk allowed for simpler management, it also allows for simplified regulation and supervision. As result, the supervisor may be able to allow a larger number of such entities to enter the market as these require less capacity to supervise.

This is not a simple solution and will require careful and risk-sensitive design to implement effectively. We highlight some of the issues and potential responses below:

- There are other risks that need to be monitored, for example, the risk from a geographically concentrated portfolio for microinsurers operating in a specific region. This could be addressed by reinsurance.
- Institutional supervision of specific types of entities may fall beyond the mandate of the insurance supervisor or its governing ministry (e.g. co-operatives are in some cases regulated by the ministry of agriculture or ministry of trade and industry). As result, the insurance supervisor does not always have the mandate to ensure that these entities are sufficiently regulated from an institutional and governance point of view. One way to deal with this is to include some aspects of institutional regulation in the insurance regulation (for example setting minimum governance requirements that exceed that required by the basic institutional regulation).
- Product regulation may introduce its own set of capacity requirements and problems. Managing and evaluating the basic set of microinsurance products allowed may require a fair amount of capacity. Capacity constraints in this area may frustrate market development by, for example, delaying product approvals. The system should be carefully defined to avoid this. File-and-use processes can be used to avoid bottle necks and industry associations can be tasked with developing the product definitions, which can then be ratified by the supervisor.

Box 9 illustrates the application of this approach to carving out a regime for microinsurance in South Africa.

Box 9. The proposed new regulatory regime for microinsurance in South Africa

Background and rationale: South Africa is in the process of designing a dedicated microinsurance regulatory regime. The motivation for this policy move, driven by the National Treasury, has been two-fold:

- **Need for an access-facilitating regulatory framework:** On the one hand,

government is committed under the Financial Sector Charter to remove any regulatory obstacles that may undermine industry's efforts to reach its Charter targets. It has also come to Treasury's attention that the institutional form for formal insurance provision is currently constrained and that this may prevent some mutual-type organisations (most notably burial societies registered under the Friendly Societies Act in South Africa) currently providing informal insurance cover from formalising.

- **Concerns about consumer abuse:** On the other hand, there have been numerous reports of consumer abuse in the low-income insurance market. Many funeral service providers are alleged to provide insurance illegally (i.e. without an insurance license) and not to practice sound risk management or benefit pay-out practices, to the detriment of policyholders. Consumer abuse has also been reported in the credit life industry, where practices are often opaque, premiums as extremely high and many policyholders do not even know that they are covered. These concerns have prompted Treasury to reconsider the regulatory framework with a view to extending the regulatory reach and encouraging formalisation.

Regulation tailored to risk of microinsurance: The route taken for creating a dedicated microinsurance framework has been to tailor regulation to the risk associated with microinsurance provision. This is in line with the regulator's risk-based approach and ensures that no regulatory concessions are passed that will lead to unsound insurance practices.

Definition to limit risk: The first step in creating such a framework is to define microinsurance as a product category for regulatory purposes. This definition is crafted so as to limit the product space to those products exhibiting lower risk characteristics. In the South African context, the proposed definition to limit both the associated prudential and the market conduct risk is:

- Benefits capped at +/- \$7,000
- Term of less than 12 months
- Limited to risk-only
- Allowing both life and non-life underwriting in a single entity
- Simple terms and conditions

Not all low-income market products will qualify as microinsurance: Note that there will still be products of relevance to the low-income market, for example weather-related agricultural insurance, which will fall outside of the definition of microinsurance for regulatory purposes, based on their risk characteristics. These products can still be provided to the low-income market, but only by conventional insurers.

Proposed dedicated regulatory framework for microinsurance: Once such a definition is established, regulation can be tailored to the microinsurance product category. A dedicated microinsurance license is proposed to facilitate entry and competition, independent of institutional form, and that will entail a tailored prudential as well as market conduct regime.

Details of the proposed regulatory regime: The following tailored regulatory framework has been proposed for microinsurance in South Africa. In defining these regulatory parameters,

proposed concessions were tested on actuarial grounds, as well as with the regulator and industry role players:

Underwriting requirements:

- Limited to microinsurance products as defined
- Upfront capital of +/- \$0.5m, vs current: \$1.5m life, \$750k non-life
- Reserving based on simplified standard model
- Reduced organisational capabilities
- Minimum set of corporate governance requirements
- Registration open to public companies, friendly societies and co-operatives
- Restricted investments of assets to limit risk

Market conduct requirements:

- Similar regime to current funeral insurance intermediaries:
- Reduced minimum skills level in favour of training requirements
- No advice required (but incentivised through commissions)
- Simplified and clear language disclosure
- Uncapped commissions
- Reporting to regulator for monitoring

Regulatory review process underway. These proposals are contained in a discussion paper released by National Treasury for public comment during 2008. This is the first step towards the implementation of a dedicated regulatory framework for microinsurance.

6. Emerging guidelines for microinsurance policy, regulation and supervision

This section presents a set of guidelines for policy, regulation and supervision based on the cross-cutting findings presented in the preceding sections⁷⁸. Before proceeding to the guidelines we outline the goal, purpose and principles such guidelines need to adhere to and also outline the general regulatory approach underlining the proposed guidelines.

6.1. Goal, purpose and objectives

The **goal** of these guidelines, which are based on the cross country lessons emerging from the country findings, is to assist insurance policymakers, regulators and supervisors (collectively referred to as regulators if not specifically distinguished) to design policy and regulations and supervise compliance in a manner that will facilitate the growth of a micro-insurance market in their countries.

Microinsurance is defined as insurance that is accessible to the low-income population, potentially provided by a variety of different providers and managed in accordance with generally accepted insurance practices. This means that it should be funded by premiums and managed based on generally accepted risk-management principles. It therefore excludes social welfare as well as emergency assistance provided by governments.

The **purpose** of growing microinsurance provision is to extend financial inclusion in the insurance domain. The objective with financial inclusion is that individual consumers, particularly low-income consumers currently excluded from using formal financial sector services, must be able to access and on a sustainable basis use financial services that are appropriate to their needs and provided by registered financial service providers.

Insurance provides clients with a market-based means to mitigate material risks that they face. Microinsurance must do the same for low-income consumers. Although informal community-based risk pooling mechanisms (those not registered with the insurance supervisor to provide insurance to the public) provide low-income clients with a risk mitigation option and need not necessarily be formalised if they present low risk, the approach of these guidelines is to grow the formal microinsurance market. This can be done by (i) formalising existing informal providers of insurance (referred to in these guidelines as formalisation), (ii) encouraging existing commercial insurers to reach out to lower market segments (referred to in these guidelines as outreach), or (iii) encouraging new entrants, both domestic and foreign, that are particularly focused on the low-income market.

To develop microinsurance markets, regulators should pursue the following general **objectives**:

- Facilitate both outreach and formalisation, ensuring a level playing field for big and small players where they seek to serve the same market;
- Promote products, providers and distribution channels that will trigger the favourable introduction of low-income clients to insurance and its benefits;

⁷⁸ Please note that this section was drafted to be able to serve as a standalone document without necessarily having to be included in the full report.

- Adopt risk-based regulation, tailoring regulation to the distinctive risks posed by microinsurance products and intermediation;
- Minimise the regulatory burden on underwriting and intermediation.

6.2. Guidelines relating to policy on micro-insurance and financial inclusion

6.2.1. Guideline 1: Take active steps to develop a microinsurance market

Explanatory notes:

In most countries the development of a microinsurance market requires the extension of insurance provision to client groups (notably low-income client groups) that are not currently served by formal insurers and with limited exposure to any other formal financial products. Insurers either consider these client groups unprofitable (or less profitable than other opportunities) or have not investigated serving these markets. As a result of regulatory drift or inadvertent regulation, insurers, both formal and informal, may also be subject to a high regulatory burden that imposes regulatory costs that make it unprofitable to offer low premium products.

On the other hand low-income clients pose distinctive challenges that need to be overcome before they will make a voluntary purchase of an insurance product. Amongst others, low knowledge and awareness levels mean that few low-income consumers are aware of the potential benefits of insurance. Furthermore, the high discount rate applied by low-income persons causes them to place a low value on future cash payments, undermining the sales of life policies with future cash benefits. Low-income clients also show a disproportionately high distrust of insurers and insurance, requiring particular attention to product design, the sales process and claims payment. Yet poor people are much more vulnerable to the debilitating impact of life events, asset loss and health setbacks. Many a household that has clawed its way out of abject poverty was cast back into the most severe poverty through the happening of an event entirely insurable within their means. To overcome these behavioural challenges microinsurance markets, more often than not, have to be triggered or made and will not arise through natural market dynamics.

Guidance notes:

- (1) Confer a market development mandate on regulators over and above their normal supervisory mandate. This enables regulators to initiate market development actions without falling foul of their statutory mandate. At the least regulators should be required to consider and minimize the negative impact of regulation on market development.
- (2) Understand the existing as well as the potential market, i.e. both the served and unserved sections of the population.
- (3) Consider both formal and informal providers. Informal products and providers usually indicate needs in the low-income market segment not being met by the formal market and reveal regulatory and other obstacles to formalising their operations.
- (4) Place information, especially representative market surveys about the extent and characteristics of unserved market segments, within the public domain.
- (5) Make a public commitment to the growth of microinsurance. Create general public awareness about the potential for and ways to secure microinsurance.

- (6) Allow space for market experimentation while monitoring risk to the market and consumers. Monitor general market development and respond with appropriate policy statements and regulatory adjustments.

6.2.2. Guideline 2: Adopt a policy on microinsurance as part of the broader goal of financial inclusion

Explanatory notes:

Public policy expresses the intent of government. Public and private sector actors alike take their cue from the declared policy of the government of the day. Explicit policy objectives on microinsurance market development provide market players with the necessary security and guidance to invest with confidence in market areas where the regulatory framework may still be uncertain or in the process of development (that most often are the case for microinsurance). Public officials, on the other hand, are sanctioned by public policy to spend public resources on microinsurance development initiatives.

The policy formulation process also forces regulators to align microinsurance policy with other government policy objectives. These objectives can be supportive, such as a general policy to promote financial inclusion, or conflicting, such as the imposition of specific taxes on financial transactions or even publicly funded social protection measures that undermine the provision of market-based risk mitigation products.

The relationship between microinsurance policy and the government's general approach to financial inclusion is particularly important. Experience shows that the development of microcredit and microinsurance are mutually supportive. While credit insurance assists debtors to discharge their debts in time of need or death, it also mitigates major risks for the creditor, thereby making the extension of credit more viable. At the same time the microcredit (or microfinance) sales process provides a ready, cost effective and, in the case of community-based microfinance institutions, a client-orientated channel to both develop and market additional microinsurance products that meet the needs of low-income clients. Similarly micro-savings, transaction banking services directed at low-income clients and money transfer services facilitate the intermediation of microinsurance.

Guidance notes:

- (1) Formulate a policy on the development of microinsurance that is appropriate to the circumstances of the country. Avoid the adoption of template solutions from other countries unless these have been shown to meet the needs and resource envelope of local market conditions.
- (2) Consult formal and informal market players, as well as other relevant government departments. These may include other financial sector regulators, the revenue authority, and institutional regulators (those responsible for the regulation and supervision of legal persons such as companies and co-operatives).
- (3) Locate the microinsurance policy within the government's broader approach to financial inclusion, to the extent that this exists. Coordinate policy initiatives, supervision and law enforcement with other regulators responsible for the promotion of financial inclusion.

- (4) Base the policy on sound information about the market and its evolution. Leave enough scope for the regulator to respond to market changes and demand-side challenges and to facilitate innovation.
- (5) If a substantial informal market exists, the policy should facilitate both outreach by existing registered insurers and formalisation of informal insurers.

6.3. Guidelines relating to prudential regulation

6.3.1. Guideline 3: Define a microinsurance product category

Explanatory notes:

Microinsurance products require small premiums to be affordable to low-income clients. Profitable microinsurance operations therefore depend on least cost underwriting and distribution⁷⁹.

In jurisdictions where the overall insurance regulatory burden – both prudential and market conduct – is low, the likelihood is good that least cost microinsurance operations can be achieved within the existing regulatory framework. The development of a microinsurance market may then require limited or no regulatory intervention, but will still require active government encouragement. However, in jurisdictions where existing insurance regulation imposes a higher compliance burden or is more restrictive, it is less likely that least cost underwriting and distribution can be achieved within the existing regulatory framework. In these jurisdictions a reduced compliance burden – both prudential and market conduct - may be necessary to trigger or accelerate microinsurance development. Such a reduced compliance burden can only be justified on the basis of reduced risk. Invariably this requires the regulatory definition of a microinsurance product category that entails systematically lower risk.

Microinsurance products tend to entail lower risk: (i) benefit values are lower, (ii) policy terms tend to be shorter – often one year or less, (iii) the risk events covered are relatively predictable and the financial impact of each event relatively small, and (iv) the terms of the policy tend to be simple, avoiding complex underwriting processes. Most microinsurance policies are sold on a group basis and do not require individual underwriting. Although not all policies sold to low-income clients answer to these characteristics, most do. Utilising these parameters a microinsurance definition can be crafted to entail systematically lower risk.

The income level of the prospective policyholder is not considered a viable element of a microinsurance definition since the verification of individual or household income is too expensive and often of suspect integrity. The actual income levels of the policyholders will only become relevant if the policy premiums are subsidised by the state to a significant extent. Under these circumstances governments will normally require more precise targeting of state support to the poorest sections of the community.

⁷⁹ Least cost does not necessarily refer to the absolute lowest cost strategy but the lowest cost strategy at which an appropriate sale can be achieved ensuring that the client understands the policy bought.

The key parameters for a national microinsurance definition are the policy contract duration, benefit cut-off level and types of risk events that are included. Policy contract duration has a significant impact on the underwriting risk of a particular product with longer term policies being more risky than short-term policies. The benefit cut-off level, or maximum value to be written under a microinsurance policy, will differ from country to country. In setting this maximum benefit, policymakers must take care not to set the level too low. Particularly in countries with a low insurance penetration, most of the population is unserved by insurance and the maximum benefit should be set as high as possible, constrained only by the inherent risk posed by the benefit size and the need for a lower compliance burden.

The types of risk events to be included in the microinsurance product category should be determined by a number of factors, notably (i) the key risks faced by low-income households, (ii) how the relevant risks are generally managed or underwritten by the industry, and (iii) the market making and innovation dynamics prevalent in the particular insurance market. Both life and non-life risk events threaten low-income households and both should be included in the microinsurance definition. Life and non-life microinsurance policies tend to be underwritten on the same basis (on a group, short-term basis) and thus justify similar treatment. From a market making perspective, experience shows that most microinsurance policies are sold on the back of other microfinance services or linked to the sale of a product or service, for example a mobile phone or a future funeral. To facilitate market making, these policies (such as credit life, funeral insurance and insurance for mobile phones) should be included in the microinsurance definition.

Many low-income communities use informal risk pooling schemes to mitigate risks, especially to cover funeral expenses. As long as these schemes do not provide contractually guaranteed benefits, they fall outside the definition of insurance and thus also beyond the ambit of microinsurance. Unless these schemes are subject to large scale abuse or fraudulent practices, they should remain beyond the scope of insurance regulation. The limited supervisory capacity should instead be focused on insurance proper.

Guidance notes

- (1) Determine the extent to which the current insurance regulatory burden inhibits the underwriting and/or distribution of insurance products that are appropriate for the low-income market segment. This includes the extent of informal insurance provision and obstacles to the formalisation of informal providers.
- (2) If the regulatory burden inhibits the growth of microinsurance (and cannot be reduced across the board), define a microinsurance product category with systematically lower risk that will justify reduced prudential and market conduct regulation.
- (3) Define the microinsurance product category as wide as possible (in terms of both risk events covered as well as maximum benefit levels) to enable maximum extension of insurance penetration and integration into the rest of the insurance market. Provide an easy mechanism to adjust benefit levels to keep track with inflation and market changes.
- (4) Restrict the contract term of microinsurance policies, for example to twelve months. The actual term should be set in line with industry practices and client needs.
- (5) Set requirements to ensure simplicity of terms and easy communication thereof in the languages used by low-income clients.

6.3.2. Guideline 4: Tailor regulation to the risk character of microinsurance

Explanatory notes:

The establishment of a microinsurance product category with lower risk (refer guideline 3) allows the regulator to tailor both prudential and market conduct regulatory requirements to allow for lower-cost underwriting and distribution targeted at the low-income market. Whilst a lower compliance burden will be essential in a number of jurisdictions to ensure the viability of microinsurance operations, the failure of such operations due to inadequate regulation, e.g. inadequate solvency requirements, will undermine the growth of a microinsurance market. A balance therefore needs to be struck between a necessary reduction in the compliance burden and the maintenance of sufficient standards to protect clients and maintain trust in the insurance industry.

Regulators must consider tailored requirements, commensurate to the risks covered, complexity and size of proposed microinsurance operations, in the following areas:

- Capital adequacy, solvency and technical provisions;
- Prescribed standards on investment activities;
- Prescribed risk management systems;
- Prescribed underwriting systems and processes, including the extent and frequency of actuarial certification;
- Demarcation between life and non-life lines of business, especially the extent to which insurers can underwrite both life and non-life policies within the microinsurance product category;
- Market conduct regulation, including commission capping (see guideline 8 below);

Regulators can reduce the regulatory burden in one or more of these areas, depending on their existing regulatory framework. Generally jurisdictions follow one of two approaches. Option 1, which is often chosen if the existing legislation confers sufficient powers on the regulator to promulgate exemptions or wide-ranging subordinate legislation (removing the need to approach the Parliament or Congress to pass amending legislation), is to provide **exemptions** from existing obligations for a microinsurance line of business. Existing insurers or new insurers able to comply with the existing entry requirements are then able to offer microinsurance products under the reduced regime. This would typically include market conduct concessions, for example exempting the microinsurance product lines from commission caps applicable to other lines of business, or allowing more and cheaper distribution channels to be used for microinsurance sales. The limitation of Option 1 is that it tends to limit the universe of microinsurance providers to insurers who are already licensed or new insurers who can comply with often onerous entry requirements.

Option 2, which usually requires more extensive regulatory intervention than Option 1, is to create a second tier of insurance license with entry and other regulatory requirements tailored to the provision of microinsurance (referred to as a microinsurance license). This option provides more scope than option 1 for regulatory intervention to promote microinsurance. Tailored capital, solvency and investment requirements can be stipulated to facilitate the entry of smaller institutions wishing to participate in this market. The regulator can prescribe risk management and underwriting systems that are less costly and within the capacity of smaller operators. Moreover, since life and non-life microinsurance business is

often underwritten on the same short-term basis, and because single channel distribution reduces cost and promotes positive insurance discovery, some jurisdictions are moving towards the removal of the strict demarcation between life and non-life business in the microinsurance sphere. The same provider is then allowed to underwrite both life and non-life microinsurance policies.

Guidance notes:

- (1) Consider the specific regulatory provisions (as opposed to the overall regulatory burden – refer Guideline 3(1)) that restrict the growth of microinsurance provision.
- (2) Decide whether appropriate exemptions to the key provisions will be sufficient to deal with the material restrictions or whether there is need to create a new or second tier of regulation that provides specifically for microinsurance.
- (3) Design the microinsurance regulatory tier to be attractive to both existing registered insurers and potential new entrants, setting the entry requirements as low as is feasible, given the microinsurance risk profile, to facilitate new entry.
- (4) Develop risk-proportionate rules for microinsurance providers that are reflective of the limited business risk and will enable the participation of smaller players who do not have the capacity to comply with one-size-fits-all regimes.
- (5) Consider the need, within the microinsurance business line and if applicable to the jurisdiction, to maintain the strict demarcation between life and non-life insurers. If possible, allow a microinsurance license holder to underwrite both life and non-life business.

6.3.3. Guideline 5: Allow microinsurance underwriting by multiple entities

Explanatory notes:

In developed countries many of the older insurance companies started out as mutuals, pooling resources to mitigate the risks of members (often low-income at the time). As these institutions grew, the sophistication of the regulatory framework grew with them. In due course many of them converted into companies with shareholders rather than member-based mutuals. In low-income communities this process is repeating itself. Where this is part of the social structure of the country, member-based mutual-type institutions tend to fare better than traditional insurers in offering microinsurance, either through in-house schemes or as intermediaries for registered insurers. This is due to the high levels of trust amongst members as opposed to the general absence of trust in commercial companies that seems to prevail in most developing countries.

However, this time the “new” member-based institutions must make their way within an already sophisticated regulatory framework that imposes high compliance barriers. Existing regulation often makes it too onerous for these community-based mutuals to register as formal insurers. Yet, most member-based institutions who underwrite their own policies rather than obtaining underwriting from registered insurers, will benefit from even limited levels of insurance supervision since many of these in-house schemes are unsustainable.

Some of the most successful microinsurance operations - run by large registered insurers – are those of secondary co-operatives, or insurers owned by primary co-operatives. They are able to leverage the networks and member-bases of their owner co-operatives for cost-effective distribution. In a similar manner member-based microfinance institutions utilise

their networks and detailed client knowledge to develop and sell some of the most innovative microinsurance products around.

The primary weakness of member-based institutions tends to lie in weak corporate governance and inadequate risk management practices (for guidance on the latter, refer guideline 4(4) above). Corporate governance regulation is normally contained in institutional regulation, such as a companies act or co-operatives act, or in regulations issued by the institutional supervisors (as opposed to the functional supervisor responsible for insurance).

Guidance notes:

- (1) Allow multiple legal forms to underwrite microinsurance. This must include not only share capital companies (stock corporations) or other legal forms appropriate for large commercial insurers, but also co-operatives and other mutual-type or member-based legal forms more suitable to smaller and community-based insurance operations.
- (2) Ensure that institutions that underwrite the same products are subject to the same regulatory requirements (to ensure a level playing field conducive to a more competitive environment). This may require coordination with other government supervisors where the functional (insurance) supervision of the different legal forms falls under different supervisors.
- (3) Ensure that all institutions underwriting microinsurance are subject to corporate governance, accounting and public disclosure standards that are adequate to ensure compliance with the applicable insurance regulations. Where the standards contained in the current regulation of the different legal forms are inadequate, the necessary standards can be included in insurance regulation. However note that, microinsurance programmes have unique characteristics which imply that they may not fit into traditional methods of accounting (IAIS, 2007). According to the IAIS (2007, par. 197): “This does not preclude the necessity of well considered methods for determining current and projected values of assets, liabilities, income and expense. Appropriate disclosures should be considered in the plan of operations. Regulators should consider the possibility of combining their regulatory approaches with other forms of general purpose accounting, especially those simplified methods permitted for small and medium size enterprises in their jurisdictions. Generally, the purpose of the accounts should be a conservative and prudent presentation with a primary focus on policyholder protection”.
- (4) Enable all microinsurance providers to access reinsurance.

6.3.4. Guideline 6: Provide a path for formalisation

Explanatory notes:

Many countries experience a high incidence of informal insurance provision (as opposed to informal risk pooling). These unlicensed providers have normally emerged in response to real needs for risk mitigation within low-income communities. They also enjoy the trust of low-income clients.

Although they serve a valuable social and economic function, informal operations may be the source of consumer abuse and operations may fail due to inadequate risk management. Formalising these operations is in the public interest. However, limited resources available to insurance supervisors usually make this a difficult objective to achieve.

In these circumstances, experience shows that the best way forward is to define a clear evolution path whereby informal institutions can gradually and realistically meet the minimum regulatory requirements, including minimum capital requirements. Supervisors will in all likelihood also have to adopt a more entrepreneurial engagement with the informal sector to aid them along the way to formalisation or coordinate with other government functions tasked to do so. This may include the extension of amnesties or grace periods, capacity building support, including training of owners and managers, triggering consolidation activity or partnering informal operators with formal underwriters.

Experience has shown that market-based organisations, especially microfinance rating agencies (which tend to reduce the ratings of microfinance institutions with self-insured insurance portfolios) and dedicated microinsurance support institutions can play a major role in formalising informal insurance operations.

Throughout the formalisation process, the supervisor must be careful not to overreach its capacity or make idle threats. Both of these will undermine its credibility and thus the commitment of informal operators to regularise their operations.

Guidance notes:

- (1) Define an evolutionary path whereby informal insurers that have the potential to become registered entities for the delivery of microinsurance (refer Guideline 4) can formalise their operations. Such a regulatory framework for formalisation can include the following features:
 - Allowing new institutional forms more appropriate for the informal provider's operations to underwrite insurance (see Guideline 5);
 - Provide a tiered minimum capital and solvency structure, whereby insurers are also allowed to graduate to the minimum capital requirements over time at a prescribed rate. This will also help to avoid unintended regulatory drift;
 - Mandatory underwriting of all or certain lines of business by larger insurers or re-insurers coupled with capacity building requirements pending the commencement of own underwriting operations.
- (2) Take appropriate steps to both support and compel the formalisation process. This can include awareness campaigns, amnesties, capacity building and the catalysing or recognition of industry support organisations and market rating agencies.
- (3) Coordinate the formalisation drive with other state agencies, for example law enforcement agencies and revenue authorities, whose support is required to ensure compliance with the formalisation regime.

6.4. Guidelines relating to market conduct regulation

6.4.1. Guideline 7: Create a flexible regime for the distribution of microinsurance

Explanatory notes:

Low-cost distribution is essential to successful microinsurance development. However, cost is not the only criteria. Distribution channels should be able to actively sell policies to clients (see Guideline 8) and deliver policies as close as possible (geographically) to the normal locations of low-income clients. Experience also shows that microinsurance uptake increases

with the level of trust that potential clients have in the distribution channel, be that a retailer with a trusted brand, a bank with which the person has an existing banking relationship, a public utility, or another institution such as a religious group or trade union of which the person is a member.

Not all of these intermediaries fit comfortably into the traditional broker/agent regulatory definitions. Neither can the traditional regulatory requirements applied to insurance intermediaries, such as fit and proper requirements, be transferred to these channels with the same ease and in a manner allowing for low-cost intermediation. Different approaches are required. Moreover, with the rapid evolution of the financial system, it is difficult to predict what new models are going to develop at what point.

Increasingly new technologies are also used for client communication, data collection, premium collection and even the payment of claims. These can include mobile telephone networks, POS networks and the internet. Whilst substantial benefit can be obtained from allowing these new distribution methods to grow and intermediate insurance for low-income clients, their inability to actively sell the product to the client imposes a restriction on their ability to create new markets. As with other passive models these technologies also pose their own risks of consumer abuse and mis-selling. Appropriate measures to control market conduct therefore need to be put in place.

Guidance notes:

- (1) Allow multiple categories of intermediaries. Particularly encourage models that are able to actively sell products (see Guideline 8) or at least are able to verbally disclose critical product information to the client.
- (2) Avoid prescriptive regulation that restricts the design and nature of potential intermediaries beyond what is required for risk management purposes. Business models and technologies are changing at an increasing pace and regulatory systems need to be designed to accommodate changing models. Increasing monitoring and reporting requirements can be utilised where the impact of models are not clear (see Guideline 9).
- (3) The underwriting party must have a formal contractual relationship with the intermediary that outlines the respective obligations of the parties. This bestows joint responsibility on the insurer to ensure that its policies are sold without consumer abuse. An intermediary should however not be restricted to only one contractual relationship with a life or non-life insurer.
- (4) There must be ease of consumer recourse. The underwriter/ intermediary must provide an acceptable consumer recourse option. At the very least the customer must be able to lodge a complaint and/or channel enquiries via the POS.

6.4.2. Guideline 8: Facilitate the active selling of microinsurance

Explanatory notes:

Microinsurance, similar to insurance in general, is sold rather than bought. Experience shows that voluntary microinsurance uptake is highest when it is actively sold, particularly with another product or service, such as credit, goods purchased on credit, future funeral services, mobile phones or other financial services such as banking services. In each of these

cases, with the exception of compulsory insurance, the insurance value proposition has to be explained to the client and an active sale made in order to achieve take-up.

One-on-one sales processes may provide clients access to good information on the product but are expensive and can easily push already thin margin, low-premium microinsurance products into unprofitability. The imperative is therefore to avoid market conduct regulation that can make the individual sales process too costly. In many jurisdictions the traditional agent/broker model that relies on dedicated insurance professionals to do the selling, will be too expensive for microinsurance products.

A particular challenge in the microinsurance sphere is to overcome the lack of knowledge that most potential clients have of basic insurance concepts and products. This is best overcome by standardising or commoditising microinsurance products with simple terms and conditions. Some countries are developing a microinsurance standard, often referred to as CAT standards (fair Charges, easy Access and decent Terms) with which microinsurance products can be branded to facilitate easy recognition by clients.

Some jurisdictions have resorted to some form of price control on commissions payable to agents and brokers for services rendered in the intermediation of insurance policies. Whereas a conceptual case can be made for such controls in markets with very limited competition, experience shows that institutions find many ways to circumvent overly restrictive commission caps. Moreover, commission caps can be particularly restrictive in the microinsurance environment. A capped commission on a small premium may lead to so small an actual payout to the agent/ broker that it does not justify his or her going out to sell the product.

Guidance notes:

- (1) Apply the lowest possible levels of market conduct regulation to the microinsurance product category without compromising consumer protection (refer guideline 4). Specifically avoid market conduct regulation that imposes per transaction costs in favour of those that support developing the scale of distribution required by microinsurance.
- (2) Develop standard simplified terms and conditions for microinsurance or catalyse the development of such standards by the industry. This does not only simplify the sales process but also ensures that the general level of knowledge and awareness based on a standardised vocabulary is raised with every sales transaction.
- (3) Ensure minimum disclosure of product and supplier information to the client. If possible, encourage this to be done verbally.
- (4) Avoid price controls on the intermediation process. As an alternative, require microinsurance providers to disclose agreed commission levels to the supervisor.

6.5. Guidelines relating to supervision and enforcement

6.5.1. Guideline 9: Monitor market developments and respond

Explanatory notes:

A regulatory regime tailored to microinsurance risk entails (i) a compliance regime as set out in the guidelines above (an adjusted regulatory burden, where necessary, in terms of prudential and market conduct requirements), as well as (ii) the supervision and enforcement of such a compliance regime. The latter is as important as the first, because it is only through supervision and enforcement that a regulatory regime becomes effective.

While the need exists for effective enforcement of regulation by the supervisor, the microinsurance market at the same time requires the space for innovation. A microinsurance regime needs to allow for the emergence of new products (guideline 3), new players (guideline 5) and new distribution channels and technologies (guideline 7).

The supervisor's task is therefore a balancing act: to implement enforcement in such a way as not to make conditions overly onerous to market players, while at the same time responding to areas of abuse through careful market monitoring. For this purpose, it is important that minimum levels of information must be submitted to the supervisor. The reality of limited capacity may also mean that some areas of the market may remain completely unregulated. Directing capacity to high-risk areas while monitoring unregulated areas for changes in risk profile may, therefore, be the only option available within resource constraints.

Guidance notes:

- (1) Base the regulation and supervision strategy on a careful assessment of the areas of risk facing the consumer and the industry.
- (2) Prioritise supervisory capacity according to this assessment – targeting high-risk areas and in line with the capacity of the supervisor.
- (3) Complement this strategy with careful monitoring to ensure that supervisory forbearance or prioritisation can be adapted to changing circumstances and risk experience.

6.5.2. Guideline 10: Utilise market capacity to support supervision in low-risk areas

Explanatory notes:

In an environment of constrained supervisory capacity, supervisory approaches drawing in the capacity of market participants and other entities may enhance supervision. This may take several formats and should be designed around the specific conditions and entities in the market. For example, the supervision of certain market players (such as primary co-operatives) may be delegated to entities such as secondary/umbrella co-operatives providing services to primary co-operatives. The supervision of tied agents may also be delegated to insurers where they have the incentive to ensure that agents are appropriately trained and behave in an appropriate manner.

Such a strategy can reduce regulatory costs and capacity requirements as it does not require every single intermediary to register with or be monitored by the supervisor. Where this is

designed to utilise existing business processes that are also in the insurer's interest (e.g. agent training) the additional cost to the insurer could be limited. The incentive of being able to utilise a wider pool of agents may also compensate for increased costs. Combined with appropriate reporting to the regulator, this will allow careful monitoring and intervention where required. In this example, care should be taken to ensure that incentives for rigorous supervision is in place while, at the same time, the increased responsibility delegated to the insurer should not discourage them from utilising legitimate distribution channels.

Delegated supervision is not the same as self-regulation. With the former, the authority for regulation and supervision is retained with the regulator and only some functions are delegated to the support agency. Self-regulatory systems are more complicated to design and require specific criteria and incentives to be in place to ensure effective supervision.

Guidance notes:

- (1) Where feasible according to the assessment of the risks posed by various spheres of underwriting and market conduct (guideline (9)(1)), delegate aspects of supervision of certain players (for example intermediaries) to certain other market players (for example insurers).
- (2) Clearly delineate roles and responsibilities and ensure that delegated supervision is part of a coherent supervisory strategy rather than applied in an ad hoc manner.
- (3) Ensure that the strategy followed limits the increase in regulatory burden for those entities entrusted with delegated supervision and that the strategy indeed decreases supervisory costs while remaining effective in communicating breaches to the supervisor.
- (4) Monitor the situation and back it up with an effective consumer recourse mechanism (refer to guideline 7) to ensure that a delegated supervision strategy does not put the consumer at risk.

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Appendix 1: Cross-country summary table

		Colombia	India	Philippines	South Africa	Uganda
Population (m)		46m	1.1bn	89m	47m	28
Urbanisation		57%	29%	63%	59%	13%
Population <\$1/day (PPP adjusted)		93%	61%	93%	82%	82%
Population <\$2/day (PPP adjusted)		8%	40% rural; 20% urban	14%	23%	96%
Insurance penetration: premiums/GDP	Life business	0.7%	4.1%	0.9%	13.0%	Negligible as % of GDP
	Non-life business (incl. accident and health insurance)	1.7%	0.6%	0.5%	3.0%	0.6%
MI share in formal insurance market (% of premiums)		5%	1.0%	3%	<2%	Unknown
MI policyholders: % of adults (formal)		9% (2.7m) 19% (5.7m) including informal	1.95% (13.7m) 2% (14m) including informal	3.1% (1.7m) 5.4% (2.9m) including informal	16% (4.9m) 30% (9m) including informal	5% (0.6m) Informal negligible
MI market composition estimates	Formal insurers of which:	48%	98%	59%	54%	Almost 100%
	Formal mutuals/ co-operatives share in total formal	62% (1.7m)	Limited (distribution rather than underwriting)	32%	<10%	None currently
	Compulsory credit-driven insurance share of total formal	27% (about 750k)	90%	49%	41% (2m) [22% of total MI market]	100%
	Informal/unregulated	52% (3m of 5.7m)	20%	41%	46%	Negligible
Context-specific qualifications		Financial liberalisation and crisis in 1990s	State-dominated market; recent privatisation	Strong mutual and MFI credit life drive; adaptive	Low-income market product and distribution innovation by formal sector enhanced by	Very small market; regulation only recently

		Colombia	India	Philippines	South Africa	Uganda
				regulatory stance	Charter pressure	established
Regulation	Underwriting (min cap. requirements as proxy)	\$3-4.2m min (depending on business line)	\$25m	* \$24m - new insurers * \$3m - new MBAs (\$305k existing MBAs) * \$122k - all MI MBAs; to be phased up to \$305k over time	\$1.3m life \$0.7 non-life	\$580k (double for composite)
	Intermediation	Low entry barrier and regulatory burden	Restrictions on entities that may act as intermediaries excludes key low-income networks Requirements on intermediaries increase cost of doing business	Low entry barrier and regulatory burden	Potentially restrictive requirements for low-income intermediaries Medium to high burden for advice-based sales; Low compliance for non-advice sales	Restrictions on who may be remunerated as intermediary

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