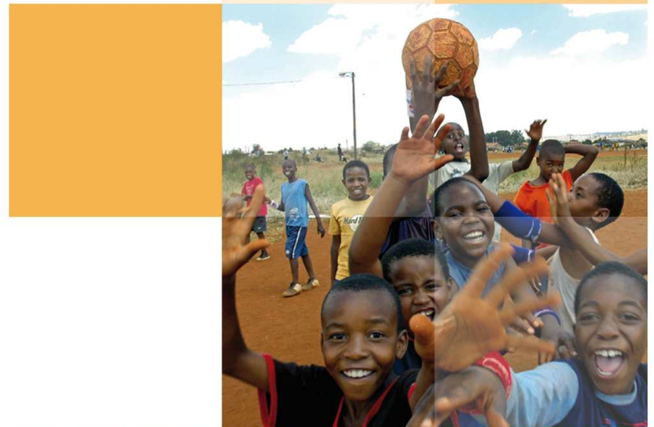
access to insurance initiative

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

South African case study



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IDRC CRDI
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Date: 27 **October** 2008

cenfri
The Centre for Financial Regulation & Inclusion

Version 6 (12 January 2009): Final

This document presents the findings from the South African component 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 and 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 BMZ[2] (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.

The South African case study was conducted by Genesis Analytics (www.genesis-analytics.com).

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

[2] Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung – German 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
- 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 (GIZ, former GTZ)
- Michael McCord (Microinsurance Centre)
- Martha Melesse (IDRC)
- Craig Thorburn (World Bank)
- Sabir Patel (ICMIF)
- Martina Wiedmaier-Pfister (GIZ, former GTZ)

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Executive Summary

This is the report of the South African country study on the impact of regulation on the development of the micro-insurance market. As such it forms part of a larger cross-country study which considers the micro-insurance experience in Colombia, India, the Philippines, South Africa and Uganda with a view to develop a set of guidelines that can assist developing countries to establish a facilitative regulatory environment for micro-insurance.

The report describes the regulatory landscape in South Africa as it impacts on the delivery of micro-insurance. It then proceeds to analyse the existing market for micro-insurance in South Africa, looking at the nature of the demand, products offered, the spread of current suppliers as well as the methods of distribution employed. Against this background the key drivers – both regulatory and non-regulatory – that have shaped the evolution of the micro-insurance market are identified.

Background

Low-income insurance usage in South Africa is among the highest in the world. Approximately 15% of the low-income population in South Africa has some kind of formal insurance policy. When informal cover is added, the reach among the poor extends to 33%, mainly in respect of funeral insurance. Furthermore, this insurance is sold on a voluntary basis, driven by culturally-created demand. This distinguishes South Africa from much of the international experience, where micro-insurance is usually associated with compulsory credit life insurance sold by NGO micro-finance institutions. Yet the market is not without its problems and a regulatory review process is currently underway to reconsider the regulation of micro-insurance.

Regulatory framework

In South Africa, insurance is demarcated into long-term (mainly for life risks) and short-term (or non-life) insurance. The former is governed by *the Long-term Insurance Act, 52 of 1998*, and the latter by the *Short-term Insurance Act, 53 of 1998*. No insurer (except dedicated reinsurers) is allowed to have licenses under both acts. Each type of insurance includes a number of lines of business. Within the Long-term Act, one of the lines defined is *assistance business,* defined as a life policy with a benefit value not exceeding R10,000 ($1,398). In practice, assistance business is applied as funeral insurance, the most popular type of insurance among the poor.

Only public companies and friendly societies (in terms of the Friendly Societies Act of 1956) are allowed to provide insurance. Friendly societies are mutual organisations. Most registered friendly societies in South Africa are burial societies formed to provide social and financial support to members upon the death of a family member. Registered friendly societies are exempted from registration under the Long or Short-term Act, should they provide policies of which the benefits amount to no more than R5,000, i.e. half that of assistance business, or should they not contractually guarantee their policy amounts (i.e. only provide informal cover).

The *Cooperatives Act, 14 of 2005* provides for the formation of financial services cooperatives (including cooperative burial societies) as legal persons. Such cooperatives may provide insurance but are obliged by the Act to then register for insurance purposes under the Long or Short-term Act as well. As insurance registration involves conversion to a public company, it implies that the cooperative is not in practice a viable form for the provision of insurance to the low-income market.

Other options for the provision of insurance by mutual groups are via underwriting by a registered insurer, or via cell ownership in a cell captive insurer.

Insurers are also subject to *market conduct regulation*. This includes commission capping. Assistance business is the only line of business where no commission caps apply. Market conduct is further regulated by the *Financial Advisory and Intermediary Services Act of 2002*, which requires the authorisation of all financial service providers and their representatives (including those selling insurance) who provide *advice* or *intermediary services*. It further regulates the manner in which financial products and services are to be marketed and sold. Amongst others, it requires financial intermediaries to provide advice to their clients it they sell a product to them. Due to the onerous nature of this provision in the low income market, the regulator has issued a Guidance Note which defines intermediary services to exclude any clerical service that does not require judgment and does not provide advice, including premium collection or sales (previously classified as intermediary services). This has allowed for a category of sales staff not registered as representatives and for the non-advice based selling of insurance products on a commoditised basis, often through retailer networks.

In South Africa, the extension of access to financial services to the low-income market is an explicit policy goal, and the financial sector has been committed to certain access targets under the *Financial Sector Charter of 2003*.

Market overview

Insurance sold to the low-income market in South Africa is dominated by funeral insurance. Traditionally, the funeral insurance market has largely been served by *informal* players (burial societies providing informal, unguaranteed cover rather than insurance) and *illegal* insurance providers in the form of self-insuring but unregulated funeral parlours. There have also been a number of smaller, dedicated assistance business players in the formal insurance market. Increasingly, the formal sector is however entering the lower-income market. This movement has gained momentum since the Financial Sector Charter was signed, as insurers are now obliged to fulfil access targets by 2014.

Apart from funeral insurance (which is also the only product for which an informal market spontaneously developed), generally low take-up has been achieved in the low-income market, despite a range of products that have been launched since the Charter was signed. The less successful products include basic household structure and contents insurance, asset insurance and personal accident insurance. The relatively more successful non-funeral products include credit life insurance, credit insurance (an insurance policy associated with a specific credit purchase which provides for the replacement or repair of the purchased item in the case of it being damaged, lost or stolen – as opposed to credit life which provides for

the repayment of the outstanding amount upon the death of the purchaser), cell phone insurance and legal insurance. Credit life insurance is the second largest type of micro-insurance in South Africa. It is mostly associated with furniture, appliances and other durable goods sold on credit by retailers and is often cloaked in opaque sales and pricing practices. As it is based on a credit purchase, it is not a voluntary insurance product; rather, its take-up is driven by compulsion. Legal insurance, though its uptake is still almost negligible relative to the overall market, is a product which has developed historically, without any Charter pressure, due the need for the underlying service among the poor. Cell phone insurance take up has been driven by the high importance attached to the cell phone as a business and personal accessory, and the distribution of insurance during the phone sale process.

Focus group research has thrown light on the demand characteristics of the low income market. Funerals are an important cultural phenomenon and too costly for most families to cope with without dedicated financial strategies. Thus, traditionally, the burial society developed as a means to cope with the financial shock of a funeral. Short-term insurance, on the other hand, does not enjoy the same status. Though focus group participants valued the "convenience" of insurance in replacing lost/stolen goods, this was only one way of coping with the loss. Many respondents accept the need to go without an asset, rely on family or "start over" when such an asset is lost. Short-term insurance is also understood as insurance *for a short period*, most often related to the purchase of a household good/appliance on credit and regarded as "part of the package" to ensure that you do not need to continue paying down a product that you do not even have, should it be stolen or destroyed. All in all, focus group findings reveal that the need for a regular premium is problematic and would prevent them from maintaining a short-term policy. In the end, when resources are constrained, short-term insurance is unlikely to be high up on the spending priority list. The one exception is cell phone insurance: a very high value is placed on the cell phone as a means of communication and most respondents indicated a high willingness to insure their cell phones.

- *Key market features*. Apart from the funeral insurance dominance and the trends among non-funeral products as described above, the main features of the micro-insurance market in South Africa are identified as:

- *Short-term, group-based products.* All micro-insurance products in the market have short policy contract terms and are underwritten on a group basis (i.e. not individually underwritten even if sold on an individual basis)

- *Demarcation*: no composite products by one supplier. Suppliers provide life, non-life and health insurance exclusively - one supplier being limited to one of these product lines.

- *Informality*. Of all people with (formal and informal) funeral cover, the bulk (52%) only has burial society membership (informal).

- *Illegality*. Of the 48% with formal cover of some sort, the bulk is provided by or through funeral parlours, much of which could be self-insured or not compliant with FAIS regulations on intermediaries.

- *Micro-insurance category emerging*. There is a new wave of products being launched that comply with industry created standards for targeting the low-income market. These standards represent an implicit move towards defining a "micro-insurance" product category. This movement is being extended by the current National Treasury process to develop a discussion paper on the regulation of micro-insurance.

- *Distribution models*. New mass distribution models are developing beyond the traditional broker, often based on partnerships with existing distribution networks or with organised low-income groups and employing innovative technologies.

- *Advice-less selling*. The insurance market is being bifurcated according to the way in which policies are sold. Micro-insurance is predominantly sold without providing advice (employing the so-called tick-of-the-box selling method), whereas the high-income market is characterised by advice (in the form of financial needs analyses) by independent brokers.

- *Cell captives*. Cell captive insurers allow organisations to rent part of a third party's insurance license, and provide a suitable vehicle for groups not yet able to obtain their own insurance licence to graduate beyond distributing a product underwritten by a registered insurer.

Drivers of the micro-insurance market

What has shaped the features of the micro-insurance market as identified above?

Non-regulatory drivers. A number of non-regulatory market drivers determine the state of the market:

- *Groups as coping strategy and as means of distribution*. The fact that social groups are so important in low-income communities adds to the attractiveness of the burial society as a coping strategy and hence the high level of informality. Social groups furthermore play an important role in distribution. Organised low-income groups provide a basis on which insurers can distribute products. Group-based policies can be sold at low cost via burial societies, affinity groups or unions, as they spread administrative expenses and selling to large groups reduces selection risks.

- *Culture produces unavoidable expenses*. For the largest part of the South African population, culture dictates the need for a dignified, expensive funeral. Thus culture produces unavoidable expenses which can best be mitigated through insurance (be it informally so or via a formal product). This explains the dominance of funeral insurance among the low-income population.

- *The development of the micro-lending market has driven credit life insurance*. Credit life insurance is directly linked to a credit purchase. The micro-credit market has over recent years developed significantly in South Africa, thereby catalysing the rise of credit life insurance.

- *Low awareness of insurance as a personal/individual financial product amongst the low income population*. The fact that negligible take-up of non-funeral and non-compulsory (i.e. non-credit life) insurance has been achieved can, conversely, be explained by the fact that there is no cultural driver or compulsion necessitating the use of the underlying service or product. Therefore the imperative to use insurance as a coping strategy is less pronounced. Furthermore, people often are also just not aware of such insurance products or of the value that it can offer them. This is driven by low levels of financial literacy in the market as well as the fact that, historically, few if any products were available that were tailored to the needs of the poor.

- *Presence and power of the cell phone market drives the only type of asset insurance achieving take-up in the low-income market*. Almost half the South African low-income population now has access to a cell phone. The importance of cell phones to the low-income market drives the take-up of cell phone insurance, the only type of asset insurance which has achieved any success (though still limited) in the low-income market.

- *Innovation in the characteristics of micro-insurance products are driven by the needs of the market*. Low premiums, simplicity, flexible terms and appropriate premium payment mechanisms are prerequisites in achieving success in the low-income market and are driving the product and distribution innovation taking place to serve the low-income market, e.g. cell phone based payments, allowances to skip a certain number of premiums, etc.

- *Availability of a large retail distribution and payment system network in South Africa has provided new potential distribution models*. Retailer distribution is an important feature of the low-income market. This is only possible due to SA's large retailer footprint and sophisticated payment system.

Regulatory drivers. Apart from these non-regulatory drivers, there are however also a number of regulatory factors shaping the micro-insurance market. Ten main regulatory drivers were identified and analysed:

1. The absence or non-enforcement of existing laws and regulations has facilitated the development of the informal and illegal micro-insurance market;
2. Institutional regulation is blocking the entry and development of mutual and cooperative insurers;
3. Prudential regulation does not provide a framework that encourages entry and development as its requirements are quite stringent for low risk forms of insurance;
4. Strict demarcation between long-term and short-term insurance undermines the development of short-term micro-insurance, as a separately registered and regulated entity is required to write each type of business;
5. Regulatory concessions (e.g. allowing unlimited commission) have facilitated the development of the formal market, but this has been limited to funeral insurance;
6. Market conduct regulation shapes the distribution models used in the low-income market – with the relatively high cost of compliance for intermediated distribution prompting the extension of adviceless, "tick box" selling models;

7. Micro-insurance market activity is facilitated by financial inclusion regulation, for example, the Financial Sector Charter sets access targets for formal insurers to reach low income markets;
8. The existence of a sophisticated regulatory structure and well resourced supervisors have contributed to a strong financial sector that made a regulatory down-market push possible; and
9. The Usury Act provided the incentive for credit providers to sell insurance by reducing the margins they could earn from lending

Key insights

The need to facilitate positive market discovery beyond funeral insurance. 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.

Need to facilitate entry and formalisation. There is currently no effective space for member-based entities to formalise into for the provision of insurance. The friendly society space that currently exists may pose risks to consumers and is also limited in terms of the benefits it can provide.

Proposed new microinsurance regime takes on board lessons. The current proposed regulatory reform (initiated by the South African National Treasury to correct market imperfections) is encouraging in that it suggests an active engagement of the regulatory authorities to address the challenges highlighted by the case study. It also forms part of a broader policy to empower the previously disadvantaged citizens of the country. Should the proposal for regulatory reform be accepted and enacted, it will provide a valuable case study on the impact of regulatory change on the development of a microinsurance market.

1. Introduction

This document presents the findings from the South African component 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 base, cross-country lessons are 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 identify 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.

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Low-income insurance in South Africa

South Africa has one of the highest insurance penetrations in the world: premiums make up slightly less than 14% of GDP, which far exceeds the emerging market average of 3.9% and the industrialised country average of about 9% (SwissRe, 2006). This also holds true for insurance aimed at the low-income market. Though very small as a percentage of overall premium flows[5], insurance taken up by the low-income population is not a new concept in South Africa and relative to its peers South Africa has a well-developed formal micro-insurance industry. The prevalence of insurance among the poor is the result of a tradition of saving for death through so-called burial societies (informal risk-pooling mechanisms), or through funeral insurance policies, often from a funeral undertaking parlour, for a funeral service in the event of death. Thus micro-insurance is historically dedicated mainly to funeral insurance as a type of life insurance, a phenomenon which is largely the result of the cultural importance attached to a dignified funeral. The *commercial* (formal[6]) micro-insurance

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[3] Funded by the UK Department for International Development – DFID.

[4] Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung - Federal Ministry of Economic Cooperation and Development

[5] In 2005, assistance business (the only distinct “low-income” type of insurance for which data is recorded in South Africa) accounted for 2.3% of total net insurance premiums in South Africa.

[6] Throughout this document, the term “formal” is used to denote regulated and supervised organisations.

industry is also well developed and reaches more than 15% of the low-income population. In particular, South Africa is one of the few jurisdictions where commercial providers are successfully offering *voluntary* micro-insurance. Whereas the bulk of micro-insurance internationally is based on compulsory/embedded sales of credit life insurance through NGO microfinance institutions (MFIs), and on mutual or other community-based insurance schemes, these institutions play a small role in SA compared to other developing countries.

There is however still much room for improvement in order to reach a larger proportion of the population, to increase the share of *formal* products and to diversify the offering and take-up of insurance beyond funeral insurance. At the same time, it must be ensured that consumer interests are adequately protected. At the heart of the challenge facing the insurance regulator therefore lies the need to reconcile the objectives of limiting potential abuse in the market (in respect of prudential and market conduct risk[7]) while promoting financial inclusion.

Regulatory review process

South Africa is currently in the process of reviewing the insurance regulatory framework in order to facilitate the development of micro-insurance. This process has its origins in a number of dynamics and trends that are shaping the development of the South African micro-insurance market, such as the need to mitigate the risk of consumer abuse on the one hand, and to tap into the opportunities for financial sector development and inclusion on the other hand. While this process is still in its early stages, it signals the government's commitment to micro-insurance, which is in line with a broader recognition within government objectives of the importance of access to financial services. This makes it an opportune time to consider the regulatory framework for insurance provided to the low-income market in South Africa within the broader effort of developing guidelines for the regulation and supervision of micro-insurance internationally.

Document structure

The document is presented in five parts.

- **Section 2** provides an overview of the methodological approach

- **Section 3** provides an overview of the insurance regulatory framework in South Africa, in terms of the various pieces of legislation and their relevant characteristics, as well as the cross-cutting features defining the framework. Understanding the insurance regulatory framework more broadly is key to developing guidelines for adapting the framework to accommodate and facilitate micro-insurance.

[7] We note that both prudential and market conduct regulation ultimately aims to protect consumers. The former does this through regulating the risk management practices of insurance providers while the latter regulates the manner in which the products are intermediated to consumers.

- **Section 4** considers the current market for micro-insurance in South Africa. By unpacking the providers, intermediation, products offered and take-up of micro-insurance, we derive the key features and trends characterising the market.

- **Section 5** highlights the drivers of micro-insurance development to date in South Africa, specifically noting non-regulatory and regulatory drivers which have influenced usage and level of access to insurance products.

- Based on these findings*,* **Section 6** summarises and concludes.

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 findings in the cross-country report. The full analytical framework is contained in Appendix 1. It covers:

- The financial inclusion framework

- The goal of microinsurance, namely increased welfare for the poor through risk mitigation to reduce vulnerability.

- The definition of microinsurance, namely insurance managed according to insurance principles, in exchange for a premium, that is accessed by or accessible to the low-income market.

- The parts of the insurance value chain covered, including underwriting, administration and intermediation/distribution.

- The distinction between formal and informal insurance and intermediation.

- The categories of risk identified, namely prudential risk, market conduct risk and supervisory risk.

- A typology of public policy instruments, namely policy, regulation and supervision.

- An overview of the insurance regulatory scheme (most notably financial inclusion policy or regulation, prudential regulation, market conduct regulation and institutional regulation)

Please refer to Appendix 1 for a detailed analysis of each of these areas.

2.1. Methodological approach

The following research process was followed in compiling this study:

- *Understanding the microinsurance market*. The microinsurance market is described in terms of: (i) the various players (corporate and mutual/cooperative, 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 conclude on 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*. Furthermore, the study gives an overview of the insurance regulatory framework, in general and as pertaining to microinsurance.

- *Drivers of microinsurance*. In light of the above, it seeks to draw out respectively the non-regulatory (market, macroeconomic and political economy context-related) and regulatory drivers of the state of microinsurance. These drivers are synthesised in the cross-country document.

- *Conclusion*. The drivers are used as the basis for highlighting conclusions on the development of the market, the impact thereon of regulation and other factors and the way forward for microinsurance policy, regulation and supervision.

The methodology consisted of desktop research as well as consultations with industry role players, regulators, supervisors and other stakeholders. It involved:

- Traditional demand and supply mapping

- Qualitative focus group research

- Regulatory and policy analysis

- Controlling for context and the distinctive evolution of the broader insurance market

2.2. 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 was excluded from the scope of the study. Indemnity health insurance is an extremely important product for the low-income market but requires a dedicated study as it is often 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.

3. The insurance regulatory framework in South Africa

In this section an overview of the insurance regulatory scheme in South Africa is given, rooted in a discussion of the various options for micro-insurance provision created by regulation. This is the context against which the market overview discussion in Section **4** should be considered and it will form the basis of information for the in-depth analysis of the regulatory drivers of the micro-insurance market characteristics in Section **5.2**.

Demarcation along product lines. South African insurance regulation demarcates insurance into long-term insurance, short-term insurance, and medical schemes, each governed by its own act, supervised by different registrars[8], and each defining a number of classes of policies[9]. The regulatory framework is therefore designed around product definitions though it does not entail detailed product regulation or individual product approval. Life insurance is regulated under the Long-term Insurance Act, non-life or asset insurance regulated under the Short-term Insurance Act and medical schemes are regulated under the Medical Schemes Act. As noted in the introduction, medical schemes fall beyond the scope of this study.

Current review of micro-insurance regulation. To date, micro-insurance in South Africa has not been embedded in a coherent and supportive regulatory framework. Beyond a few concessions for funeral insurance, there is no dedicated regulation for micro-insurance. Recently, however, a regulatory process was initiated to review the current insurance regulation framework in order to support the development of micro-insurance.

Supervised by Financial Services Board. The day to day regulation and supervision of the insurance industry is the responsibility of the *Financial Services Board* (FSB). All insurers have to register with the FSB and report data to the FSB, who must ensure compliance with all insurance legislation. It also issues guidance notes (e.g. on the interpretation of legislation) and may make policy inputs. Designing insurance policy and implementing legislation to effect this is primarily the responsibility of the *South African National Treasury* but supported by the FSB. In exercising this responsibility, Treasury has to take into account a number of government objectives. Most notably for the insurance sector is the need to ensure consumer protection through the prudential stability of the industry, as well as by ensuring proper market conduct. In addition, Treasury also has to take into account an increasing array of broader government objectives. In particular, black economic empowerment and financial inclusion (as embodied in the Financial Sector Charter of 2003). This forms the backdrop against which the current regulatory review process to create a framework for the provision of micro-insurance is playing off.

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[8] The Long-term and Short-term Insurance Acts falls under the jurisdiction of the Financial Services Board, whereas the Medical Schemes Act falls under the jurisdiction of the Council for Medical Schemes.

[9] The demarcated scheme was introduced in 1998 in an attempt to more completely ring-fence different kinds of insurance risk. Previously, one insurance act had governed the whole range of insurance provision.

Below, the insurance regulatory framework is sketched, preceded by a classification of the various options for writing insurance to which the regulatory framework will pertain.

3.1. Options for microinsurance provision

Micro-insurance can be provided in a number of ways and by a number of entities under the current regulatory framework. Each option involves different regulatory requirements and costs, ultimately affecting the value proposition available to consumers.

- *Underwriting arrangement with a licensed insurer*. Any entity (including a burial society, affinity group, sole proprietor, etc.) wanting to provide micro-insurance to its members or clients but that has no insurance license, and/or is unable to underwrite the risk or conduct the day to day management of those products, can obtain underwriting from a formal insurer. Although the entity may design and brand the product, all risk is transferred to the underwriting insurer, which has to comply with the full set of insurance regulation. Such an entity effectively acts as an intermediary, but with more flexibility in product design and options for co-branding. An underwriting arrangement removes the need for own capital and skills and provides scale to a group. The insurance risk can now be shared across the full portfolio of the insurer, thereby allowing for more affordable pricing.

- *Cell owner*. Entities looking to provide insurance can opt to buy into a cell captive insurer, thereby "renting" part of an existing insurer's license. Under the cell captive arrangement an insurer (the cell captive) sells a "cell" (in the form of a class of preference shares) to an organisation wanting to provide insurance, but without an insurance license of their own. This affords the organisation more autonomy in product design than the underwriting option and also allows for some risk and profit sharing. Even though the entity may share in the underwriting risk and profits, the ultimate risk is still transferred to the cell provider (a registered insurer) who remains responsible to honour the cover even if the cell renter fails. The insurer has arrangements in place to ring-fence cells (as required by the special conditions placed upon its long- or short-term license) to limit the exposure of a cell to losses in a neighbouring cell. The cell captive route, therefore, allows organisations to provide insurance while building up skills and capital. These organisations also benefit from centralised back-office and risk management operations and assistance with product development and pricing, which reduce costs and the minimum capital required for each cell.

- *Friendly society*. Mutual entities can register as a friendly society (a non-profit society aimed at providing support to members), which allows it to conduct limited insurance activities. Unlike the first two options, the society carries the full insurance risk and must make the necessary provisions to meet its liabilities. A friendly society may obtain reinsurance for specifically defined areas of risk, but in practice this rarely happens, as reinsurers have not shown an appetite for this market. The friendly society market is quite small and there are some concerns about the governance and operational controls implemented by these societies.

- *Full insurer*. The last option is to register as a full insurer (either life or non-life in the South African set-up). Becoming a licensed insurer entails meeting certain entry and

ongoing requirements of a prudential, institutional and market conduct nature. Cell captives and reinsurers are regulated as specialised insurers under the Long-term and Short-term Acts.

As the discussion below will indicate, cooperatives can also provide insurance, but only if they register as insurers under the relevant insurance act as well. Therefore the cooperative form is not currently a self-standing option for the provision of micro-insurance in South Africa.

Potential dedicated micro-insurer. A further option that is being considered as part of the regulatory review is to create a dedicated micro-insurance license. The argument is that the current options are insufficient and not without limitations (as will be apparent from the market discussion in Section **4**) and that a dedicated micro-insurance space would therefore promote financial inclusion in the insurance realm. Such a dedicated micro-insurance license would be based on the provision of a limited set of products with low prudential and market conduct risk characteristics, on the basis of which the regulatory requirements could be softened.

These options can be represented schematically as follows:

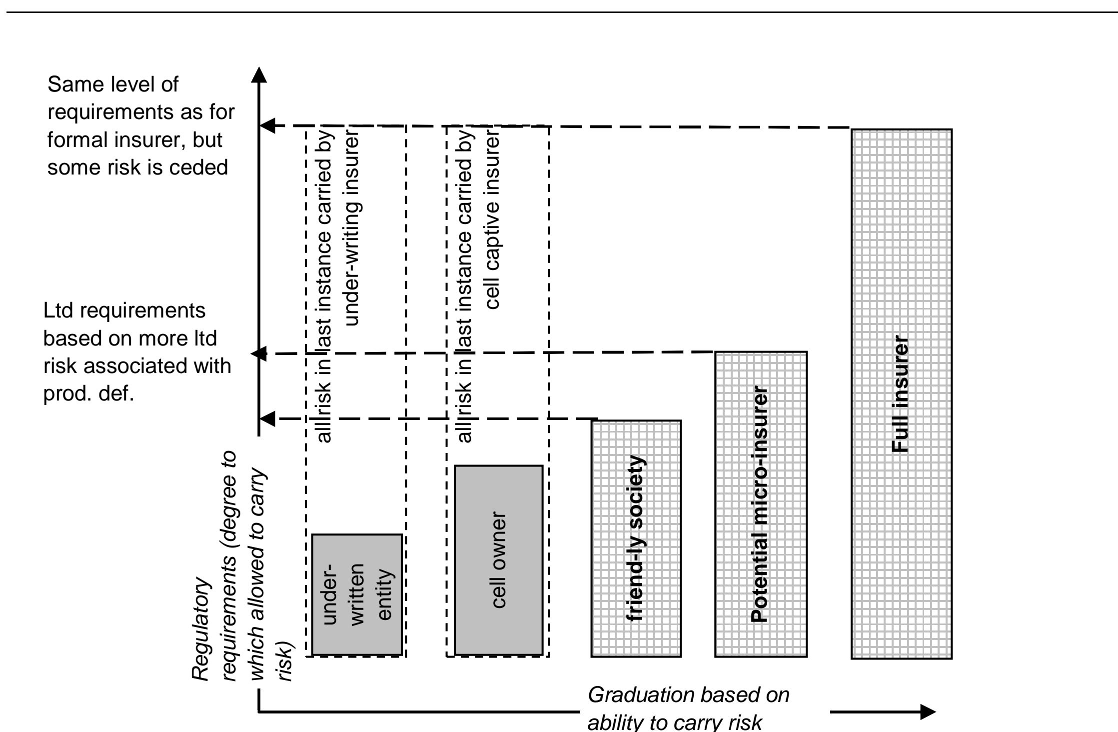

Figure 1. Regulatory options for providing micro-insurance

Source: authors

The details of the regulation that establishes these options are discussed in more detail below.

3.2. Regulatory scheme

Regulatory review process. The South African National Treasury recently initiated a review of the insurance regulatory framework applicable to the low-income market in order to facilitate the formal provision of micro-insurance while still ensuring adequate insurance risk management. This process has its origins in a number of dynamics that are shaping the development of the South African micro-insurance market:

- *Risk of consumer abuse.* A number of concerns have been expressed regarding abuse in the market for funeral services and related financial services. It is alleged that funeral service providers often provide illegal insurance policies (self-underwritten without accreditation or proper risk management) and that consumers' right to a monetary pay-out is not honoured (though this is required by law). Instead, payment is provided in the form of a funeral service of which the real value is often much lower than the nominal value for which the policy was taken out. Consumers are however to verify the true value of the service provided. These concerns were brought to Parliament's attention in a Portfolio Committee on Finance meeting in 2003 and again in 2005, which placed emphasis on the need for a regulatory review process to ensure better consumer protection in the market. The emphasis on consumer protection is in line with a number of other policy movements, such as recently enacted intermediation legislation.

- *Opportunities for financial sector development and inclusion.* Although concerns about potential abuse were the initial motivation for the regulatory review, it was also established that insurance can provide good value to low-income households. Recent developments in the market include a move beyond just narrow funeral insurance as non-life products are starting to enter the market. These developments have gained added momentum since the Financial Sector Charter was signed in 2003, committing [the formal] industry to reach certain access targets to extend the footprint of the financial sector, including insurance. As counterpart to this agreement, government is committed to creating an appropriate regulatory framework in support of expanding the set of products on offer to lower-income households.

The current regulatory scheme defines the underwriting options (as noted above), the conditions for becoming and being an insurer, as well as the way in which insurance should be sold to consumers and the incentive structures that may be set. The regulatory framework therefore determines in part the types of insurance that will be provided to the poor and how. Importantly, it also determines intermediaries' incentive structures to serve the poor. The micro-insurance landscape in South Africa is regulated by a complex web of laws and regulations that govern different aspects of micro-insurance. There are essentially four parts to the insurance regulatory framework in South Africa:

- *Institutional and prudential regulation.* The Long-Term Insurance Act (Act 52 of 1998), Short-term Insurance Act (Act 53 of 1998), Friendly Societies Act (Act 25 of 1956) and the Co-operatives Act (Act 14 of 2005) establish the basic regulatory framework which determines who can provide insurance and on what terms. These acts also contain some requirements regarding proper market conduct (e.g. permissible commission structures are set out under the regulations to the Long and Short-term Acts). These acts are discussed in more details in Section 3.2.1.

- *Market conduct regulation.* Market conduct regulation is primarily contained in the Financial Advisory and Intermediary Services (FAIS) Act, 37 of 2002, which sets the conditions for the intermediation of insurance (and other financial services) to the public in order to enhance consumer protection. As noted some elements of market conduct regulation also appears in the Long-term and Short-term Insurance Acts. The FAIS Act is discussed in more detail in Section 5.2.

- *Financial inclusion regulation.* Financial inclusion regulation, as embodied in the Financial Sector Charter (FSC) of 2003, is an important factor impacting on the South African market and recently also on the regulatory framework for micro-insurance. Though not explicitly part of the insurance regulatory framework, it interacts with all other legislation as an important and sometimes clashing objective to be reckoned with. The FSC is discussed in more detail in Section 5.2.

- *Other, non-insurance regulation.* In addition to the FSC, there are a number of Acts and other regulatory developments (e.g. on social security) that do not form part of the insurance regulatory framework, but may nonetheless to an extent impact on the market for micro-insurance. See discussion in Section 5.2 for more details.

Below, an overview of the relevant pieces of regulation will be given. We will return to the coherence of the regulatory scheme, the linkages and implications thereof in the discussion of the regulatory drivers of the micro-insurance market in Section **5.2**.

3.2.1. The Long-term[10] and Short-term[11] Insurance Acts

The Long- and Short-term Acts (together with the Medical Schemes Act), were tabled in 1998 as sister-acts to replace the Insurance Act of 1943. Both acts limit entry to the insurance market to appropriately capitalised and supervised insurers.

Insurance defined as guaranteed benefits. Both the Long- and Short-term Acts define insurance as “a contract in terms of which a person, in return for a premium, undertakes to provide policy benefits upon, and exclusively as a result of, [an] … event…”[12] By definition, therefore, insurance is defined as a *contract* between the insurer and insured, to provide a *contractually guaranteed benefit* upon the specified contingency. The relevance of this definition is that it excludes the type of cover provided by informal burial societies where the level of cover is not guaranteed (see discussion in Section 5.2).

Products differentiated based on type of cover rather than term. Though referred to as the “long-term” and “short-term” acts, the term of the policy contract is not used as definition to categorise products under the long-term or short-term acts. Instead, all policies relating

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[10] Act 52 of 1998.

[11] Act 53 of 1998.

[12] Contained in Section 1(1) of the respective acts – wording differs slightly for various types of policies. E.g. life insurance would specify “as a result of a life event”.

to life-events are captured under long-term insurance, while short-term insurance tends to cover the loss of an asset or another indemnity event and personal accident or disability events are included under both. As result, policies under the Long-term Insurance Act may have short-term risk features, whereas some policies under the Short-term Act may have long risk terms. An example relevant to this study is funeral insurance[13], which is written almost exclusively on a short-term (less than 12 months) basis. This implies that, though it is classified as a long-term product, assistance business actually has a short-term risk nature. Yet short-term insurers are prohibited from writing funeral insurance.

Basic conditions and structure of Long-term Insurance Act

The Long-term Insurance Act, 1998, including the Regulations passed under the Act and the Policy Holder Protection Rules of 2001 (collectively referred to here as the Long-term Act) provides for the registration of long-term insurers and for the control of their activities. No legal entity is allowed to carry on any kind of long-term insurance business unless he or she is registered with the Registrar of Long-term Insurance[14].

Long-term insurance business is defined in the Act as the business of undertaking to provide policy benefits under long-term policies[15]. These policies are defined in the Act and include: assistance policies[16] (defined as life policies for which the benefits paid may not exceed R10,000 - $1,398[17]), disability policies, fund policies, health policies, life policies and sinking fund policies. The Act requires insurers to register for and report on each category of insurance they provide. Health policies are carefully defined to exclude indemnity medical insurance policies which are regulated separately under the Medical Schemes Act. Health policies under the Long-term Act (and the Short-term Act) are therefore restricted to policies providing a fixed amount (non-indemnity) of cover on a defined health event and typically take the forms of personal accident or critical illness policies. All long-term insurers are required to at all times have a statutory actuary. Long-term insurers may "not to enter into any particular kind of long-term policy unless the statutory actuary is satisfied that the premiums paid, benefits and other values are actuarially sound"[18].

Special treatment afforded to assistance business. Funeral insurance (referred to as assistance business in the Long-term Act) is defined as a separate product category allowing

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[13] Referred to as assistance business in the Long-term Insurance Act.

[14] Section 7 of the Long-term Insurance Act.

[15] Section 1 (1).

[16] As assistance business is traditionally regarded as funeral insurance, the definition of assistance business as a line of business implies that funeral insurance is explicitly and separately defined (though the definition of assistance business is related to the value of the policy, rather than whether it is applied to funeral expenses). Within the South African context, assistance business can be regarded as the pioneer and prime form of micro-insurance in the formal sector.

[17] Note that all currency conversions in the document are based on the average ZAR/USD year to date (1 January 2007 to 8 August 2007) exchange rate as obtained from www.oanda.com/convert/fxhistory.

[18] Section 46.

the regulator to determine different regulatory requirements for this category of insurance. There are three main differences between assistance business policies and other long-term policy categories:

- The benefits payable under an assistance policy on any one life are limited to a maximum of R10,000 ($1398)[19] No such cap applies to the other categories of life insurance. However, in reviewing the legislation no sections could be found explicitly preventing a person from taking out more than one assistance policy with the same insurer.

- Unlike other long-term policies, there is no limitation on the commission that may be paid to an intermediary in respect of an assistance policy.[20] Although the FSB has in the past threatened to apply commission capping, it was recently publicly announced that it will no longer be seeking to cap assistance business commissions.[21]

- The Act specifically requires that insurers 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).[22] Assistance business is the only type of long-term insurance subject to this requirement, and no short-term insurance has the same requirement.[23]

- Until 1998, insurers providing only funeral insurance were also subjected to lower upfront capital requirements than other insurance categories. This is no longer the case.

Basic conditions and structure of Short-term Insurance Act

The Short-term Insurance Act (Act 53 of 1998) governs both insurers and intermediaries providing specifically defined types of asset or non-life insurance. No entity is allowed to carry on any kind of short-term insurance business unless it is registered with the Registrar of Short-term Insurance[24]. Short-term insurance is defined as the business of providing or

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[19] This cap is currently being reconsidered by National Treasury for its appropriateness and may be replaced by a broader micro-insurance cap under the proposed micro-insurance regime. However, the cap has not necessarily limited assistance business clients in the level of cover they can obtain, as individuals often opt to complement a formal policy with an informal burial society, or to have more than one policy to cover different aspects of the funeral expenses. The calculations in Bester, Chamberlain, et al (2005) also showed the limit to exceed the average value of a funeral in South Africa.

[20] Section 49 and Part 3 of the regulations to the Long-term Act.

[21] Deon van Staden of the FSB, at the meeting of the Assistance Business Standing Committee on 30 June 2004 in Pretoria.

[22] Section 53. The right to a monetary benefit was instituted to protect consumers from abuse where funeral service providers may claim that the funeral service is worth X amount, but the actual value is much lower. The value of the mandatory monetary benefit option however relates to the *cost* for the insurer – that is, should an insurance policy of R10,000 be sold, but the actual cost to the insurer be only R5,000, the insurer is obliged to offer the consumer the option of a monetary benefit of at least R5,000.

[23] This implies that, for short-term insurance, insurers may insist on replacing the asset, e.g. a cell phone.

[24] Section 7 of the Short-term Insurance Act.

undertaking to provide policy benefits under short-term policies. Short-term policies include, amongst others, property policies, engineering policies, liability policies, motor policies and accident and health policies. The definition of accident and health policies contains exactly the same exclusion in respect of medical schemes business as that contained in the Long-term Insurance Act.

No actuarial requirements for short-term insurers. There are no actuarial requirements for short-term business. However a review is under way considering whether actuarial requirements should be imposed on all policies under short-term insurance. This has resulted in the proposed introduction of Financial Condition Reporting, which is discussed in more detail in Section 5.2.

Short-term insurers prohibited to offer funeral insurance. Until 2003, it was possible to write funeral insurance under the Short-term Act, and there is still no outright prohibition in the Act preventing a short-term insurer from providing a funeral benefit to a policyholder. However, there is a prohibition on short-term insurers using the term “burial” or “funeral” in any policy or advertisement[25] and the implication is that assistance business should not be written under a short-term license. However, some insurers continue to offer a form of funeral insurance on short-term basis as an add-on to other short-term insurance products. This is done under the name of “bereavement” policies in order to get around the restriction.

Regulation of intermediaries. Unlike the Long-term Act, the Short-term Act contains provisions that regulate the conduct of the business of intermediaries and their relationships with short-term insurers. In particular, a short-term insurer cannot pay any consideration to an independent intermediary unless that short-term insurer has entered into an agreement with the short-term insurer.[26] The agreement must be in writing and must contain, amongst others, the kinds of short-term policies that the intermediary may enter into on behalf of the insurer. No intermediary is allowed any other remuneration than commission.

Differences and commonalities in the provisions of the Long and Short-term Acts

Different regulatory burden for long-term and short-term insurers. Though the two acts largely overlap in their provisions, long-term insurers are subject to more strict requirements than their short-term counterparts in a number of cases:

- Long-term insurers are required to provide R10m ($1.4m) start-up capital, versus only R5m ($0.7m) for short-term insurers[27]. Both types of insurers must maintain a minimum surplus of assets over liabilities.

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[25] Section 27 of the Insurance Amendment Act, Act 17 or 2003.

[26] Section 48. No equivalent requirements are in place under the Long-term Act.

[27] *By law* (contained in Regulation 2 under S. 29 of the Short-term Act) the minimum additional additional asset requirement (i.e. the minimum capital required) is R3m ($0.4m), or 15% of net premium income in the previous financial year, whichever is higher. Section 6.2(b) of the FSB’s Guidelines for Registration of short-term insurers however requires a minimum capital adequacy requirement of R5m ($0.7m). R5m is therefore the minimum upfront capital amount required *in practice*.

- While long-term insurers must obtain the services of a statutory actuary to annually sign off its valuation, no such requirement is placed on short-term insurers who may also conduct reserving based using simplified formulae (e.g. a fixed proportion of premiums received).

- Different commission levels are imposed on long- and short-term business. For instance, the commission on an individual life product or health and disability product is capped at 3.25% while commission on the sale of short-term personal lines insurance is capped at 12.5% and motor insurance is capped at 20%. Both acts allow for a proportion of the commission to be paid up-front but this practice is mostly limited to long-term insurance. Funeral insurance (regulated under the Long-term Insurance Act) is the only category of insurance exempted from commission caps. Commission structures across the financial sector are currently under discussion and may result in regulation on the manner in which commissions may be structured. Mainly, this will entail moving away from up-front commissions, which is seen to incentivise churn, to on-going commissions paid over the lifetime of the policy.

The differences between the long and short-term acts imply that funeral insurance, the one type of insurance traditionally targeted at the low-income market, enjoys preferential treatment in terms of commission, which incentivises selling and hence should have positive implications for financial inclusion. However, as it is classified under long-term insurance, higher upfront capital requirements apply, as well as stricter prudential requirements such as the need for a statutory actuary. This raises the barriers to entry and the regulatory costs for long-term market players vis-à-vis their short-term counterparts.

Regulation requires public companies with insurance as main business. Only public companies are allowed to register as insurers under the Long-term and Short-term Acts and separate companies need to be established[28] (of which the main business is insurance) to do short-term and long-term business[29]. Accordingly, non-insurers must establish separate companies with insurance as main business in order to provide insurance. Both acts theoretically allow for non-public entities which are "incorporated without a share capital under a law providing specifically for the constitution of a person to carry on long-term [or short-term] insurance business as its main object"[30]. Interestingly, some of the largest insurers in the market (Old Mutual and Sanlam) started as mutual insurers (before demutualising into public companies towards the end of the 1990s), and a traditionally important player in the assistance business market, AVBOB, remains a mutual insurer. In practice, however, this requires a special act of parliament to enable organisations such as

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[28] Section 15(4) of the Long-term Act and Section 15(5) of the Short-tem Act (other than a person carrying on reinsurance business only).

[29] There are a few exceptions to this, which falls beyond the scope of this study: pension funds, the state run unemployment insurance fund and agricultural co-operatives.

[30] Section 9(3)(a)(ii) of respectively the Long-term and Short-term Acts, 52 and 53 of 1998.

mutuals to become insurers without transforming into public companies[31] – something that is not easily achieved without significant political and operational support. Accordingly mutual organisations, including financial services co-operatives, are effectively prevented from registering as insurers *unless they transform into public companies*, thereby sacrificing their mutual nature. This has implications for informal mutual-type of organisations, should they want to formalise and hence is relevant from the perspective of formal financial inclusion. An exception relevant to this study is the friendly society form, which may offer limited benefits. The Co-operatives Act is also trying to open the space for co-operative insurers. Both of these forms are discussed further in Section 5.2.

Neither Act makes explicit provision for cell captive insurers. In South Africa, cell captive insurance does not have a dedicated regulatory framework (for example via the Protected Cell Company or the Independent Cell Company legislation found in some other jurisdictions). Rather, cell captive insurers are regulated as insurers under the Long- or Short-term Acts, but with special conditions placed on their license upon registration (both Acts allow the Registrar to place special conditions on specific applicants). Such conditions relate, for example, to the ring-fencing of individual cells[32].

Friendly Societies exempted from Long-term and Short-term Acts. Friendly societies registered under the Friendly Societies Act are exempted from compliance with the Long-term and Short-term Insurance Acts as long as the policies that they offer to their members do not have benefits exceeding R5,000 ($699) per member. From an access perspective, this implies that the provision of insurance to the low-income market through this form is facilitated by the exemption. However, it has been argued that the R5,000 limit places friendly societies at a competitive disadvantage to formal assistance business providers, as they can only offer members benefits amounting to half that of their competitors.

Reinsurance regulated under both Acts. The Long- and Short-term Acts both make provision for reinsurance and all the various policy definitions extend to reinsurance policies in that regard. Reinsurers are the only insurers exempted from the requirement to establish separate companies to conduct long- and short-term insurance[33]. Reinsurers may only reinsure registered insurers. Long-term reinsurers may however also reinsure fund policies[34], the definition of which includes policies provided by friendly societies[35]. No reinsurers are, however, currently registered to re-insure friendly societies (mainly because of concerns

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[31] The three cases of such an act being passed in South Africa are: AVBOB Mutual Assurance Society Incorporation (Private) Act, No. 7 of 1951; South African National Life Assurance Company Incorporation (Private) Act, No. 3 of 1954 (Sanlam); and South African Mutual Life Assurance Society Amendment (Private) Act, No. 23 of 1937 (Old Mutual)

[32] The "Prescribed Requirements for the Calculation of the Value of the Assets, Liabilities and Capital Adequacy Requirements of Long-Term Insurers", issued in FSB Board Notice 72 of 2005, however does mention of cell captive insurers by making determinations on the calculation of value of assets held in cell captive insurers.

[33] Section 15(4) of the Long-Term Act and S. 15(5) of the Short-term Act.

[34] Section 15A of the Long-term Act (inserted by the Insurance Amendment Act, 17 of 2003).

[35] Definition of Fund Policy (Section 1.1) .

about their governance and operational processes), implying that this route for reducing the risk carried by friendly societies and thereby making them more viable is currently underutilised.

The Registrars of respectively Long-term and Short-term Insurance[36] *have discretion to impose limits and relax regulatory requirements.* The Registrar has the discretion to change certain provisions for insurers. This includes the right to limit the license of particular applicants where the applicant may not have the necessary skills or capacity to qualify for a full license, the right to impose certain conditions on the license (e.g. limiting the policy benefits or premiums[37]) and the freedom to limit the business insurers (e.g. insurers limited to funeral insurance). Furthermore, the Registrar has the discretion to relax certain regulatory requirements upon application from insurers, including minimum capital adequacy requirements. This discretion is provided for in the Board Notice 72 of 2005[38], which states that: "[the] Registrar may relax a provision in these Requirements, for such duration and on such conditions as the Registrar may determine"[39]. In practice, the FSB is however reluctant to apply this discretion as it complicates supervision. The FSB has indicated that this discretion is not applied to any new licenses, but has only been applied for assistance business insurers having to scale up their capital from lower levels under the previous insurance act.

Policy Holder Protection Rules governing both. As forerunner to extended consumer protection under the FAIS Act, Policyholder Protection Rules (PPR) were issued for long-term and short-term insurance[40] in 2001. These have remained in force even though the FAIS Act has been passed. The PPR provide, amongst others, for matters relating to: disclosure (including the statutory notice to be supplied to policyholders as well as the commission received by an intermediary); replacement policies, cancellations of policies and an obligatory cooling off period; record-keeping and monitoring; and the marketing of products directly to the public, including telephone sales.

4. The micro-insurance market in South Africa

This section provides an overview of the micro-insurance market in South Africa, considering the formal and informal[41] players, the distribution models employed, the products offered

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[36] With the FSB being the body within which both registrars are housed.

[37] See sections 10 and 11 of the Long-term Act for more details.

[38] "Prescribed Requirements for the Calculation of the Value of Assets, Liabilities and Capital Adequacy Requirements for Long-term Insurers" grants (Section 10.1) issued under Schedule 3 of the Long-term Act (as amended by the Insurance Amendment Act, 2003) Repealing Board Notice 38 of 2004.

[39] A 2004 FSB Directive 140.A.ii(LT) named "Relaxation for Provisions in Requirements – Long-term Insurers" also clarifies the procedures for and conditions under which the Registrar may relax certain requirements.

[40] Promulgated in Regulation Gazette 7010 on February 23, 2001 and came into operation on July 1, 2001.

[41] We distinguish between formal and informal players according to whether they are regulated and supervised or not. We distinguish between formal insurance (i.e. guaranteed benefits) and "informal insurance" i.e. unguaranteed benefits as e.g. provided by burial societies that informally pool risk, by referring to the former as *insurance* and to the latter as *cover*.

and the take-up thereof among the low-income population. It does not attempt to provide a detailed market review but rather to highlight the salient features relevant to this paper. The discussion focuses on the features of the formal market, but also notes the presence of informal and illegal providers. As micro-insurance has to date not been formally defined in South Africa[42], we focus the discussion on the products and players that are targeting the lower-income market (including those developed under the various Financial Sector Charter initiatives). Box 1 captures the main findings that emerge from the section.

Box 1. Key features of the micro-insurance market in South Africa

- *Product characteristics*. All micro-insurance products in the market have short policy contract terms and are underwritten on a group basis (i.e. not individually underwritten).
- *Demarcation*. Suppliers provide life, non-life and indemnity health insurance exclusively - one supplier being limited to one of these product lines.
- *Funeral dominance*. Funeral insurance (and cover) dominates micro-insurance market
- *Informality*. Of all people with some sort of funeral cover, the bulk (52%) only has burial society membership (informal).
- *Illegality*. The remaining 48% of those who have cover indicated that they have *formal* insurance. Of this, the bulk is however provided by or through funeral parlours, much of which could be self-insured or not compliant with FAIS regulations on intermediaries.
- *Compulsory*. The second biggest micro-insurance market (though still very small in relation to funeral insurance) is credit life (provided through credit retailers, rather than MFIs), which is driven by its compulsory nature.
- *New products*. The past few years have seen the emergence of new micro-insurance products in cell phone insurance, housing insurance, and funeral insurance offered through new distribution channels.
- *Credit insurance dominates short-term insurance market*: Despite the emergence of new products, the short-term insurance market for the low-income population is dominated by credit insurance, i.e. asset insurance purchased with goods purchases on credit.
- *Micro-insurance category emerging*. Increasingly, products are launched that comply with industry created CAT (fair Charges, easy Access, decent Terms) standards. This can be regarded as an emerging new micro-insurance category. The definition of this category is to be extended in the ongoing National Treasury Discussion Paper process.
- *Adviceless selling*. A bifurcation of the market is taking place in how policies are sold: micro-insurance is predominantly sold without advice, while the higher end of the market is served by brokers providing advice.
- *New distribution models*. New mass distribution models beyond the traditional broker, e.g. retailer distribution, are gaining prominence in the low-income market and are based on the non-advice selling model.
- *Cell captives***.** The existence of cell captives and the potential for groups to use this vehicle to graduate from underwritten or informal insurance entities to more formal insurance provision

[42] Note that the international definition of micro-insurance referred to in the introduction of this document (essentially as being commercial insurance targeted at the poor) is not an operational insurance definition within regulation in South Africa, as it is not possible for insurers to guarantee that a product will only be taken up by a certain segment of the market. Rather, a regulatory definition, should it be adopted, is likely to be product-based, defining a range of products that limit insurance risk to such an extent that it warrants a tailor-made, less onerous regulatory regime, and which is *likely* to be largely taken up by the poor due to its product features.

has come to the fore.

4.1. Products & take-up

In the distribution discussion above, many micro-insurance product examples were referred to. There are a number of trends in micro-insurance product provision and take-up in South Africa:

Insurance penetration in the low-income market low relative to higher income segments. Figure 2 below (based on FinScope 2006 data) indicates insurance penetration in the low-income market in South Africa. 56% of LSM 10 individuals have some form of *formal* funeral cover, reducing to about 16% of all LSM 1-5 adults (33% of LSM1-5 individuals have *any* sort of funeral cover, including formal insurance and burial society membership). Burial society membership ranges from 21% in LSM 1-5 to 7% in LSM 10. 52% of LSM10 individuals have life cover other than funeral, versus only 2% of LSM1-5. The contrast is even starker for general or asset insurance: 48% of LSM 10 adults indicate that they have some form of general insurance. This is compared to only 0.5% uptake of general insurance in the LSM1-5 market (FinScope, 2006). Therefore the poorest part of the population tends to rely more on burial society membership, often provided informally (i.e. without any insurance *guarantee* of the amount payable). The following diagram indicates usage of various types of insurance across LSM groups:

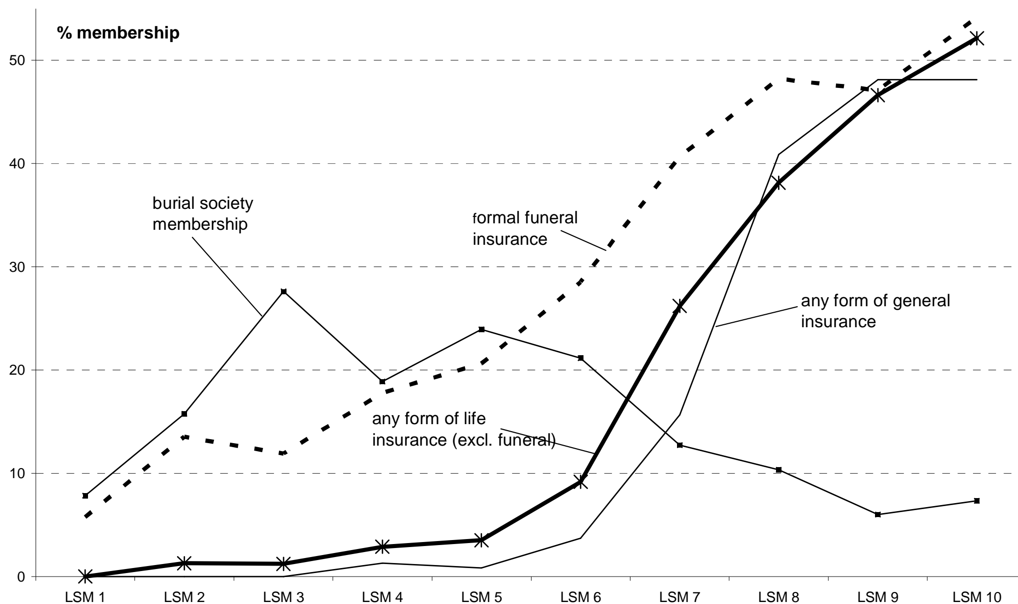

Figure 2. Insurance uptake across LSM groups.

Source: Derived from FinScope 2006 data.

Micro-insurance market dominated by funeral insurance. Despite the entry of non-funeral products, it is clear from Figure 3 below that funeral insurance still dominates products used

by the poor and significantly exceeds usage of non-funeral life insurance, credit life insurance and general insurance. In fact, the numbers for credit life and general insurance are extrapolated from such a limited number of respondents that they are essentially negligible. It must be noted that the number of people with credit life insurance is likely to be significantly underestimated by the survey[43] but it remains lower than that of funeral insurance.

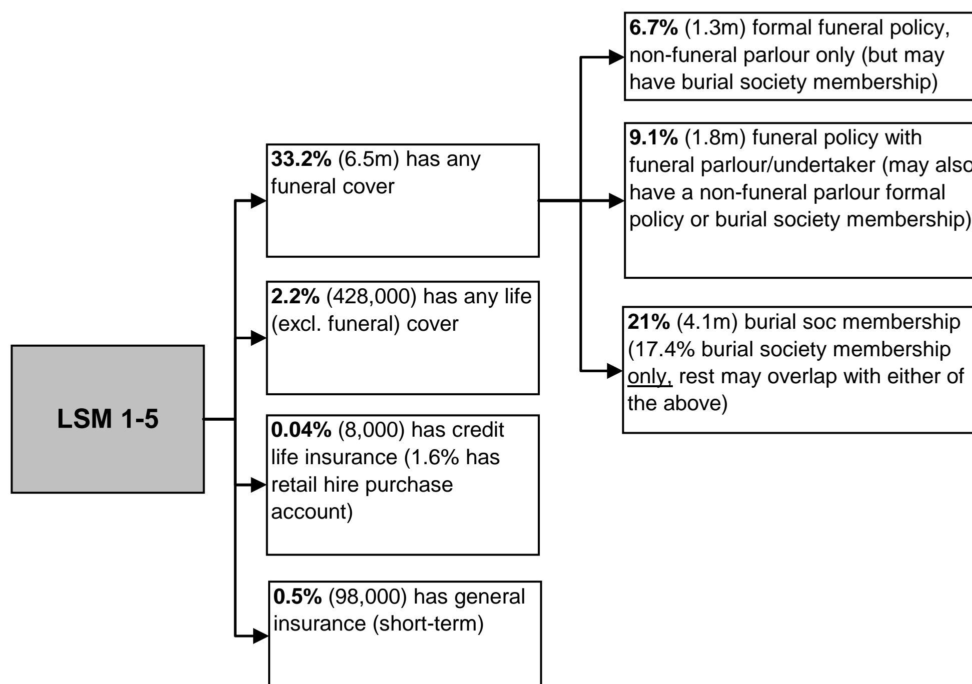

Figure 3. Breakdown of insurance usage among LSM1-5.

Source: Genesis calculations based on FinScope 2006 data[44]. Note that all percentages are as % of the total LSM1-5 market

Low-income market penetration on the rise for funeral products. A significant increase in uptake of funeral insurance was also recorded by the FinScope survey, with individuals in LSM 1-5 reporting some form of *formal* funeral cover (provided by formal insurers plus funeral parlours as indicated in Figure 3 as the sum of 6.7% and 9.1%) increasing from 8% in

[43] Due to current opaque sales practices many people will be unaware that they obtained credit life insurance with their loan or credit purchase (most of which will have credit life insurance bundled with it). It is also not possible to estimate the credit life penetration using credit figures as this is also significantly under-reported in the survey (a problem common to surveys).

[44] Note that the way that the questionnaire is set up allows for overlap between different types of cover. Thus the percentages do not add up to a total figure.

2003 to 16% in 2006. Some caution must be taken in comparing FinScope data across years as some of the increase may be due to improvements in the questionnaire. In comparison, the take-up of short-term insurance has remained stagnant at less than 1%, despite the existence of a number of products targeted at the low-income market. Demand-side reasons for this low take-up will be considered below – it would seem that, other than funeral insurance, other forms of insurance are not demanded by the poor, probably due to matters of relative preference given a limited budget. It is not possible to comment on trends for other classes of policies, as their uptake in the low-income market is too limited, or is insufficiently recorded in the FinScope survey[45].

Of the reported funeral cover usage, a large proportion is through informal burial societies or potential illegal insurers. Of the 33% (6.5m) of LSM 1-5 individuals that have any form of funeral insurance:

- *Informal.* 63% (4.1m) are members of a burial society and 52% (3.4m) are members of a burial society only (i.e. they do not use any of the other funeral insurance products). Although a proportion of the burial society uptake may actually be referring to formal funeral insurance products sold through informal societies, this is a limited phenomenon and not expected to constitute a large component of the informal product usage.

- *Illegal.* 28% (1.8m) indicated that they obtained funeral cover through a funeral parlour. From previous research (Genesis, 2005) such policies may include policies sold by a funeral parlour that acts as the agent of the formal insurer or by a funeral parlour group registered as an insurer. In many cases, however, this reflects illegal insurance schemes run by funeral parlours without any relationship with a formal insurer. It is not possible to identify illegal insurers through the survey, but evidence from qualitative research suggests that it could be significant. The implication for the consumers of illegal insurance, as indicated in Section 3.2, is one of the reasons for the current revisiting of the insurance regulatory framework as pertaining to micro-insurance in South Africa. There have been numerous claims of consumer abuse by illegal insurers, not offering fair value for money and submitting customers to overly high insurance risk where insurance is illegally underwritten. Therefore, though access via funeral parlours may be high, an imperative is to formalise such channels to ensure better consumer protection, i.e. better *quality* of access.

New products extend beyond funeral insurance. A number of new low-income products have been launched recently. The formal sector products on offer still focus on funeral insurance[46] but increasingly also include legal insurance[47], personal accident insurance, cell phone

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[45] E.g. survey responses tend to under-report on credit usage and due to current opaque sales processes, many individuals who have credit may be unaware of the fact that they also have credit life insurance.

[46] Apart from the examples and case studies provided in the text below, further product case studies are provided in Appendix , Appendix , and Appendix .

[47] As described in Box 3 below, as well as Appendix

insurance[48] and, to a more limited extent, household structure and content insurance[49]. Apart from these standalone products, credit life remains an important product sold to the low-income market.

Credit life insurance. Credit life insurance is normally sold as part of or ancillary to an instalment sale or other credit sale agreement in terms of which durable consumer goods are sold. This market is often characterised by low awareness among clients of the fact that they have bought the product (as it is bundled with the sale of the retail product). There is a particularly close relationship between credit life and furniture retailers. Sales are driven by credit merchant risk and profit seeking (insurance premiums to be added to the monthly credit instalment can be used to circumvent interest rate ceilings). It provides high value to the merchant, who cannot cost-effectively reclaim assets on small amounts of credit, should the client pass away. It requires no additional sales effort, as it is bundled with the sale of the retail good, and a captive market implies the opportunity to levy high risk charges (consumers more often than not do not exercise their right to "shop around" for the most appropriate policy).

There are however concerns about consumer abuse in this market. Consequently, an official inquiry into the credit life environment and practices was launched recently. Box 2 below gives an overview of the credit life provision by a prominent South African furniture retailer.

Box 2. Credit life insurance provision: the case of Ellerine Holdings[50].

Ellerine Holdings (a large furniture retailer) offers credit life insurance to clients who buy furniture on credit in order to cover the value of the loan in the event of death. It owns 3 insurance companies to handle credit insurance[51]. Ellerine owns a total of 1,220 stores across South Africa which could all potentially sell insurance products. Policies are sold in-store upon the credit purchase of a product and have the branding of the relevant Ellerine insurance company.

A typical credit life policy sold with the instalment purchase of furniture or other household goods at an Ellerine Holdings contains four main types of insurance: (i) *asset insurance* provides for the replacement or repair of the purchased item in the case of its being damaged, lost or stolen. Depending on the discretion of the insurer, the policyholder can also receive cash compensation; (ii) c*redit life insurance* provides for the full repayment of the outstanding balance of the loan if the policyholder dies, is injured and/or retrenched; (iii) l*ife insurance* provides a fixed payout in the case of accidental death and/or a defined funeral benefit for the policyholder (i.e. not for the family of the policyholder) (any outstanding debt is deducted from the value); and (iv) *health insurance* provides benefits if the purchaser discovers that he or she is HIV positive during the term of the policy, but only if he or she undergoes immediate treatment for HIV/AIDS[52]. The cost of the treatment is also covered by the health policy and paid for by the insurer. The four types of insurance contained in the policy overlap in a variety of ways. This overlap tends to limit the final

[48] See amongst others the case study on the Pep/Hollard model, which includes a cell phone insurance product (Appendix).

[49] See Appendix and Appendix for short-term household insurance example case studies.

[50] The full case study is contained in Appendix 14.

[51] The fact that there are three insurance companies in the group is the result of mergers over the last five years mergers (where retailers merged into Ellerines had their own insurance companies). It is expected that the insurance components will eventually be reduced to one life insurer and one short-term insurer.

[52] Note that this is a fixed benefit, therefore the insurer is not conducting the business of a medical scheme.

liability of the insurer and, by implication, the policyholder's ultimate cover.

Enforcing the right to choose insurance provider. The National Credit Act of 2005 provides that, where credit life insurance is required, the client be granted the option to choose the insurer. Most lower-income South Africans, especially those that reside in townships, have difficulty obtaining insurance due to the high risk profiles associated with these areas. If they are indeed able to obtain the insurance, premiums are high. Because of an inability to obtain credit insurance through the normal channels, the customer is then obliged to buy the insurance from the retailer. Many customers also do not realise that they have the option of buying insurance from other providers. This creates a captive market, allowing the retailer's insurance company to charge higher premiums and add a number of riders to the insurance policy.

Awareness of insurance product. The "tick-of-the-box" method employed in the selling of the policy also creates a distinct possibility that many customers will not be aware of the fact that they actually own a policy covering a specific contingency. This finding has emerged from the FinScope Survey, where the vast minority of people indicating that they regularly make repayments at furniture retailer outlets were not aware that they had insurance.

Opaque and complicated pricing structure. Market research has indicated that a product of about R3,935 ($550), when bought on credit, can amount to a total of R5,839 ($816), paid over 12 months. Insurance levies (payable upfront and hence capitalised on the loan) amount to R1,021 ($142.70) (almost 25% of the purchase value, inclusive of VAT). As a result, the total cost to the consumer may be about double the purchase price – a value proposition which could probably be improved for the poor.. Given the bundled nature of the product, it is difficult to asses the overall value of cover relative to the premium charged. However, the total cover for all the insurance elements is limited to the maximum value of the outstanding loan or the funeral benefit. The effective cost to cover ratio is not improved by the multiple riders included and questions can be raised about the value for lower-income customers.

Cover ceases on repayment of credit: The repayment period for store credit is up to 36 months. At the end of the period, all the cover provided as part of the bundled product ceases. While this may be appropriate for the credit life component of cover, its appropriateness is questionable for the funeral, health and asset cover provided. The consumer does not have the option of extending these components of cover beyond the repayment period.

Credit insurance[53]. Though not captured independently of "general" insurance in the FinScope data, focus group findings highlight the role of credit insurance in the low-income market for short-term insurance. With the exception of cell phones not bought on credit, credit insurance accounted for virtually all the short-term insurance that respondents had. In fact, most of the participants' understanding of the term short-term insurance related directly to credit insurance:

> "If, for instance, you buy a TV on credit it is automatically insured. When you pay it off monthly, it includes insurance cover. The insurance cover is valid according to the duration of the debt." (Male, LSM 5-6)

Though the impression was not that such credit insurance is compulsory (unlike credit *life* insurance), it was still considered as "part of the package" when buying household goods on credit (as illustrated by the various components of the insurance offered by Ellerines in Box 2 above).

[53] We define credit Insurance as an insurance policy associated with a specific credit purchase which provides for the replacement or repair of the purchased item in the case of it being damaged, lost or stolen.

> "When we purchase things, we are informed and offered insurances." (Male, LSM3-4)

Participants generally did not indicate that they continued with the insurance on an item after the debt had been paid off.

Cell phone insurance. Though the FinScope dataset also does not single out cell phone insurance, focus group discussions revealed this the most important short-term insurance product in the minds of respondents, even more so than the credit insurance bought as "part of the credit purchase package". All respondents had a cell phone, even those with the lowest income. For male and female groups alike, the cell phone was mentioned as one of, if not the, most important assets to hold. The cell phone was considered a core tool to keep a social/business network intact for all groups. Respondents with a slightly higher and more regular income (who also had a bank account) tended to have cell phone insurance. The rise of mobile telephony as a driver of the micro-insurance market is discussed in Section 5.1.

Legal insurance. Another type of insurance worth singling out is legal insurance. Like funeral insurance, it is used to pay for an underlying service, rather than for the benefit of the cash pay-out. As with funeral insurance, a natural demand (independent of Charter pressure) evolved to establish the product over time. Typically not targeted to the poorest of the poor, legal insurance provides a way for the salaried poor to protect themselves against legal contingencies such as labour disputes or debt settlement issues. A prominent example of legal insurance in South Africa is that offered by LegalWise (see Box 3 below, or Appendix 4 for the full case study).

Box 3. Legalwise – an example of insurance to pay for legal services.

Legalwise is the largest player in the legal insurance market, a market which is aimed at that proportion of the population too affluent to be allowed access to state-provided legal aid, but too poor to be able to make payments for legal counsel as and when needed. According to Legalwise, expressed demand for such insurance is quite high and Legalwise has been operating in reaction to this demand for a number of years, first as an administrator for products underwritten by another insurer, and more recently as a registered insurer in its own right.

Two products are sold: one provides R42,000 worth of cover per legal matter for R42 per month, while the other provides R75,000 cover at R60 per month. In both instances, actual expenses incurred are covered up to a maximum, rather than the full benefit being paid out. Clients are only allowed to use a designated network of legal service providers, who are reimbursed directly by Legalwise. Typical cases include labour disputes, debt related cases, or childcare matters.

Premiums are paid largely via payroll deductions (as the target market is not the poorest of the poor, they are more likely to be in formal employment), or via the post office or EasyPay (a system that allows utility and other bill payments at retail outlets).

Distribution takes place through an agent selling force. Such agents are not FSP-registered (a fact which they have cleared with the FSB), but are specially trained to provide disclosure, without giving advice. Their branches give legal advice, rather than advice on the most appropriate insurance product to purchase.

Long-term contractual savings products. Generally, long-term contractual savings products are not aimed at the low-income market. However, as part of the Charter process a number of these endowment type products aimed at the low income market have recently been launched. Examples include African Life's Cash Growth Plan, Momentum's Investo

investment plan, Clientele Life's Classic Saver Endowment Plan, Metropolitan's Dreambuilder Save Plan, Old Mutual's Money Care Plan, Domestic Workers Product and Umbono product, and Hollard's As'Investe (in partnership with Umbono Capital Partners). These types of products are generally marketed as savings plans with additional risk components which are sometimes voluntary 'add-ons'. Such products have however not achieved much success yet. No data is available specifically on the use of endowment products among the poor. However, FinScope (2006) data indicate that for the adult population as a whole, usage of endowment policies with some death or disability cover is only 2%. 1.2% of LSM1-5 individuals indicated that they have *one* of the following types of products (it is not possible to single out just the endowment component): unit trust, education policy, endowment policy with death or disability cover, or retirement annuity. The number of policies reduced from 404,238 in 2003, when the FinScope survey was first conducted, to the current 133,693 (Eighty20, 2007). Apart from changes in the questionnaire which influence comparison of responses, the overall market for endowments and retirement annuity products has been reported to be declining. Some insurers are talking of pulling out of the low income market due to new rules around the minimum surrender values they have to provide on early withdrawal from the product

It is furthermore debatable whether the cost structures, complexity and penalties for early withdrawal associated with such products make them appropriate to the needs of the low-income market. The fact that long-term contractual savings funds are taxed is also not suitable to the low-income market, as low-income individuals are mostly not required to pay any income tax (Solomon, 2006). It therefore introduces a disproportionate tax burden for the poor. Furthermore, the risk characteristics of such products (being by definition long-term, and entailing investment risk as well as insurance risk) would suggest that they are not suitable candidates for less strict prudential regulatory treatment of providers. This also holds true on the distribution side: as such products are contractually bound over a long term, often with significant penalties payable for early termination, it is important that consumers understand the products that they are buying and receive advice on what is most appropriate to their needs. They also need to be made aware of the pitfalls of early termination, the fee structure, etc. When less financially sophisticated individuals are dealt with, it is advisable not to leave these aspects to the interpretation of the client based on the policy documents, but to have a verbal disclosure and advice process[54].

Charter pressure largely drives micro-insurance product expansion. Many of the recent product launches to extend micro-insurance beyond funeral insurance (with the exception of credit life insurance and some legal insurance products as described above) have been in reaction to the Charter. The long-term industry (through its industry body the Life Offices Association - LOA) has developed product standards that are applied in the recently

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[54] Note that our contention is therefore that long-term contractual savings products aimed at the low-income market should be excluded within the South African context. As shown above, the fee structure of such products already undermines the viability thereof for the low-income market and the level of risk involved suggests that no prudential relaxations can be brought about. Likewise, advice and verbal disclosure are pivotal in this market and non-advice based models should not be encouraged. Uncapped commissions, though providing a positive incentive to sell such products to the low-income market, will add to the already high costs associated with long-term contractual savings products from the consumer's point of view. Therefore it would seem appropriate for full intermediation requirements to be upheld for such products.

launched Zimele[55] accreditation programme (where products are accredited by the LOA to qualify for Charter purposes. A number of products have already obtained the Zimele stamp of approval. The short-term industry, likewise, has developed product standards through its association, the South African Insurance Association, though the initially planned product has not been launched due to concerns by the competition authorities[56].

Box 4. Product features of Charter-compliant industry initiatives

Zimele accreditation for long-term insurance products

In the case of the long-term industry, so-called CAT standards were developed, based on the UK precedent of product standards to ensure fair charges, easy access, and decent terms. The CAT standards were incorporated and refined into the Zimele product accreditation for funeral insurance, soon to be expanded to other forms of long-term insurance.

Launched by the LOA in 2007, Zimele products are aimed at the low income market and will enable providers, based on geographic availability of the product, to score points towards meeting their FSC access targets[57]. Zimele products rely on simplicity and flexibility. For a product to gain Zimele accreditation, customers have to be able to buy the policy, pay a premium or amend a policy at least once a month within 40km of their residence or place of work. It is envisaged that Zimele-accreditation will send a signal to consumers that products are trustworthy and reasonable in terms of pricing and terms.

The CAT standards require all products wishing to gain accreditation to fulfil various criteria, with the main goal being the provision of a product that is easily accessible, flexibly, simple and easy to understand:

- Policy documents must use standardised policy terms, simple product descriptions are required and a summary of the policy terms has to be available in all eleven official languages of South Africa.
- No HIV/AIDS exclusions or benefit reductions are allowed in any policy under the CAT standards.
- CAT standards for assistance business furthermore require an allowance for interrupted contributions, with grace periods to make up lost payments.
- Minimum and maximum benefit levels are also defined, with a minimum of R5000 and a maximum of R20 000 (with some exceptions).
- Beneficiary nomination has to be provided for.
- Undertakers cannot be paid directly by the insurer (i.e. a monetary benefit must be paid to the customer).
- In keeping with the drive towards simplicity, standardised exclusion wording is required and there are limits on allowable exclusions.
- No rate differentiation is allowed except on the basis of age, which means that the same rate applies to all policyholders of the same age when entering the scheme.

[55] Zimele is a Zulu world that means “to stand on your own two feet”.

[56] As the products would have common features and a common branding, the concern was expressed that it would amount to collusion.

[57] The LOA decided that availability, and not penetration, would be the basis for measuring access in terms of the Charter targets.

Thus far, seven assistance business products have attained Zimele accreditation.

Proposed Mzansi product for short-term products

To fulfil their charter obligations, the short-term insurance industry (via their association the South African Insurance Association – SAIA) opted to develop a standardised "Mzansi[58]" product which different providers can roll-out. Mzansi Insurance is envisaged as a no frills policy to provide cover for dwellings, household goods and personal effects against specified perils i.e. fire, lightning, explosion, storm, flood, impact and theft. To be branded "Mzansi" products a standardised policy wording and schedule (which was developed by the industry association following the Charter guidelines for a simplified product) must be applied. Notable features include:

- A 15 day grace period in premium payments
- Suggested pricing for various standardised coverage options (ranging from R10,000 to R220,000); and
- Restrictions on claims from theft
- The proposed Mzansi brand is currently being reconsidered

Demand-side insights

The discussion above highlighted the various micro-insurance products available and their uptake among the low-income population. It is evident that the uptake of funeral insurance dwarfs that of other types of products. Can this phenomenon be ascribed to a lack of access, or are there demand features that keep usage low, even though there are no absolute barriers to access?

Focus group discussions were held for respectively long-term[59] and short-term insurance to obtain a better understanding of the market dynamics as perceived by current and potential users.

Funeral insurance demand-side insights

The main finding is that there is a cultural imperative to provide a dignified funeral and that this drives the high take-up of funeral insurance (formal as well as informal) relative to all other types of insurance. From a young age people are expected to start providing financially for death, so that they can provide adequately for their own funeral and those of their dependents. The fact that culture causes funeral insurance to be a virtually unavoidable expense and the fact that this prompts rational risk-management decisions (namely to join a burial society and/or buy a formal insurance policy) is discussed further as one of the key

[58] Mzansi is a colloquial Nguni expression meaning "South".

[59] Note that these focus groups were conducted in 2004 as an input into Bester, Chamberlain et al (2005) – A regulatory review into formal and informal insurance markets in South Africa. As part of the current study, only short-term insurance focus groups were conducted. The insights from the 2004 long-term insurance focus groups are unlikely to have changed. Note that the short-term insurance focus groups covered LSM3-6 respondents, therefore slightly deviating from the LSM1-5 market defined. This is because those in LSM1-2 were not considered to have enough insurable assets to place them in the potential market for short-term insurance. Also, it was argued that LSM6 may provide valuable insights, as they are likely to have more insurable assets and can represent an important stepping stone in reaching out to the LSM1-5 market.

drivers of the micro-insurance market in Section 5.1. Focus groups also revealed some more nuanced insights into the dynamics of the market for funeral insurance:

Funeral insurance is "bought, not sold". According to the old adage, "insurance is sold, not bought", suggesting that it is a grudge purchase requiring the persuasive energies of a salesman. However, this is not the case in the funeral cover market, where providing for death is generally a pro-active decision by the consumer who actively joins an informal group, approaches providers of formal products, or will be willing to buy a product (with a trusted brand) off the shelf.

Multiple forms of cover and providers per client. The social importance and expense of funerals may explain the prevalence of individuals holding multiple forms of funeral insurance (as observed in the high level of likely overlap indicated in Figure 3). Most focus group participants used more than one policy from more than one provider of funeral cover, often to provide for different aspects of the funeral. According to one focus group participant:

> "As a person you have needs, there is a hierarchy of needs. Socially you need to have money should something happen – so you need the burial society, and then you need the undertakers who will take care of the funeral. The money from the insurance company takes time to pay out so whenever that money comes, you can settle all your outstanding bills, so it is worth it. It's for peace of mind in a way."

A respondent quoted by Thrivikraman (2003, as referred to in Bester, Chamberlain et al, 2005) made a similar point, saying "I know if I die, that first one will do everything. The second to give my children after funeral to have something to eat. Also, the third one the same". The focus groups pointed out that each type of provision plays an important and often complementary role. In short, then, multiple policies may be *rational,* but are unlikely to be *optimal*, particularly if multiple intermediaries need to be rewarded.

Insensitivity to prices. A surprising observation from the urban focus group discussions was the relative insensitivity towards the *price* of funeral cover and, indeed, to the higher costs of providing for death associated with using more than one insurance provider. This is illustrated by one respondent who mentioned that, in addition to having a formal insurance policy, he is paying R350 ($49) per month to a funeral parlour that covers himself, his father, his brother and his child. He justifies such a high monthly premium by the fact that he has been assured that he will receive a very fancy coffin and the best service as part of the package. In his words this fancy coffin will ensure "a dignified funeral". This is someone whose monthly household income is between R3 000 and R5 000 ($419 to $699) and therefore spends up to 10% of his income on the funeral parlour policy alone.

Respondents were also asked about the details of their current policies. In most cases, the premiums of the policies used by various respondents would differ substantially, but this information was never met with concern and did not lead to them questioning the value of their own policies. This was the case, for example, in one group where two respondents

indicated in conversation that they paid R30 ($4.20) and R70 ($9.80) per month respectively for policies providing the same cover but did not question the difference in premium[60]. This would suggest that, probably as a result of the cultural imperative, affordability cannot be regarded as an access barrier in the low-income funeral insurance market.

Urban-rural differences. Two major differences emerged in the focus groups between rural and urban consumers of funeral cover.[61]

- None of the respondents from the rural areas owned a formal insurance product or had a direct relationship with a funeral parlour. Instead, the relationship was one where the individual had joined a burial society, and through the society had access to a funeral parlour. Urban respondents seemed to join a society in addition to holding a policy directly with a funeral parlour and/or a formal insurer.

- Rural burial societies seem to have savings relationships with funeral parlours, as opposed to urban burial societies where the relationship is a mixture of insurance and savings. In addition, rural parlours in some cases still extend funerals on credit based on their relationship with the society. This is no longer the case for urban parlours.

<u>Short-term insurance demand-side insights</u>

While short-term insurers have traditionally not had an explicit low-income market focus, the situation is changing under the Financial Sector Charter and, as the discussion above has indicated, a number of new products have been launched that extend beyond funeral insurance into short-term insurance. Yet, in stark contrast to funeral insurance, FinScope data record almost negligible take-up of short-term insurance. The focus group findings throw some light on this phenomenon.

Absence of informal risk-pooling in the short-term market. Whereas funeral insurance was actively "bought, not sold", it would seem that short-term insurance very much needs to be sold to the consumer. An important indicator of the lack of "natural demand" for short-term insurance is the fact that, unlike for funeral insurance, no informal markets spontaneously developed to fill the low-income gap left by the formal sector. This can be ascribed to the risks of moral hazard – people simply do not trust family and friends where indemnity insurance is considered. People will pool risk informally for death, a once-off, defined event which can easily be confirmed, but not for indemnity-type claims. When asked whether informal short-term risk-pooling groups will be viable, focus group participants responded:

> "I may pretend to have lost my cell phone and claim it from the group. I can crook my friends or family with the risk-pooling group to benefit myself." (Female, LSM 3-4)

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[60] This may however be an urban phenomenon. Thrivikraman (2003, quoted in Bester, Chamberlain et al, 2005) found high price sensitivity among people in rural KwaZulu-Natal province.

[61] Note that the urban focus groups consisted of respondents from the greater Johannesburg area and the rural focus groups consisted of respondents from the rural area of Dikebu (in the Limpopo province). It is, therefore, not possible to generalise this to all rural households in South Africa.

> "People are generally not trustworthy." (Female, LSM 5-6)
>
> "It is impossible. It will just cause a lot of problems." (Female, LSM 3-4)

Focus group research also revealed an awareness among low-income people that social risk-pooling is unlikely to provide a large enough pool to cover possible claims and that it would be regarded as unfair towards those who never claim in such a small, socially close set-up. Rather, low-income people prefer to pool together for savings towards assets (or other goals) where moral hazard is not such a large threat and prefer to trust large, formal insurers with indemnity-type insurance. The findings revealed that short-term insurance is perceived as indeed having a value proposition for the low-income market.

Value proposition of insurance. On the whole respondents tended to have a positive view of the insurance industry and indicated that being insured is to your benefit (though one or two indicated the disadvantage of "paying for nothing" if you never experience a claim event). Most respondents acknowledged the value proposition offered by short-term insurance. There is a general perception that if you can afford insurance "it will make life easy" if you incur a loss. Responses include:

> "Insurance is a form of saving. It helps because we cannot predict the future" (female, LSM5-6)
>
> "I know from reading the newspaper how good insurance helps people" (female, LSM 5-6); or
>
> "Every evening I look forward to watching my TV programmes that I enjoy, like Generations. I would think, if I had insurance, I would be able to claim. It would pain me to buy something that I know I had before." (Female, LSM 5-6).
>
> In terms of house structure insurance, one respondent remarked: "I think it is OK to have insurance for the house because we now have what you call global warming. Anything is possible there can be a storm as result of it and your house can be damaged so it will help" (male, LSM3-4).
>
> The alternative to buying insurance would be "starting over", saving for a new product (which one LSM 3-4 respondent indicated could take "five to ten years", or buying a new product on credit. "Well if you do not have insurance, you are compelled to fork out money to buy another one; that is if you have the money. Maybe you will only pay a small deposit on a new one…" (female, LSM 5-6).

The importance of cell phone insurance. As indicated in the discussion of cell phone insurance, this is the product indicated to have the highest value proposition to respondents. The importance of cell phone insurance within short-term insurance can be related to three factors: (i) the very high value respondents placed on the ownership of a cell phone, (ii) the fact that cell phone insurance is offered at the sale of new phones in the formal sector and (iii) the fact that such insurance is perceived as value for money. In addition, the insurance of cell phones bought on account at retail stores or from the service provider when entering into a cellular contract was linked to their monthly account and perceived as hassle free. The importance of cell phones to the low-income market will be discussed in more detail in Section 5.1 as a driver of current market characteristics.

Yet overall short-term insurance uptake remains low. How could this be explained? From the focus group findings, this would seem to be the result of a combination of factors:

Lack of understanding. The findings reveal that, though people generally have a grasp of the concept of short-term insurance as covering assets, their understanding largely relates to credit insurance. Except for a few knowledgeable respondents, the terminology of long and short-term insurance was interpreted as "for a long or short period." Short term insurance was described as that which one takes out with a retail company on a purchased item (see the discussion on credit insurance above). For these respondents the "insurance term" expires the moment the item is paid off. As one respondent put it: "it is insurance for a short period" (female, LSM3-4). Insured respondents indicated that they required the insurance since they would not be able to pay for a lost item as well as a new one. Insurance is thus very important while still making down-payments. Once the item was paid for, however, they would be able to start paying for a new item should they lose the purchased item, therefore the insurance was not a necessity any longer. "If I pay off my TV, I do not see a reason or need to continue with a short term insurance on it. In my case, it is rare that I will have a house break-in" (male, LSM 5-6).

Claims hassle. Despite revealing trust in short-term insurers in general, respondents felt that claims were not automatically paid out and that procedures and rules were strictly adhered to. Responses include:

> "Most insurance companies do not like paying out." (Male, LSM 5-6);
>
> "With insurance companies, there is always a catch in their cover. For example, the cell phone insurance does not cover batteries, water or steam damage. These instances are the ones that happen often and cause more damage." (Male, LSM 5-6).

Another respondent remarked:

> "I have seen the bad experience my grand mother had with her cell phone insurance. When it was faulty, they kept on fixing it without replacing the phone. The one day it was the speaker broken, on the other the zero button will not work. We move to and fro trying to have it fixed with the insurance. 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" (female, LSM3-4)

The claims process was also perceived as difficult:

> "….the process of claiming to me is painful. I would not want to go through the process of getting a case number, claiming etc." (Male, LSM 5-6);
>
> '……it takes time to get stuff from insurance companies" (male, LSM 5-6).
>
> "If I had to lose my house, hi-fi, and car... I would be much stressed. The thought of claiming from insurance would be a hassle, based on experiences of insurance companies sending you from pillar to post before replacing items. Possibly, by then I would have bought some of the items. (Male, LSM 5-6)

Affordability of a regular premium. The general feeling is that, though insurance offers value, one sometimes simply cannot afford it given one's other spending priorities. This is especially relevant for those participants with irregular incomes or persons who cannot commit to a certain amount every month, as other contingencies may arise that demand all their resources in certain months:

"We wish we could have insurance, but because we do not work, we cannot afford insurance." (Female, LSM 3-4).

"A cell phone insurance may cost +- R35 ($5). If I have R50 ($7), 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." (Female, LSM 3-4)

The following response indicates the difficulties relating to regular monthly payments: "There was a month when I skipped payment for my TV insurance. It so happen at the time my TV gave me problems. On claiming for repairs, I was told that they could not help me due to the once skipped payment. I had to fix the TV myself." (Male, LSM 5-6). Another respondent indicated that: "The only set back is when you loose your job. You loose out on the money paid towards the insurance."

Affordability of a *regular* premium, given other obligations and spending priorities, therefore appears to be the main factor impacting on the low short-term insurance uptake among the poor. Funeral insurance, on the other hand, enjoys high priority due to the cultural importance of funerals – making it an almost "unavoidable" expense that needs to be provided for. This will be discussed in more detail when we consider the drivers of the current market characteristics (Section 5.1).

It must however be noted that, when asked what they would need to sacrifice to buy short-term insurance, a number of responses would indicate that insurance indeed competes with luxury goods in terms of spending priorities for some respondents in the LSM5-6 group:

"I would pinch from my booze money." (Male, LSM 5-6)

"I would limit the number of times I go to the movies every month." (Female, LSM 5-6)

"I would take it from my money that I spend on drink to pay for this insurance." (Female, LSM 5-6)

"I would pinch from my pocket money." (Male, LSM 5-6)

"I would rather take lunch to work and use the money I used to buy my lunch to pay for the insurance." (Female, LSM 5-6)

This would suggest that it is a matter of relative rather than absolute affordability.

Micro-insurance product features

What distinguishes micro-insurance products from the rest of the insurance market? A number of common features of the products on offer (apart from the products discussion above, see the appendices for more detailed case studies on each type of product) can be observed:

- *Simplicity*. Driven by the Charter product standards but also the recognition of the needs of the target market, the features of the products on offer are being simplified, with an emphasis on simple wording that is easily understandable to the target market. Simplified disclosure and communication of essential policy information are also contained as part of the product standards. An important additional element of simplicity is the need for simple and quick claims pay-out procedures through channels

accessible to clients (e.g. in cash or, as some insurers are starting to do, into a nominated bank account, e.g. that of a family member, should one not have an account of one's own). Simplicity adds credibility to insurance products amongst the poor.

- *Flexibility*. Products are also increasingly sold in ways that are convenient to the market and are designed with market segment's particular needs for flexibility in mind. Under the Charter product standards, products now allow for some flexibility around defaults, which seeks to cope with the sometimes unpredictable and irregular income flows in the low-income market. The pursuit of simplicity and flexibility is however not solely Charter-driven. Market forces also dictate the need to design products that are as cost-effective (and hence simple) as possible – if products are not relevant and appropriate to the target market, they will not achieve the desired take-up.

- *Short-term policies*. Virtually all the products in the low-income market are written on a one month (or one year at the most) renewable contract basis, even those sold under the Long-term Insurance Act. The risk that the insurer will not be able to meet its future claims is directly related to the length of the contract term. All other things being equal, under a one year policy there is a reduced chance that the insurer will miscalculate pricing and be unable to meet claims which fall in that year. Therefore shorter contracts are also a means for insurers to contain the prudential risk involved. This in turn allows for more affordable pricing for the low-income market.

- *Group-based underwriting*. Micro-insurance policies in South Africa are also underwritten on a group rather than an individual basis, a strategy which tends to dictate shorter contract terms.

- *Limited benefit values*. The size of the benefit is an important determinant of the premium to be paid. To develop affordable products, benefit size therefore needs to be contained. It also reduces the liability of the insurer, thereby reducing prudential risk faced. Benefit size however also relates to the perception (whether accurate or not) of the level of cover required by lower-income households. In the case of funeral insurance, the policy values provided furthermore relate to the limit set by legislation, should insurers wish to reap the commission and intermediation benefits offered for assistance business, and the limit set under the product standards developed as a Charter initiative (Zimele, Mzansi). Regulation therefore sets incentives in favour of lower benefit values.

- *Lower prices*. Although this market is still characterised by wide variation in prices, a number of cheaper products are now available (including funeral insurance cover of R10,000 ($1,398) for premiums of less than R50 ($7) per month). At 2.4% of the average LSM1-5 household income this would seem affordable, especially based on the high willingness to pay witnessed in the funeral insurance market.

Shared micro-insurance product features limit risk. Insurance provides guaranteed benefits on a defined risk event in return for premiums which are paid in advance. Guaranteed benefits create 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. The exposure for the insurer is driven by two factors: the uncertainty over the claim event and

the size of those claims. These are, in turn, directly linked to the nature of the insurance products written. The simplicity of an insurance product, its term and its benefit size are the most important elements determining the prudential risk associated with providing such a product. The aim of insurance regulation is to ensure, through capital, skills, reporting and other compliance requirements, that such prudential risk is adequately carried. Should it be possible to define a category of micro-insurance products that limits the risk associated with providing such a product, and could the boundaries of this category be enforced, it could imply that a less strict regulatory approach is warranted for the provision of such products. This would be in line with a longer-term move towards fully risk-based regulation.

4.2. Players

The micro-insurance market in South Africa has a "dual nature" – on the one hand established formal insurers, traditionally serving the high-end of the market, are now starting to target the low-income market (not least due to regulatory pressures in this regard). This is attempted through product and distribution innovation to make their offering more appropriate and attractive to the low-income market. On the other hand, there is a plethora of informal players which spontaneously evolved over time to fulfil the funeral insurance needs of the poor at a time when few suitable formal alternatives existed. Such players are often mutual groups, the most important example of which is the burial society. In addition, there is a large market for "illegal" insurance provided by funeral parlours without an insurance license.

While the formal part of the market is faced with the challenge of reaching down into an untapped client base, it is currently difficult for the informal market (which has an established low-income client base) to transform or graduate into formal organisations, should they wish to[62]. In this "formalisation" process (as indicated in Figure 1 in the Regulatory section) there are a few intermediate steps, none however without its associated challenges. The challenges for the informal players are therefore largely related to institutional and prudential aspects as well as the market conduct regulation challenges posed by FAIS registration and compliance, whereas for formal sector players distribution (and related FAIS challenges) is the main concern.

Formal players

Large number of formal insurers. Currently there are 75 registered long-term insurers in South Africa (not counting the 3 dedicated long-term reinsurers and the 4 composite reinsurers), of which 46 are fully licensed and are able to offer all long-term lines of insurance. Three registered fully licensed long-term insurers entered the market between March 2005 and March 2006, but none in 2006-2007. There are 97 registered short-term

[62] As noted elsewhere, it is usually in the consumers' interest from a risk management point of view to rather buy formal products than illegal products from funeral parlours. In the case of providers of *informal cover* such as burial societies, the risk to the consumer may be less pronounced and informal groups will continue to play a vital social role. However, should they *want* to formalise into insurers, they face a number of regulatory challenges (such as building up enough capital and skills). The aim of this document is to provide guidelines for an insurance regulatory framework that will facilitate the micro-insurance market, i.e. provide the space for formalisation, while still applying risk-based supervision and thereby leaving room for entities such as informal burial societies.

providers (once again not counting the 5 short-term reinsurers and 4 composite reinsurers), of which 30 (two of which entered the market in 2007) are 'typical insurers' who are licensed to offer most of the product lines available under a full short-term license (FSB Annual Report, 2007). The long-term insurance market is significantly larger than the short-term market, with long-term insurers collecting R220.3 billion ($30.8bn) in premiums (net of reinsurance) during 2006, compared to the R37.6 billion ($5.3bn) collected by short-term insurers (FSB Annual Report, 2007). The following tables capture the market shares for short-term and long-term insurance respectively:

Top 10 general short-term insurers	% of total gross premiums written
Santam	28.3
Mutual & Federal	20.1
Hollard	12.0
S A Eagle	9.2
Outsurance	5.7
Auto & General	4.6
Lloyd's	4.2
Regent	3.5
AIG (SA)	3.4
Constantia	3.3
Total market share	**94.3**

Top 10 long-term insurers	% of total net premiums written
Old Mutual	18.7
Liberty Group	13.2
Sanlam	12.8
Momentum Group	11.0
Investec	8.0
Investment Solutions	7.9
Metropolitan	3.7
Allan Gray Life	2.9
Coronation	2.4
Liberty Active	2.0
Total market share	**82.5**

Table 1. Short-term and long-term insurance market shares, 2005[63]

Source: FSB Registrar of Short-term Insurance, tables to the Annual Report, 2005; FSB Registrar of Long-term Insurance, tables to the Annual Report, 2005.

Few dedicated assistance business players in traditional formal market. There are 47 insurers licensed to provide assistance business products, of which 28 were active in the market in 2005 (FSB Long-term Insurance Registrar, 2005). Most are also licensed to write other classes of policies, with only four insurers (of which two are in the process of winding down) holding licenses that allow them to exclusively offer assistance business (FSB Annual Report, 2006). Over the last decade, the licensing conditions for operating as a funeral insurer have been increased to be the same as that of a full life insurer and there is, therefore, little incentive to register only as a funeral insurer[64]. The FSB may however, based on an assessment of the skills of the applicant, decide to grant only a limited license. The following table reflects the market shares within assistance business. Note that all the top assistance business players are registered as full insurers, rather than as assistance business insurers only:

[63] Note that these figures exclude reinsurers. In the case of short-term insurance, it also excludes the so-called bank segment and specialist segment of the market, focusing instead on general short-term insurance. Also note that the long-term insurance figures include employee benefits (retirement annuity) and other long-term contractual savings figures. It is not possible to single out the market shares just for risk benefit insurance.

[64] Under the previous insurance act, upfront capital requirements for assistance business insurers were less than for "full" insurers.

Top 10 assistance business insurers	% of total net premiums
Liberty Active	21.9
Standard General	11.5
Hollard Life	10.6
Safrican	10.5
Assupol	10.1
ABSA Life	7.3
Rentmeester	4.7
Prosperity	3.5
Metropolitan	2.9
Momentum Ability	2.6
Total market share	**85.6**

Table 2: Top assistance business market players.[65]

Source: FSB Registrar of Long-term Insurance, tables to the Annual Report, 2005.

Low-income insurance enjoys increasing attention from formal sector players. Assistance business has traditionally been the domain of smaller insurers with a particular low-income market focus. Partly as a result of the Charter, the large players traditionally not active in the low-income market are however also starting to enter the market and to launch products aimed explicitly at the low-income market (for example Discovery Life with its Prepaid Funeral Plan – see product discussion below). Over the last five years, the market for funeral insurance has furthermore been characterised by both consolidation and entry of new players.

- *Acquisitions*. Whereas in 2003 the funeral insurance market was dominated by smaller independent players, a few of these players have since been taken over by large life insurers[66]. The market shares for funeral insurance now more closely resemble that of the overall life insurance market. These acquisitions, combined with a number of recent product launches, suggest a greater awareness among traditional, large insurers of the opportunities offered by the low-income market.

- *New entry.* In 2005/06, three new long-term insurers were registered (FSB, 2006). New entrants in recent years include administrators, microfinance organisations and low-income groups which traditionally obtained underwriting from registered insurers, but now acquired a license of their own, striving for more product development and management autonomy.

Box 5. Real People: an established lower-income financial services market player entering the insurance market

Real People is an example of a new entrant to the long-term insurance market. With its head office

[65] Note that this data may be misleading. As all these insurers also insure a number of other classes of policies, it is not certain that each class is accurately reported and captured. So, for example, no assistance business market share is recorded for African Life, though they are known to be an important player in the assistance business market.

[66] Safrican and African Life were taken over by Sanlam in 2005. Sanlam furthermore acquired a 50% share in Channel Life and subsequently transferred its 55% holding of Safrican into Channel Life.

in South Africa's generally poor and rural Eastern Cape province, Real People is a non-bank financial service provider with more than 150 branches and 1,300 employees. Its traditional focus is microfinance. It has expanded its reach to small, medium and micro enterprise financing, housing solutions (small home loans), housing improvement loans, etc. At the end of 2005 it was awarded a long-term insurance license and has since been selling funeral insurance. It is also an authorised service provider under the FAIS Act of 2002.

Cover offered. One of the insurance products offered is the "Real Funeral Plan". It offers various options and combinations, the cheapest of which provides R5,000 ($699) cover each to the main member, the spouse, and up to 6 children of ages 14-21 (cover reduces for children younger than 14; when children are full-time students, they will be covered up to the age of 25) for a monthly premium of R57 ($8). Free accidental death cover (for which there is no waiting period) is also included as part of the package. Other policy features include that cover is available for an additional spouse or additional family members other than the spouse and children, at an additional amount. Furthermore, technology that the market is familiar with and finds convenient is employed: potential policy holders send a free "please call me" sms to their call centre, which then phones the customer.

Recently, Real People's offering was enhanced by the launch of the "5-in-1 Family Care Plan". For a basic premium of R99 ($14) per month it offers a package consisting of:

- medical trauma cover of a lump sum of up to R100,000 ($13,975) per specified event for the main member (the spouse can be covered at an additional monthly premium);
- commuter cover of R20,000 ($2,795) for the main member and spouse in the event of death in a vehicle accident;
- unplanned pregnancy cover of R5,000 ($699) per minor female dependant between the ages of 10 and 16
- funeral benefits of R10,000 ($1,398) each for the main member and spouse and up to four children (extended family members may be added at an additional monthly premium); and
- a livestock benefit of one head of livestock for the burial gathering in addition to the funeral cover.

Knowing the target market. Real People's aim is to become the financial services provider of choice to the low and middle income group (their target market is LSM4-7) and their stated advantage is the fact that they understand the target market. This enables them to accommodate the market in terms of flexibility and product features. For example, in the Real Funeral Plan up to 5 premium lapses are allowed in a 12 month period before the policy is terminated – the cover is just adjusted in line with each lapse[67].

Limited presence of formal mutual insurers in the form of friendly societies. Formal mutual insurance is currently limited to a small number of friendly societies providing funeral cover under the exemption to the Long-term Act. Only five out of the 220 registered friendly societies are registered to provide insurance and reported a collective premium of R41m ($6m) in 2005. This means that the formal market for insurance obtained from burial societies who have registered as friendly societies is very limited – the bulk of the burial

[67] For example: should a policy holder have a policy with R 10,000 ($1,398) cover and only pay 9 premiums in 12 months, the cover will reduce to R 7,500 ($1,048). The total premiums paid are divided by the premiums due to calculate the % cover (9/12 = is 75% of the insured sum, amounting to R7,500 cover). The policy will lapse if the policy holder fails to pay more than 5 consecutive premiums or misses more than 5 premiums in a 12-month period (www.realpeople.co.za).

society market remains informal, providing unguaranteed cover to members as will be discussed below[68].

Cell owners as players in the low-income market. Traditionally, cell owners often include large corporations wishing to self-insure, or franchises such as vehicle manufacturers, durable goods retailers or cell phone retailers selling branded policies to their customers. As insurance is not their main business, they opt to buy a cell (which enables them to brand their own products and to share in underwriting profits – which is more favourable to them than underwriting) rather than obtaining a license of their own. Recently, the cell captive route has also emerged as an option for low-income groups to legitimately provide their own insurance products to members. Though from the cell captive insurer's perspective there is a certain level of scale necessary to make a prospective cell buyer attractive, it still presents a convenient intermediate step towards full licensing, as it allows a low-income group/organisation to build up the capital, scale and skills to potentially become an insurer in their own right. Microfinance organisations and furniture retailers have been seen to buy into cell captives to provide micro-insurance, and in one notable example a large funeral parlour used the cell captive route to "legalise" and has since applied for its own insurance license.

Informal players

Apart from the formal insurers noted above, cover (currently limited to funeral cover) is also provided to the low-income market through respectively informal and illegal mechanisms[69]:

Informal cover through mutual risk pooling mechanisms. It is estimated that there are between 80,000 and 100,000 burial societies (each with on average between 50 and 80 members)[70]. Of these burial societies, only around 180 are registered as friendly societies, 74 of which have to submit financial statements to the FSB because their annual turnover exceeds R100,000 per year (Registrar of Friendly Societies Annual Report, 2003[71]). Burial societies provide comfort and support to members in times of bereavement, as well as, depending on the nature of the burial society, monetary or other benefits. Burial societies therefore play an important role in risk management for the poor. Most burial societies do not guarantee benefits to members. This means that payments are adjusted to the amount of money available in the pool and that no contractual guarantee is given as to the amount

[68] It was not possible to include similar data to that included in the tables for long-term, short-term and assistance business insurers for friendly societies. The database on friendly societies obtained from the FSB does not include fund names. There are also no data on which to calculate market shares.

[69] Note that we distinguish between informal and illegal in that "informal" is regarded as being outside of the scope of regulation or supervision. Following a risk-based approach, informal burial societies are defined as not providing insurance and therefore do not need to be regulated for insurance purposes. Illegal providers, on the other hand, do provide "insurance", but illegally so, as they are not regulated or supervised.

[70] Genesis 2004, quoting FinScope 2003 data.

[71] This is the latest annual report that was available at the time of writing.

of the benefit to be paid[72]. These unguaranteed risk-pooling activities do not qualify as insurance and accordingly fall beyond the scope of insurance regulation. Some burial societies furthermore act as intermediaries by obtaining underwriting for their members (see the distribution discussion below). In some instances, burial societies have attempted to formalise into formal insurers, but with limited success – see Box 6 below.

Box 6. The formalisation challenges facing mutual groups: the case of the Great North Burial Society[73]

The Great North Burial Society (GNBS) has been in existence for a number of decades and until recently covered between 15,000 and 20,000 lives. It comprises several primary burial societies, which, through regional bodies, form part of GNBS - a registered Friendly Society.

Until 2000, Great North managed its risk under the Friendly Societies Act without the involvement of formal insurers. GNBS contractually guaranteed benefits to members and risk was managed from a central pool to which all members contributed. They employed their own actuary, were required to submit three yearly actuarial evaluations to the FSB, and their books were audited. In its 2000 evaluation, the actuarial report suggested that the risk pool was not sustainable and, based on this, the FSB advised GNBS to obtain underwriting from a formal insurer. This was an interesting recommendation as the insurer would either apply similar evaluation models and simply increase the premium or re-insure some of the risk. Both of these options were also available to GNBS, and did not require the involvement of a formal insurer. In retrospect, it may have been better for them to consider reinsurance or possibly even becoming a full insurer. At the time, the capital and other requirements for becoming a full insurance however prevented them from taking up this option. There is also limited appetite among reinsurers for the low-income market, given its lack of sophistication and scale, and especially the governance and operational risks.

Following this recommendation, GNBS obtained underwriting from New Era in 2000. The terms of the underwriting agreement were however not optimally negotiated by GNBS and turned out to be to their detriment. There were two major concerns:

- New Era revised premiums twice yearly, whereas GNBS could only do this on a yearly basis at annual general meetings. Any increases in the interim would, therefore, have to be carried by the society until the next general meeting.
- Lapses were treated differently by GNBS and New Era. GNBS was bound by the Friendly Societies Act, stipulating that individuals who have been members for more than 5 years are allowed to miss six payments before the policy lapses. The contract with New Era, however, stipulated that policies will lapse if two payments are missed. This resulted in GNBS remaining liable for benefits to members who lapsed according to New Era, but were still within GNBS's grace period. It seems that GNBS understood the agreement with the insurer to replace that under the Friendly Societies Act, while members insisted on the terms as stipulated in the Act. In total, this cost GNBS between R600 000 and R700 000, which was paid by liquidating some of their investments.

GNBS has been severely hurt by this experience and has since seen a rapid decline in its

[72] Given this nature of informal burial societies, it may imply that cover acquired through one burial society is often not enough to cover the full cost of a funeral. Leibbrandt & Collins (2007) find that, in a sample of 152 households in the Financial Diaries study, 61% are underinsured to allow them to cover the full expense of a funeral. While one cannot generalise from such a limited sample, it may explain why so many people take out multiple cover: from more than one burial society, or from a burial society and a funeral parlour/insurer, etc. Ultimately, however, it can expected that poor people will take out the amount of funeral cover that they want and can afford, so that affordability becomes the ultimate barrier rather than the availability of suitable products.

[73] Taken from Genesis (2005), where it was compiled based on information supplied by GNBS.

membership. Ironically it seems that the evaluation leading to the underwriting agreement was based on incorrect information. GNBS has since exited the agreement with New Era and has requested a temporary moratorium on underwriting from the FSB, in order to reconsider its options. No solution has however been found yet.

Illegal provision of funeral insurance, often through funeral parlours that self-insure. Accurate data is not available, but qualitative research suggests that there is a significant number of funeral parlours offering illegal insurance (i.e. giving guarantees in the market but not underwritten by a registered insurer). This has been noted as an area of concern not only because of the inadequate management of the insurance risk but also due to the potential consumer abuse by operators that do not comply with the consumer protection and insurance legislation. The business model of such illegal insurers relies on the fact that benefits are paid out in the form of a funeral service rather than a monetary benefit, which in itself is illegal (customers have to be offered a cash payout in terms of Section 53 of the Long-term Insurance Act). In this way, costs to the parlour are minimised, while consumers may still believe that they are getting an expensive service. It is estimated that there are between three and five thousand funeral parlours in South Africa, a large proportion of which are fully or partly self insured (Genesis, 2005)[74]. The pervasiveness of illegal funeral parlour insurance can be ascribed partly to an inability to enforce regulation

4.3. Distribution

In the quest to develop products for the low-income market, more cost-effective distribution has been the focus of many insurers. There are a number of features characterising the distribution of products to the low-income market in South Africa:

Different intermediation models in South Africa to that mostly associated with micro-insurance internationally. Internationally, micro-insurance is often synonymous to the microfinance institution-linked partner-agent model. In this model, formal insurers' insurance products are distributed to low-income clients (often microfinance clients for credit life insurance) via partnerships with non-profit organisations such as microfinance institutions, or mutuals or cooperatives (see Philippines). In South Africa, however, this model is limited, mainly due to the very small NGO MFI sector. Rather, insurance is distributed through broker networks (though this model is limited in the low-income market), in partnership with retailers, or via direct marketing (internet or telesales).

The importance of organised social groups in low-income insurance distribution. Groups play an important role in distribution to the low-income market in South Africa. Apart from burial societies that provide informal insurance to their members the basic reason for the existence of such groups is often not related to insurance, but in most cases focused on the provision of credit (microfinance organisations) or the facilitation of savings (savings and

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[74] The earlier study by Genesis (2005) estimates the total number of funeral parlours as 3,000: in 2004, there were 1,200 registered parlours which belonged to industry associations. Should one assume that there are another 300 parlours which do not belong to an industry association, it brings the total number of registered parlours to 1,500. When one then assumes an equal number of unregistered parlours, it brings the total to 3,000. The ruling "guesstimate" in the industry (based on conversations with industry role players) is however that there are between 3,000 and 5,000 funeral parlours.

credit co-operatives) or other financial services. Some of these groups are member-owned and all monetary surplus derived from their activities is used to the benefit of group members, e.g. stokvels. These groups are all client-facing and the intermediation of insurance is initiated as a client collective process rather than by an existing intermediary or product provider. Although these groups normally have a relationship with only one insurer, the group is independent in the sense that if the products of a specific insurer no longer meet the needs of its clients, it can move to another insurer. The group (acting as intermediary or group policy holder), rather than the insurer, thus owns the clients. The group drives the product innovation process (with the help of the insurer) and products are tailored to meet the needs of the group members.

Examples of group-based distribution. The most notable example is burial societies. Though most burial societies informally pool risk themselves (as described in the Players section), many of them also act as intermediaries or group policy holders for formal insurers who aim to broaden their reach in terms of their Charter targets. That is, the exposure of the burial society is underwritten by an insurer. Typically, the insurer will sell a group policy to a burial society, which then distributes/on-sells it to its members. Burial societies are however not the only groups distributing micro-insurance. In a recent initiative, African Life has partnered with the ZCC[75], a large church group among the low-income population in South Africa to sell insurance to its members. African Life regards the affinity group as the best way to reach unbanked, unemployed individuals. In any given month, about 400,000 people will pay for funeral cover in this scheme (Solomon, 2006). The ZCC is the group policy holder. It handles the administration and sales of policies to churchgoers at church gatherings. The trust of the congregation in the church group builds trust in the insurance product on offer – the church will be morally accountable to members, should there be any losses. Another group-based distribution example is that of Lesaka Administrators. In this case, the group is comprised of labour unions (who are also the owners of Lesaka) bargaining with insurers to provide appropriate and affordable insurance products to their members. Box 7 provides a more detailed overview.

Box 7. A labour union group as intermediation platform: the case of Lesaka Administrators[76]

Lesaka Administrators is an interesting case, with the clients being both 'owned' by the administrator (i.e. not under the control of the insurer) and owners of the administrator. Lesaka is 100% owned by a trade union, whose members (though not exclusively so) also form the client base of the administrator. It is, therefore, similar to a bargaining group through which the union members can negotiate underwriting with insurers and provide their own administration to reduce costs. This setup has ensured that the efficiencies gained through the administrator have been applied to the benefit of the client, and has resulted in premiums to members that are a fraction of those available in the open market. Currently, they have almost 700,000 policy holders (and estimate to cover in excess of 3m lives), most of which take out funeral insurance.

Lesaka does not see itself as an intermediary but rather as a product provider, as it designs its own products and then finds an underwriter who is willing to underwrite them. Products are sold via an agent network. Agents regularly visit the work-place and sign members up there. Premiums are then paid through a pay-roll deduction system (through agreements with more than 400

[75] Zionist Christian Church

[76] Compiled from consultation with Lesaka Administrators, 2007.

companies), while claims are paid into bank accounts (or, where a member has no bank account, by cheque delivered to the work-place).

Lesaka aims to become a registered long-term insurer in its own right and has applied for a license.

Low-income insurance is however not distributed exclusively through groups:

Emergence of "tick-of-the-box" sales. The promulgation of FAIS has increased the cost of selling insurance, most notably by prescribing the process and content of the advice to be given to prospective buyers of insurance policies. These provisions may make it too expensive to pro-actively sell insurance policies which return low premiums. As a result, the low-income market is now mainly served by so-called "tick-box" sales models, based on the sales of group-underwritten policies. As part of the insurance purchase, the customer is given a policy document that provides written disclosure, but there is no verbal disclosure or explanation of the product terms and no advice. Concerns have been noted about the potential for misselling due to the limited information communicated to the client during the intermediation process. On the other hand, it would currently seem the only cost-effective way for the formal insurance sector to distribute insurance products to the low-income market.

New distribution models using partnerships with existing distribution networks[77]. Parallel to the move to non-advice models in the low-income market, innovative new business models have emerged where insurers partner with retailers, air time vendors or other groups such as churches to distribute insurance products (e.g. through joint ventures or, more recently, through cell captive arrangements). Not only does this significantly extend the reach of formal insurers, but it also benefits from the often strong low-income brand presence of the distribution partner. These models are still quite new and have yet to prove themselves. Some of the features include:

- *Cell phone technology.* In at least two cases, cell phone technology is also used to sign up customers and to communicate premium payments (e.g. made at the retailer by buying a voucher and inserting its number to "top up" insurance cover, similar to loading pre-paid airtime). For example, Discovery Life[78] (based on the technological platform and linkages with retailer and vendor networks provided by Smartcall, with whom they have a joint venture for the product) has made use of cell phone technology coupled with existing retail distribution to distribute their Zimele accredited assistance business product, named the PrePaid Funeral Plan. Using the same concept as pre-paid airtime, customers can pay premiums by buying vouchers and keying a PIN into their mobile phones. These "recharge vouchers" are available at a multitude of retailers, and purchasing them does not require customers to have a bank account. Details of transactions and payment reminders are sent to clients via SMS messages – a cost-

[77] Note that virtually all the product examples discussed in this section were launched within the past year. It is therefore too early to arrive at any conclusions on their success.

[78] Information based on brochures and consultations with Discovery Life, 2007.

effective and popular means of communication for the low-income market (the full case study is contained in Appendix).

- In a similar model, Hollard Insurance underwrites a product launched by Shared Phone called "My Funeral Card" (see Appendix). The unique feature of this product is that it is sold by agents who use their cell phones to sign up clients (much in the same way that each individual client would sign up in the Discovery Life PrePaid Funeral Plan model). The main distinction between My Funeral Card and the Discovery Life product is that it is sold through an agent network rather than a retailer and vendor network. These models are very recent, but anecdotal reports suggest that volumes so far are limited, at least in part because it is taking a while to get people to trust this model of insurance distribution.

- *Cash premiums.* The new distribution models also allow for cash payment of premiums, often through retailer networks. (This contrasts with traditional insurance policies which require payment of premiums by debit order.) This feature has proven essential in ensuring take-up among the low-income market, many of whom do not have access to bank accounts. Currently, claim pay-outs are however still limited to bank accounts. This can be prohibitive for some clients. Some insurers however solve this problem by allowing the beneficiary to nominate the bank account of a friend or relative for the payment, should they not have their own account.

- *Passive sales.* The retailer models rely on off-the-shelf purchases by the client and the product is not actively sold. While this reduces the cost of intermediation, it has yet to prove its success in achieving take-up. This is especially true of new non-funeral insurance products. As noted above, the limited information provided to clients during the intermediation process raises concerns about potential misselling.

The Discovery Life Prepaid Funeral Plan[79] is one example of a passive sales technique. Another example is the sales of HTG Life insurance policies via the in-store Money Market counters of Shoprite/Checkers (a large supermarket chain). Money Market counters allow customers to pay utility bills, buy bus tickets, and conduct a range of other financial transactions. In addition, customers can now also buy an insurance policy (which is activated in-store by phoning the HTG Life call centre) and pay their monthly premiums. There is however no active marketing of the product and Money Market staff members are not trained to provide any information on the product. The full HTG/Shoprite case study is contained in Appendix 13.

This is also the model employed by Pep Stores, a low-income cash clothing retailer with a very large footprint across South Africa, in a joint venture with Hollard Insurance (see Appendix for full case study). Hollard insurance products (funeral insurance, cell phone insurance and personal accident insurance) are sold as "starter packs" to mimic cell phone SIM card sales on the Pep Stores shelves. Each product provides policy benefits of R5,000 ($699) in value, at a monthly premium of R20 ($3). The policy number and cell phone

[79] As described above, as well as in Appendix .

number of the customer is captured by the cashier. The Pep/Hollard call centre then phones the client within 48 hours, provides basic disclosure of the product terms (though no advice) and activates the policy. Premiums are payable in cash each month at Pep Stores, and clients receive SMS reminders when premiums are due.

Box 8. Account-based insurance distribution partnerships: the example of Edcon and Hollard[80]

A number of South African retailers offer insurance products to their account customers. That is, customers that have been approved to buy clothing or other goods on credit, are also offered an insurance policy. It must however be noted that the purchase of insurance is not linked to the purchase of any other product – the insurance is a standalone product. The monthly premium of the insurance policy is added to the balance of the customer's account and the premium is payable as part of the monthly instalment on the balance of the account. Most retailers that offer this type of insurance policy also offer an affinity club membership to accountholders. Club membership entails a fixed monthly fee, for which the accountholder receives a package of benefits, which may, for example, include funeral cover.

The best example of this model is Edcon Insurance Services, a joint venture between Edcon, the largest clothing, footwear and textiles retailing group in South Africa (and also the largest credit retailer in Southern Africa) and Hollard Insurance. Credit and other financial services are offered to about 3.5m active account holders across Jet's 280 and Edgars's 150 stores in South Africa. Of the two, Jet is more explicitly targeted at the low-income market. Through the joint venture, insurance policies are also offered to all accountholders in Edgars and Jet clothing stores.

The insurance policies have store branding (i.e. not that of the insurer) and are only sold to accountholders. They are provided to affinity club members as part of a package81. Customers do not require a bank account to be eligible for a store account. Eligibility is determined by a scientific score card applied to the information contained in each application. Policies are sold over-the-counter and are also available via the internet. Sales personnel provide the insurance as a tick-of-the-box offering and therefore, as they are not actively providing advice to clients, fall outside the Financial Advisory and Intermediary Services (FAIS) Act requirements and are not trained to be FAIS compliant (O' Neill, 2005).

A drawback of this approach is that customers that do not qualify to become accountholders will not be able to purchase insurance through this method. This model of insurance will therefore exclude individuals that would potentially be able to afford a small monthly insurance premium, but do not qualify for consumer credit. Nevertheless, the model provides accountholders with a wide variety of insurance products at competitive prices. Survey data also indicate that Jet and Edgars do manage to reach into the lower-income market.

Other new models not related to retailer distribution. The retailer/distribution partner model is not the only model employed in tick-box sales to the low-income market. For example, Santam, the largest short-term insurer in South Africa, has recently launched a household structure and content insurance product named Multihome. The Multihome concept is based on direct, non-advice based selling via an agent selling force, so-called "runners" employed by brokers, as well as a system of marketing brochures, backed up by call centres to conduct the sales, activate the product and provide client service. Potential customers can send a free of charge SMS message to the call centre to phone them back, should they want to know more about the product or to sign up. Customers are also sent SMS reminders each

[80] The full case study is contained in Appendix .

[81] Only accountholders can join the store affinity clubs as the monthly member fee is charged to customers' accounts.

month shortly before premium payments are due. Market research has shown SMS technology to be the most suitable means of communicating with the target market. Santam is however currently redesigning the product to better suit the expressed needs of the low income market. The main features that emerged after the launch was the need among the potential customer base for some form of face to face interaction to purchase and activate the policy, rather than dealing just with the abstract image of a call centre. Debit orders were also initially the only premium payment method allowed, a fact which did not prove suitable to the market's needs. They are therefore considering new variations on the model that will also allow for cash premium payment, e.g. at retailer outlets. See Appendix for more details on the Multihome case study.

Metropolitan, another large insurer, has also launched what it calls the "Retail Enhancement Initiative" (REI) where a broker model is used to serve the low-income market, but with costs to the broker drastically reduced due to the fact that many of the functions are centralised within Metropolitan's call centre. In this way, the broker has to spend a minimal amount of time with each prospective client, making sales to the low-income market more worth their while. More details are contained in Appendix .

4.4. Conclusion: key market features

The discussion above has highlighted the characteristics of the micro-insurance market in South Africa in terms of its market players, distribution models and challenges, products and the usage of such products. The following salient market features emerge:

- **Short-term, group-based products**. All micro-insurance products in the market have short policy contract terms and are underwritten on a group basis (i.e. not individually underwritten even if sold on individual basis)

- **Demarcation: no composite products by one supplier**. Suppliers provide life, non-life and health insurance exclusively - one supplier being limited to one of these product lines.

- **Funeral dominance**. Funeral insurance (and cover) dominates the micro-insurance market.

- **Informality**. Of all people with (formal and informal) funeral cover, the bulk (52%) only has burial society membership (informal). Thus there is still much scope to extend *formal* coverage.

- **Illegality**. Of the 48% with formal cover of some sort, the bulk is provided by or through funeral parlours, much of which could be self-insured or not compliant with FAIS regulations on intermediaries.

- **Compulsion**. The second biggest micro-insurance market (though still very small in relation to funeral insurance) is credit life (provided through credit retailers, rather than MFIs), which is driven by its compulsory nature.

- **New products**. The past few years have seen the emergence of new micro-insurance products in cell phone insurance, housing insurance, and funeral insurance offered through new distribution channels.

- **Credit insurance important in short-term insurance market**: Despite the emergence of new products, focus group insights indicate the short-term insurance market for the low-income population to be largely dominated by credit insurance, i.e. asset insurance purchased with goods purchases on credit (such as a cell phone).

- **Micro-insurance category emerging**. There is a new wave of products being launched that comply with industry created standards for targeting the low-income market. These standards represent an implicit move towards defining a "micro-insurance" product category.

- **Distribution models**. New mass distribution models are developing beyond the traditional broker, often based on partnerships with existing distribution networks and employing innovative technologies.

- **Advice-less selling**. The insurance market is being bifurcated according to the way in which policies are sold. Micro-insurance is predominantly sold without providing advice (employing the so-called tick-of-the-box selling method), whereas the high-income market is characterised by advice (in the form of financial needs analyses) by independent brokers.

- Cell captives. **Cell captive insurers provide a suitable vehicle for groups not yet able to obtain their own insurance license to graduate beyond underwriting.**

In the next section we identify the determinants or drivers of these key market characteristics.

5. Drivers of the micro-insurance market

What explains the key features of the micro-insurance market in South Africa as described in the previous section? More specifically, in which way can these key features be ascribed to regulation? This section seeks to distinguish the non-regulatory drivers of market development from the regulatory ones.

5.1. Non-regulatory drivers of market characteristics

There are a number of non-regulatory factors driving the development of the South African micro-insurance market. Some of these are inherent to the nature of South African society, or the result of market forces and historical evolution. Though not an exhaustive list, these drivers capture much of the essence of micro-insurance in South Africa.

1. Group-based risk management and distribution

Groups as coping strategy. Most insurance policies sold to the low-income market are underwritten on a group basis (based on the expected characteristics of a group of people)

and informal group-based insurance, via burial societies, remains the most popular form of insurance. These phenomena can be explained by the fact that, in South Africa but also elsewhere, low income individuals use groups as a key coping strategy. In poor communities, much more so than in their affluent counterparts, a strong sense of community prevails. Thus individuals tend to cope with adverse events by turning to their social support networks. This is a necessary coping strategy where individuals will not have the capacity to cope by themselves.

The burial society is a prime example of such a group coping strategy[82]. A group of people, most often from the same community and sharing the same type of hardships, realise that in order to adequately provide for the expenses to be incurred upon death, they need to pool their resources in a risk-sharing mechanism to provide death cover to members. Apart from the insurance aspect, burial societies however also provide social support in times of bereavement. Insurance provision is thus a natural complement to the tradition of support within a social group. This is one driver of the high level of informality characterising the insurance market in South Africa.

The role of social groups in distribution. Groups however also play an important intermediation role in the *formal* insurance market. In South Africa, there is a strong tradition of social of affinity groupings (e.g. church groups or labour unions) that play a role in providing cover to their members. Some groups have traditionally done so informally (on the same principle as a burial society), whereas others have more formally acted as intermediaries to provide formal insurance policies, e.g. by acquiring underwriting. The possibility also exists for groups to develop into formal insurers or cell owners in a cell captive insurer. Insurers increasingly realise the value offered by distribution via social groups and, in the quest for lower-cost distribution, the existence of such social groups is an important driver of intermediation in South Africa.

2. Cultural importance of a dignified funeral

As mentioned in Section 4.1, a dignified funeral with a post-funeral reception for family and friends is of utmost importance in South African culture. Not only is it believed that the deceased should be treated with respect and given an elaborate funeral service and reception afterwards, but a social premium is attached to the number of people attending the funeral service. This may prompt the bereaved to go to great lengths to provide food and care to people attending prayers and the funeral itself. Focus group findings revealed that in Black South African households provision for death is an unavoidable expense that often enjoys priority above expenditures such as education, electricity or even food. Even where individuals would not want such an elaborate service, they still felt that it was expected of them by the elders of their culture, as the following quote from an interviewee (about his uncle's funeral) illustrates (as contained in Genesis, 2005):

> "I don't see why a whole cow has to be slaughtered. We don't have to buy all these vegetables. Half a cow and rice or samp will do just fine. Nothing fancy and my uncle

[82] Other commonly found group structures are rotating savings and credit associations (ROSCAs), in South Africa named "stokvels" and the self-help groups that often form the basis for credit provision by MFIs.

> wouldn't even hear of it. A whole cow had to be brought down. I think it's a trend and it's all about 'what will other people say?'…Where does it all come from? [From] the parents, the elderly".

And another:

> "…But sometimes we African people tend to have so many expenses, I mean why do we have to go through such extreme measures…But it's our culture anyway. A funeral is something so expensive and we are so used to that anyway. Imagine, slaughter a cow, hire buses, you know, I just don't get it. My mother told me the same thing, its culture but when I sit down and think about it, it doesn't make sense."

A funeral service is therefore regarded as a necessary rather than a discretionary expense – an expense for which most individuals realise that they will not have the cash in hand and will not be able to accumulate enough savings. Hence informal group risk-pooling mechanisms have emerged and funeral insurance is the most popular formal insurance product among the low-income population.

3. The development of the micro-lending market has driven credit life insurance

Credit life insurance, though not nearly as important as funeral insurance, forms the second-most used type of insurance among the poor. It is however not based on any demand for credit life insurance amongst the poor, but rather on the demand for insurance against credit exposure by credit providers (often furniture or other durable goods retailers). Credit providers compel credit customers to take out insurance policies to cover such exposure. Credit life insurance is therefore compulsory and not voluntary insurance. On the market side, it has largely developed due to the development of the micro-lending market since the early 1990's, which has enabled the low-income population to obtain micro-loans and to buy furniture, appliances and other durable consumer goods on credit.

4. Low awareness of insurance as a personal/individual financial product amongst the low income population

Apart from funeral insurance (as necessary to provide for an unavoidable expense) and credit life insurance (as an involuntary purchase), insurance has achieved negligible take-up among the poor in South Africa (as is evident from the market overview). This can be ascribed to affordability constraints, which imply that insurance will not enjoy priority as expenditure except in the circumstances highlighted above. However, the low uptake also strongly relates to the low level of financial literacy and consumer education amongst low income clients. Though focus group research revealed that consumers are aware that insurance could potentially offer a strong value proposition, especially as the low-income population starts to build assets, consumers are not yet in a position to compare the insurance offering between providers or to other coping strategies such as saving or micro-credit. Even where they are aware of insurance, the awareness is not enough to trigger actual demand, given affordability constraints related to the payment of a regular premium.

5. Rapid adoption of mobile telephony

South Africa, in tandem with many developing countries, has undergone a "cell phone revolution" over the past decade. Contrary to expectations, mobile telephony has proven particularly popular among the low-income population, with recent estimates indicating that 53% of all adults personally make use of a cell phone. For the LSM1-5 (i.e. low-income population) this figure is 40%. 22% of all LSM 1-5 individuals have two or more cell phones in the household, while almost 28% have one cell phone in the household. Thus at least 50% of all low-income individuals have access to a cell phone, either directly or via a household member (Finscope, 2006). The following focus group responses illustrate the value placed on a cell phone:

> "Cell phone keeps you in touch with people. When your cell phone is lost, it is as if you are not alive." (Female, LSM 5-6)
>
> "I just love my cell phone" (Female, LSM 5-6)
>
> "If my cell phone is lost I would have lost my important contact numbers of business people. I would be screwed. I would be very hurt." (Male, LSM 5-6)
>
> "My cell phone is my life. It helps to be in contact with people who might offer me odd jobs. For example, I am here tonight because of my cell phone. Should I loose my cell phone now my life is doomed. I do not care much for radio and other things." (Male, LSM3-4)

The popularity of cell phones has impacted the low-income insurance market in two ways. Firstly, cell phones are increasingly employed as a distribution or payment mechanism and as a way of communicating policy information to low-income clients, via sms or call centre. Secondly, cell phone insurance has emerged as one of the few types of asset insurance sold to the low-income market independently of Charter pressure. Since a cell phone is increasingly regarded as an indispensable asset to a large part of the population, it becomes insurable to them, especially given the extremely high incidence of cell phone-related theft and robbery in the country[83]. Many low income clients have their first experience of asset insurance by purchasing cell phone insurance. This was confirmed by focus group responses:

> "I have the cell phone insurance. In our days, one cannot be certain in terms of what can happen to you and your cell phone. A cell phone can be taken away from you, it can be lost, or it can disappear. The company I took out the cell phone insurance with said that I can be able to replace it in the event of it being lost or stolen." (Male, LSM 5-6)

6. Demand characteristics drive innovation

Experience has shown that low premiums are a prerequisite for insurance products to be successful in the low-income market. Furthermore, products need to be simple and product terms flexible, allowing for occasional premium lapses, as well as cash and other non-traditional premium payment methods. From a supplier point of view, the need for low

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[83] Cell phone theft is often called one of the most reported crimes in South Africa (see for example http://www.busrep.co.za/index.php?fSectionId=561&fArticleId=3980202). There are however no specific statistics available, as cell phone theft is captured under the robbery category in official South African crime statistics. No official disaggregation by type of product stolen is available. We are following up with the authorities to obtain such data.

premiums and flexibility also implies that high volumes of products need to be sold in the most cost-effective way to make them viable.

These demand characteristics (in addition to the regulatory pressures highlighted below) have driven the innovation and product developments characterising the micro-insurance market over the past couple of years. Especially in terms of distribution models (e.g. via retailers with a large footprint, where premiums can be paid in cash), and in making use of cell phone and other technologies for customer communication and as a payment mechanism, insurers have innovated to better address the needs of the market, while trying to minimise costs.

7. Availability of a large retail distribution network and payment system

Distribution at scale and lower cost is a key aspect of formal insurers' quest to serve the low-income market. Many of the models targeted at the low-income market make use of partnerships with retailer networks to allow for products accessible and suitable to the low-income market. This is made possible by the existence of an extensive retailer network in South Africa targeted at the low-income market. For example Shoprite (a supermarket retailer) and Pep (a low-income clothing retailer) both have a large footprint across South Africa and low-income consumers are familiar with and have trust in the brands of both. Both of these chains are involved in joint ventures with insurers to distribute micro-insurance products. Furthermore, South Africa has a sophisticated payment system through which premium payments in cash can be sourced.

5.2. Regulatory drivers of market characteristics

Regulation and supervision have also played and continue to play a crucial role in the evolution of the micro-insurance market in South Africa. However, the development of the micro-insurance market is influenced not only by prudential (risk management) and market conduct regulation, but also by other spheres of regulation. The various categories of regulation that have been found to impact micro-insurance are depicted as the "micro-insurance regulatory house" in Figure 4 below:

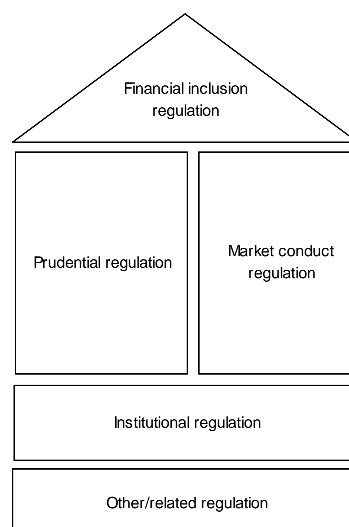

Figure 4. The insurance regulatory house

Source: authors.

These categories of regulation impacting the development of the micro-insurance market are defined as follows:

Financial inclusion regulation: refers to formal legislation or regulations promulgated by the government of a country with the objective of extending access to and usage of formal financial services by persons who are either excluded from or who do not use formal financial services (provided by registered/licensed and supervised financial institutions). Such regulation can take 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, but simply to adopt financial inclusion policies with the explicit aim that financial institutions would pursue outreach policies on a voluntary basis. Although these do not have the force of law, they will directly impact the conduct of providers.

Prudential regulation: refers to the regulation of the core business of insurance, which is the management of risk. Prudential regulation would therefore include, amongst others, the demarcation between different types of insurance, such as life and non-life, which must be written by different providers, minimum capital requirements, product regulation, actuarial requirements, etc.

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, 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, etc

Institutional regulation: Institutional regulation, which includes corporate governance regulation, refers to those statutory requirements that determine which legal forms or persons, for example public companies and cooperatives, 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 normally not specific to the insurance sector (although some countries have a tradition of passing specific statutes for individual insurance firms, especially mutuals), but generic across sectors.

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

However, it is not only regulation per se which impacts 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 which cannot be foreseen ex ante by a regulator. Below, the various regulatory drivers of the micro-insurance market are unpacked.

1. **Regulatory and supervisory forbearance**

The larger portion of persons utilising micro-insurance in South Africa are served by informal (unregistered) or illegal (providing insurance contrary to specific legal provisions) providers. The very existence of these providers is the result of explicit or implicit decisions by the regulator and supervisor of insurance. These policy decisions broadly fall into three categories:

Regulatory forbearance (low insurance risk). Burial societies have their origin in the informal realm and have traditionally operated "under the regulatory radar screen". The Friendly Societies Act exempts small societies (those with an annual turnover of less than R100,000 - $13,975) from all requirements of the Act. Larger burial societies need to register under the Friendly Societies Act, but are not subjected to any insurance regulation unless they provide guaranteed benefits. This relates to the legal definition of insurance in the South African regulatory framework: by stipulating insurance to entail *contractually guaranteed* policy benefits, it excludes informal risk-pooling (i.e. the unguaranteed benefits offered by most burial societies), thereby essentially leaving it unregulated. Therefore the definition of insurance has demarcated an informal market for funeral cover where insurance regulation is absent. This treatment also extends to the new Co-operatives Act, where it is explicitly stated (Section 94) that those financial services co-operatives who do not guarantee their benefits are not subject to the provisions of the Long-term Insurance Act. Such *regulatory forbearance* makes sense from an insurance regulatory perspective, as unguaranteed benefits limit the prudential and market risk involved (though there may still be risk of criminal abuse of members' trust and misleading perceptions of the extent to which benefits are guaranteed). The overall insurance risk is thus low justifying the absence of regulation.

Supervisory forbearance (low supervision risk). Though the Friendly Societies Act has been in place since 1956 to provide an institutional home for mutual societies to register, there has never been much pressure to do so. Only recently did it come to the supervisor's attention that there is a plethora of such risk-pooling mechanisms – too many even to trace, let alone incorporate into the supervisory net. Given the valuable social role of burial societies, and the limited risk posed when benefits are not guaranteed, the inability to effectively supervise burial societies has however not been of much concern to the FSB. Those burial societies who *do* guarantee benefits have also not been strictly supervised (due to a lack of capacity). Although they are technically subject to regulation, supervision is almost on a "voluntary" basis and mostly only applies if they declare to the FSB that they guarantee benefits and submit actuarial valuations, etc.

The same stance (though not explicitly contained in legislation) can be found within the FSB's division responsible for the implementation of the FAIS Act. Underwritten burial societies (i.e. those selling registered insurers' products to members) should technically be classified as intermediaries (and hence should register under FAIS and meet with the

necessary requirements). For enforcement purposes, they are however regarded as "group policy-holders" (with their members as sub-policy holders) rather than as financial service providers. This is regarded as the most pragmatic solution given the enforcement capacity constraints faced by the supervisor. This is based on the premise that lower-risk areas warrant lower supervisory priority.

Limited enforcement. Though funeral parlours fall within the scope of the insurance regulatory framework, should they provide insurance, this regulation is rarely enforced in practice. This inaction is due to limited enforcement capacity within the insurance supervisor as well as inaction on the side of other government agencies (for e.g. health and tax regulation) who administer laws and regulations to which funeral parlours are subject. The lack of enforcement is also due to an implicit realisation within government that a clampdown across the board could close down a large part of the market (largely comprised of black-owned micro, small and medium enterprises) – a scenario to be avoided, as this will be detrimental to the objective of Black Economic Empowerment, and may cause current clients to loose their policies.

The practical outcome is that, although the risk to the regulator may be higher, there has been little pressure on funeral parlours to formalise, even though they are in theory subject to insurance and other regulation and even though the regulators are aware of the threat of abuse posed by illegal funeral parlour insurance. The provision of funeral insurance by funeral parlours has flourished in this supervisory and enforcement vacuum, giving people access to a poor quality form of insurance, and giving rise to the abuses mentioned in the Introduction. Formalisation (i.e. greater *formal sector inclusion)* will serve to better protect current customers. To achieve this, a holistic approach is needed: on the one hand a regulatory framework that will create the space for dedicated micro-insurers who sell trusted, accredited products will facilitate competition with illegal players, thereby putting pressure on them to formalise; on the other hand, a coordinated enforcement drive, coupled with formalisation support to those organisations wishing to "legalise", is needed.

While regulatory forbearance may facilitate the development of the micro-insurance market through allowing informal structures, the existence of informal providers can also have other causes. One of these is the absence of feasible options to formalise.

2. Institutional regulation inhibits formalisation of mutual insurers

The insurance regulatory framework limits the types of legal entities that are allowed to provide insurance to *public companies* and *friendly societies.* Although Parliament can and has passed dedicated laws to formalise specific insurers, this has only happened in three instances. This is thus not a real option for new mutual entrants, especially not smaller organisations with limited resources.

Although the Friendly Societies Act does provide for the registration of mutual associations and allows them to underwrite insurance, very few of the thousands of mutuals providing informal insurance in South Africa, have registered as friendly societies. There are two primary reasons for this. Firstly, friendly societies are allowed to provide very limited types of policies, essentially amounting to funeral policies and a form of life insurance. On the asset side it may only provide insurance "against fire or other contingencies of the

implements of the trade or calling of any member"[84]. This reveals the original purpose of these types of societies. Secondly, the benefits to be provided by friendly societies under funeral policies is limited to R5000 ($700), half of that which can be offered by long-term insurers. Since most of the burial societies and other mutuals provide mainly funeral insurance, this provision has been and continues to be a major disincentive for them to formalise.

It is for this reason that the new Cooperatives Act creates the space for financial services cooperatives to provide insurance. However, the Act requires all financial services cooperatives who wish to write insurance to register under the relevant insurance act as well, thereby subjecting them to all the normal requirements for commercial insurers, including conversion into a public company. Therefore, though the Cooperatives Act of 2005 would seem to open the way for mutual insurers, the practical outcome may end up being very different.

For the time being there is therefore no feasible formal legal structure available for low-income groups with a mutual structure to move up the risk management progression to formalisation (this has been illustrated by the difficulties experienced by the Great North Burial Society in trying to graduate to becoming an insurer).

3. **Existing prudential regulation not commensurate to the risks inherent in micro-insurance products**

Micro-insurance products sold in South Africa share a similar risk profile (see Section 4.1). Whether they are written under a long-term or short-term license, all micro-insurance policies are essentially written on a short-term basis. Moreover, they are not individually underwritten, but sold on a group basis with limited benefits. As such micro-insurance policies are characterised by consistently lower risk than policies that do not share these characteristics. Yet, no allowance is made in regulation for lower prudential requirements to be applied to the providers of micro-insurance.

These prudential requirements applicable to long-term and short-term insurers act as a high bar to entry for informal insurers – many of them funeral parlours – who want to formalise. Although the insurance policies which they are writing have a lower risk profile, they have to comply with the same capital and reserve requirements, actuarial obligations, etc applied to all large formal insurers. This is not purely a matter of regulation, but of supervision. The FSB has the legal authority to relax capital and other requirements upon application. It should thus be possible to create a dispensation where at least the minimum capital and reserve requirements for new entrants is scaled up over time, allowing such entrants to build up capital as their business grows and to graduate into full-fledged insurers. However, as a matter of policy the FSB does not exercise this discretion. Moreover, the FSB has no such discretion in respect of the costly actuarial obligations imposed on long-term insurers. Ironically, short-term insurers are not subject to the same actuarial obligations, but most of

[84] Section 2(1)(e) of the Friendly Societies Act.

the current micro-insurance policies fall under the long-term license, even though they are written on a short-term basis.

The proposed introduction of financial condition reporting (FCR) would also not assist the situation. FCR entails a firm-centric approach to risk-based prudential supervision. Instead of universal capital and other requirements to be met by each applicant for an insurance license, each provider needs to meet requirements that are consistent with its own risk profile. Each insurer must therefore develop its own internal risk model. For those insurers who are not in a position to develop an internal model, a prescribed model, calibrated according to industry averages will be available. This will be the model applicable to most of new insurers wishing to formalise. And its capital and other requirements are likely to be well in excess of what these evolving insurers can afford.

Cell captives could provide an intermediate step for new entrants not yet able to meet the full license requirements, but this graduation option is currently hindered (in the case of burial societies) by the investment restrictions placed on friendly societies under the Friendly Societies Act.

Therefore insurance regulation in South Africa currently does not provide a prudential framework into which smaller players can graduate, thereby implicitly contributing to the existence of the informal/illegal market. The recently initiated insurance regulatory review seeks to rectify this.

4. **Strict demarcation between provision of long-term and short-term insurance undermines the development of short-term micro-insurance**

The statutory demarcation between short-term and long-term insurance precludes or makes it more costly to provide cross-over products, i.e products with both a life and a non-life element. The demand for asset insurance is currently very low in the low income market. Yet, short term insurers are obliged by the Charter to increase their sales to this market. The distribution of non-life policies to the low-income market is likely to be more feasible if conducted through one channel with life (in the form of funeral insurance, with which the market is more familiar). A composite product containing funeral cover and asset insurance is likely to have more of an allure to consumers than a free-standing asset insurance product. Yet the demarcated insurance framework does not allow one insurer to sell both life and non-life insurance products[85]. To be able to do so, it needs to register a separate company and obtain a second license, or must team up with another insurer to jointly distribute life and non-life products. No composite products are however allowed. In the Pep/Hollard case study sister products could be provided as a single branded product, as the Hollard Group comprises two licensed insurers: a long-term and a short-term insurance company. This option is however not available to companies with just one insurance license.

[85] Section 15(4) of the Long-term Insurance act prohibits any long-term insurer (except an insurer acting exclusively as a reinsurer) from also being a short-term insurer. Section 15(5) of the Short-term Act places the converse prohibition on short-term insurers.

5. **Market conduct regulatory concessions have facilitated the development of the formal market, but have been limited to funeral insurance**

In the South African regulatory framework, assistance business (funeral insurance) is established as a distinct line of business with a distinct license (though most long-term insurers are licensed to provide all lines of business, the FSB can limit a license to assistance business upon registration). As a product line it enjoys certain regulatory concessions related to market conduct.[86]

- *Uncapped commissions*. Assistance business is the only line granted uncapped commissions under the regulations to the Long-term Act[87].

- *Intermediary requirements*. The so-called Category A agents, to the extent that they market assistance business policies (or act as agents for friendly societies) have been temporarily exempted from the education requirements under the FAIS Act Fit and Proper requirements. This allows some leeway for advice-based selling by agents experienced in the low-income market, yet without the necessary education to qualify as registered representatives.

These concessions have been core to the success of formal insurers in the low income assistance business market. However, there is an even greater need for these concessions in the non-assistance business micro-insurance market, since there is a far greater need for active selling of products which are currently not seen by poor clients as having a value proposition for them. Yet the regulatory concessions in place are afforded exclusively to funeral insurance.

6. **Market conduct regulation shapes the distribution models used in the low-income market**

The emergence of non-advice selling and the bifurcation of the market. The requirements contained in the FAIS Act have significantly increased the cost of selling micro-insurance (by raising, amongst others, compliance, transaction and infrastructure costs). At the same time the guidance note issued by the FSB allowing certain selling activities to be classified as not providing advice or intermediary services and hence not requiring registration of sales staff has enabled insurers to carve out a niche for non-advice based selling. Over the past two years the distribution of micro-insurance products has grown largely within this space created by the guidance note. Insurers have taken advantage of the space opened up by developing "tick-of-the-box" selling techniques and focusing on retailer and other distribution partnerships to sell "commoditised" insurance products to the low-income

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[86] Historically, a third, prudential requirement-related concession existed. Before the introduction of the Long and Short-term Acts in 1998, a limited assistance business license entailed lower capital requirements, though the playing field was levelled in this regard post-1998, thereby removing the incentive for potential insurers to apply for a limited license. Apart from the assistance business concessions, the exemption granted to friendly societies of course also entails a concession, once again of an institutional and prudential nature, rather than a market conduct nature.

[87] The Life Offices Association (representing the long-term insurance industry) estimates the effective commission rate paid on assistance business by their members to be in the order of 25-30% of the premium value. This contrasts to the 3.25% allowed for other long-term policies, and which may be structured up-front.

market without any advice. Thus, by making advice more expensive and opening up the opportunity for non-advice based selling, FAIS has led to the dominance of the non-advice/passive sales model in the micro-insurance market, and has caused funeral insurance to move out of the traditional broker model into this mass market model. In the insurance market as a whole, these developments have caused a bifurcation between high-end advice-based and low-end advice-less selling.

In combination with the Charter pressure for low-income market expansion (discussed in Driver 7 below) this bifurcation has driven innovation in distribution models to the low-income market. These developments have however not all been positive. Due to the unfamiliarity of the market with non-funeral insurance, e.g. asset insurance, and the limited perceived value proposition of such products currently, non-funeral insurance needs to be sold actively to the market, should it want to achieve any notable take-up. Non-advice commoditised distribution is not viable where there is limited familiarity with and virtually no expressed demand for the product offered. Yet advice makes products more expensive and could price them out of the low-income market. It can therefore be argued that market conduct regulation contributes to the dominance of funeral insurance; for other insurance, low income clients are "protected out of the market"

7. Micro-insurance market activity is stimulated by financial inclusion regulation

The Financial Sector Charter has stimulated the process of outreach by formal commercial insurers in the low-income market. It has also caused the first legally significant definition of the parameters of a dedicated micro-insurance product line.

By setting access targets for private insurance firms, the Charter has catalysed new products and distribution models aimed at better serving the low-income market. Prior to the adoption of the Charter, products targeted at the low-income market were largely limited to assistance business policies. However, over the last couple of years new products aimed at the low income market (as well as more innovative funeral products) have been launched. Though not all of this can be ascribed to the Charter, it has certainly added momentum to the process.

The introduction of the Charter has also led to a reconsideration of existing intermediation models and has triggered much product and distribution innovation in the quest to bring down costs. The result has been more affordable, more appropriate products for the poor, sold to them in ways more suitable to their circumstances at outlets more within their reach and in such a way that cash payment and other needs are better met.

It must however be noted that, despite the market activity catalysed by the Charter and the product and distribution innovation, no large low-income market penetration has been achieved thus far. The fact that these developments are so recent suggests that some time is needed for market forces to play out and for innovations to be tried and tested. It also underlines the need for familiarity with insurance among the low-income population and, especially, for a clear value proposition to exist.

The product standards developed by the industry associations of both the long-term and short-term industry to categorise products as complying with the access standards set by the

Charter, represent the first efforts to define a micro-insurance product category. It is likely that these standards will be taken into account in future regulation of the micro-insurance industry.

8. **Existence of sophisticated regulation and strong supervision have contributed to a vibrant formal insurance sector with the potential to reach out to new low-income markets**

South Africa has a well developed and well resourced formal insurance sector. Comprehensive insurance regulation, implemented by well resourced supervisors has existed for decades. This has created the regulatory certainty and discipline for large commercial insurers to develop. These firms have the resources to invest in research and development for new products and distribution models tailored to the low-income market. Their very existence therefore provides a strong platform for outreach into the low income market.

9. **Credit regulation provides the incentive for credit providers to sell insurance**

Although credit life is an area of insurance to which lower income households clearly have access, it is tainted by the abuse of credit life insurance to push through additional fees and costs on household products. This is facilitated by regulation in two ways:

Insurance allows credit providers to circumvent the Usury Act[88] interest caps. The Determination of Annual Finance Charge Rates published under the Usury Act imposes a statutory ceiling on the interest rate that can be charged on loans. According to the latest Determination[89] this amounts to the central bank's repurchase rate (currently set at 9.5%), plus one third thereof, plus 11% for loans not exceeding R10,000 ($1,398), or plus 8% for loans exceeding R10,000. An incentive is therefore created for retail credit providers to inflate the insurance premium to, in effect, increase the interest charged on the loan. In addition, the monthly premiums are totalled and added to the value of the loan (i.e. capitalised) and interest is charged on this overall amount. This, together with the cost of insurance, could result in an effective charge on the price of the good of as high as 80% per annum – which is clearly way in excess of the allowed interest rate. In selling a product, like a loan, the financial component of the loan is not disclosed separately from the insurance component of the loan and consequently customers are unaware of the level of insurance they are paying.

Regulation allows compulsion. The National Credit Agreement Act (and now the newly commenced National Credit Act) allows credit providers to compel consumers to take out insurance to cover credit risk (though the consumer may not be compelled to use a certain insurance provider). As indicated in the market overview, consumers often are not aware of

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[88] Act 73 of 1968. Note that his Act has been repealed by section 172 (4) (a) of the National Credit Act 34 of 2005 with effect from 1 June 2006

[89] Published in Government Notice 166 in *Government Gazette* 29661 of 26 February 2007

or unable to exercise their right to choose an insurance provider. This further contributes to the opaque practices within the industry, as a captive market is created.

6. Summary and conclusions

This document provided an overview of the microinsurance market, its evolution and regulatory framework in South Africa in order to identify the core market and regulatory drivers of the development and current state of the microinsurance market.

- **Section 1** introduced the study
- **Section 2** provided an overview of the methodology and project scope
- **Section 3** then went on to sketch the insurance regulatory framework in South Africa
- **Section 4** provided an overview of the microinsurance market in South Africa
- **Section 5** highlighted the drivers of microinsurance development – both regulatory and non-regulatory

The following key insights emerge from the analysis:

Market context

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.

The policy, regulation and supervision context

Insurance is demarcated into long-term (mainly for life risks) and short-term (or non-life) insurance. The former is governed by *the Long-term Insurance Act, 52 of 1998*, and the latter by the *Short-term Insurance Act, 53 of 1998*. No insurer (except dedicated reinsurers) is allowed to have licenses under both acts. Only public companies and friendly societies (registered mutual societies providing only limited benefits) are allowed to provide insurance. The *Cooperatives Act, 14 of 2005* provides for the formation of financial services cooperatives (including cooperative burial societies) as legal persons. Such cooperatives may provide insurance but are obliged by the Act to then register for insurance purposes under the Long or Short-term Act as well.

Insurers are also subject to *market conduct regulation*. This includes commission capping (with the only exception being limited-benefit funeral insurance). Market conduct is further

regulated by the *Financial Advisory and Intermediary Services Act of 2002*, which requires the authorisation of all financial service providers and their representatives (including those selling insurance) who provide *advice* or *intermediary services*. It further regulates the manner in which financial products and services are to be marketed and sold.

In South Africa, the extension of access to financial services to the low-income market is an explicit policy goal, and the financial sector has been committed to certain access targets under the *Financial Sector Charter of 2003*.

Towards a dedicated microinsurance regulatory regime. In recognition of the particular challenges facing microinsurance (both from a consumer protection and a financial inclusion point of view) the policy makers are in the process of designing a dedicated microinsurance framework that will define a microinsurance product category to limit risk, will open up the institutional space for microinsurance, and will tailor prudential and market conduct regulation to the specific product category through a dedicated microinsurance license.

Salient features of the microinsurance market

Large proportion voluntary insurance. South Africa is unique among countries where some form of microinsurance exists in that a large voluntary market for micro-insurance exists in the form of funeral insurance. Social risk-pooling mechanisms (burial societies) and funeral parlours account for the majority of the total demand. However, the highly sophisticated formal insurance market is also increasingly expanding down-market, partly as a result of Financial Sector Charter commitments.

Microinsurance driven by demand for underlying service rather than insurance per se. Microinsurance in South Africa has primarily grown on the back of demand for the underlying funeral service, rather than via compulsory credit life insurance. The enormous cultural significance of a dignified burial in African society is therefore the primary driver of the uptake of funeral insurance. Communities have organised themselves informally through burial societies and funeral parlours to mitigate the risk of covering the substantial and usually unexpected cost of a funeral. Although this informal market is prone to abuse (usually from the funeral parlour side) it does provide much needed risk mitigation for low income families. As formal providers have increasingly catered for this market, the risk mitigation options available to low income families have increased and so has their uptake of formal funeral insurance products. Now the market faces the challenge of also selling other life products as well as non-life insurance to their funeral insurance clients. Since these products require active selling, market extension has up till now been inhibited by the onerous market conduct regulation (FAIS Act). The new microinsurance regulatory framework, aims to reduce the cost of selling and also allow previously informal providers to formalise.

Primacy of distribution: Effective market provision of microinsurance requires the distribution of products with low value premiums. Low cost distribution is therefore critical to success. Although the cost of distribution can be substantially increased by regulation it can also be substantially reduced by innovations in the use of distribution channels. South African insurance providers have been successful in using distribution channels beyond the

traditional agent/broker model. These include the use of large retailer networks, pre-paid airtime networks as well as aggregated groups of clients such as large church organisations.

Lack of awareness remains a key obstacle: Beyond funeral insurance the general awareness amongst low income persons of the value of insurance for other risks they face, remains low. Simply providing suitable products will therefore not necessarily lead to substantial uptake of such products. Such products will have to be sold to clients. The South African experience shows that this is best done when the products are bundled with insurance for which there is a demand (such as funeral) or sold when the client buys a non-insurance product or service.

Drivers of market development

Non-regulatory drivers. A number of non-regulatory market drivers determine the state of the market. This includes:

- *Social groups as a coping strategy and means of distribution*. Group-based policies can be sold at low cost via burial societies, affinity groups or unions, as they spread administrative expenses and selling to large groups reduces selection risks. Organised low-income groups also provide a basis on which insurers can distribute products.

- *Culture produces unavoidable expenses*. For the largest part of the South African population, culture dictates the need for a dignified, expensive funeral, which can best be mitigated through insurance (be it informally so or via a formal product). This explains the dominance of funeral insurance among the low-income population.

- *The development of the micro-lending market has driven credit life insurance*. Credit life insurance is directly linked to a credit purchase. The micro-credit market has over recent years developed significantly in South Africa, thereby catalysing the rise of credit life insurance.

- *Low awareness of insurance as a personal/individual financial product amongst the low income population*. Where the cultural imperative is absent and there is no compulsion take-up is negligible, indicating that the market has to be "made" through positive discovery. Furthermore, people often are also just not aware of such insurance products or of the value that it can offer them.

- *Presence and power of the cell phone market drives the only type of asset insurance achieving take-up in the low-income market*. Almost half the South African low-income population now has access to a cell phone. The importance of cell phones to the low-income market drives the take-up of cell phone insurance, the only type of asset insurance which has achieved any success (though still limited) in the low-income market.

- *Innovation in the characteristics of micro-insurance products are driven by the needs of the market*. Low premiums, simplicity, flexible terms and appropriate premium payment mechanisms are prerequisites in achieving success in the low-income market and are

driving the product and distribution innovation taking place to serve the low-income market.

- *Availability of a large retail distribution and payment system network in South Africa has provided new potential distribution models*. Retailer distribution is an important feature of the low-income market. This is only possible due to SA's large retailer footprint and sophisticated payment system.

Regulatory drivers. Ten main regulatory drivers were identified and analysed:

- The *absence or non-enforcement of existing laws and regulations* has facilitated the development of the informal and illegal micro-insurance market;

- *Institutional regulation* is blocking the entry and development of mutual and cooperative insurers;

- *Prudential regulation* does not provide a framework that encourages entry and development as its requirements are quite stringent for low risk forms of insurance;

- *Strict demarcation* between long-term and short-term insurance undermines the development of short-term micro-insurance, as a separately registered and regulated entity is required to write each type of business;

- *Regulatory concessions* (e.g. allowing unlimited commission) have facilitated the development of the formal market, but this has been limited to funeral insurance;

- *Market conduct regulation* shapes the distribution models used in the low-income market – with the relatively high cost of compliance for intermediated distribution prompting the extension of adviceless, "tick box" selling models;

- Micro-insurance market activity is facilitated by *financial inclusion regulation*, for example, the Financial Sector Charter sets access targets for formal insurers to reach low income markets;

- The existence of a *sophisticated regulatory structure and well resourced supervisors* have contributed to a strong financial sector that made a regulatory down-market push possible; and

- The Usury Act provided the *incentive for credit providers to sell insurance* by reducing the margins they could earn from lending

Key issues for the regulation of microinsurance in South Africa going forward

The need to facilitate positive market discovery beyond funeral insurance. Large-scale voluntary insurance uptake has only been achieved for funeral insurance. 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.

Need to facilitate entry and formalisation. Furthermore, informal insurance remains pervasive. There is currently no effective space for member-based entities to formalise into for the provision of insurance. The friendly society space that currently exists may pose risks to consumers and is also limited in terms of the benefits it can provide.

Proposed new microinsurance regime takes on board lessons. The current proposed regulatory reform (initiated by the South African National Treasury to correct market imperfections) is encouraging in that it suggests an active engagement of the regulatory authorities to address the challenges highlighted by the case study. It also forms part of a broader policy to empower the previously disadvantaged citizens of the country. Should the proposal for regulatory reform be accepted and enacted, it will provide a valuable case study on the impact of regulatory change on the development of a microinsurance market.

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Meeting list

Organisation	Person	Date
African Life	John Solomon	14-Dec-06
Centriq	Michael Blain (CEO)	09-Mar-07
Discovery Life	W van der Merwe	01-Feb-07
dti	Cooperatives Unit: Acting Chief Director Jeffrey Ndumo and team members	01-Mar-07
FSB	Billy Clarke and Melonie van Zyl	12-Mar-07
FSB	Mashudu Munyai, Jacky Huma, Kamcilla Naidoo, Billy Clarke, Suzette Vogelsang, Patrick Ward	19-Feb-07
FSB: Actuarial division	Hantie van Heerden (actuarial specialist)	13-Apr-07
FSB: FAIS Department	Manasse Malimabe	19-Mar-07
FSB: FAIS Department	Wendy Hattingh and Charene Nortier	Jun 2007
FSB: Friendly Societies (part of Retirement Funds division)	Alta Marais (Research and policy) and team members	20-Mar-07
FSB: prudential	S Vogelsang	20-Apr-07
Guardrisk	A Dienst (Chief Actuary), H Schoeman (CEO) , N Pather	18-Apr-07
Guardrisk	R Eales & N Pather	10-Jan-07
Hannover Re	P Tomlinson	12-Apr-07
Hollard	R Inglis	15-Jan-07
Legalwise	T Fornali & J Luwes	16-Jan-07
Lesaka	Derick le Roux	05-Feb-07
Life Offices Association	Anna Rosenberg (Deputy Executive: Legal)	22-Mar-07
Life Offices Association	Gerhard Joubert (CEO)	14-Mar-07 and Aug 2007
Old Mutual	W Louw	19-Apr-07
Pep	John Edwards	16-Jan-07
Private Funeral Directors' Association	Dave Pietersen	Aug 2007
Real People	Emile Mouton	26-Jan-07
SA Federation of Burial Societies	Tebogu Phadu	Feb and Aug 2007
SA Underwriting Managers' Association	Douglas Everitt	19-Dec-06
SAIA	V Pearson & L Moondo	12-Jan-07
Santam	Kobus Olivier (Head of Alternative Distribution) and Simon Mokhena (Manager: Business Development)	07-Dec-07
Santam	Kobus Olivier and Nolwandle Ngoqi	Aug 2007
Small Enterprise Foundation	Dale Lampe	07-Feb-07
Swiss Re	G Jenkins et al	17-Apr-07
The Best Funeral Society	John Turnbull (MD) & Randall Mocke (Director: Finance & Operations)	15-Feb-07

List of abbreviations

BEE	Black Economic Empowerment
CAT	Fair **C**harges, easy **A**ccess, and decent **T**erms
dti	Department of Trade and Industry
FAIS	Financial Advisory and Intermediary Services Act
FCR	Financial Condition Reporting
FSB	Financial Services Board
FSC	Financial Sector Charter
FSP	Financial Services Provider
GNBS	Great North Burial Society
IAIS	International Association of Insurance Supervisors
LOA	Life Offices Association (Long-term industry association)
LSM	Living Standards Measure
MFI	Microfinance institution
PCC	Protected cell company
ICC	Independent cell company
SAIA	South African Insurance Association (Short-term industry association)
UMA	Underwriting management agent

Appendix 1: Analytical framework

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 5 indicates this schematically:

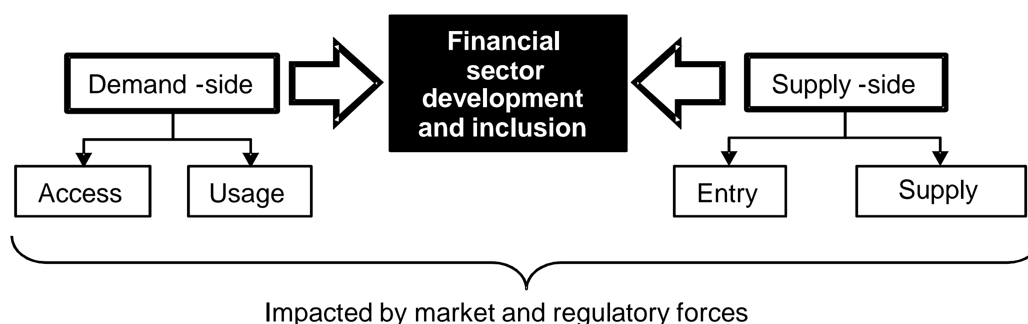

Figure 5. Financial inclusion framework

Source: Da Silva & Chamberlain, 2008

These factors may explicitly exclude individuals 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 a individual to use a particular financial service. The FinMark access methodology90 identifies five factors that impact on access: physical proximity, affordability, eligibility, appropriate product features/terms and regulation.

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

Goal of microinsurance

The country studies presented in this report accordingly focus on the role that the insurance market can play in reducing the vulnerability of the poor. Why would one want 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 therefore mitigate the most material risks faced by the 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 providing more predictable income flows to providers that ensure viability of the provision of such services to the low-income market. Therefore 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 *per se* 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 amongst 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 discussed in this document shows that microinsurance take-up is often not the result of voluntary strategies by the poor to mitigate their material risks, but is rather 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 needs to be taken to ensure fair treatment of the low-income consumer.

Definition of microinsurance

Conceptual definition. Microinsurance is defined by the IAIS (2007b) as "*insurance* that is *accessed by [or accessible to*[91]*] 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 provided by governments, "as this 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 in terms whereby an insurer, in return for a premium, undertakes to provide policy benefits. It is distinguished from e.g. 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 based 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 (that often requires distinctive methods of distribution or 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 any specific income cut-off for the microinsurance target market. Instead, 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

[91] Authors' own insertion.

insurance mechanism and will remain the 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.

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 c*ombination with a bene*fit cap) include the following:

- Product categories that particularly reflect the needs of the poor (e.g. funeral insurance, or insurance for motorcycles or cell phones important to the low-income market for business purposes)
- Distribution channels, especially channels accessible to the poor;
- Simplicity of terms, conditions and processes;
- 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

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.

Figure 6 presents a picture of the generalised structure of the insurance value chain:

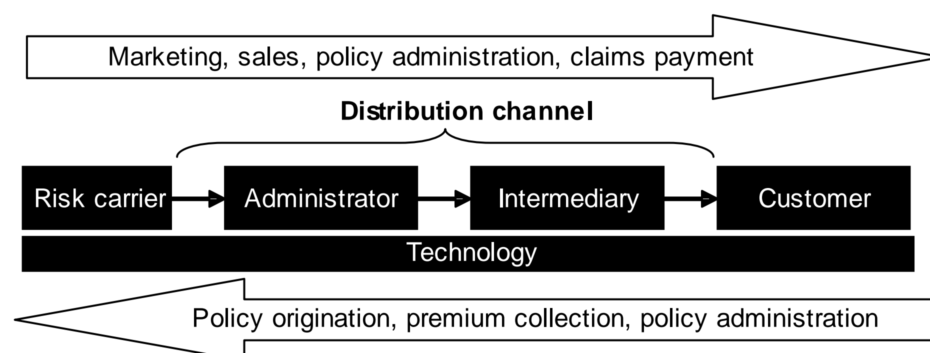

Figure 6. Insurance value chain

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 cooperative) authorised to provide insurance.

- *Administration:* Administration may be done at the level of risk carrier, 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, NGO MFIs, credit cooperatives, 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 the use of 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 requires focusing on more than just insurers and products. Particular attention has been paid to the intermediation of insurance in the markets reviewed in order to 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, distribution through retailers, etc.).

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 upfront what is implied by informality:

Formal. Formal financial products and services are defined as products or services provided by financial service providers[92] that are registered with a public authority in order to provide such services[93].

Informal. Informal financial services, therefore, refers 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. Where 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 critical role in financial sector development. The existence of large informal markets can be 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 mechanism or providing the service themselves. The scale and number of informal insurance providers may provide a reality check on the challenges facing 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 provided by the informal sector.

Categories of risk

The definition and analysis of risk and its various drivers is central to the analysis and proposals contained 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 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.

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[92] In turn defined broadly as any provider of financial services – in this instance insurance.
[93] This is the definition generally applied by the World Bank.

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 risk[94] 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 create 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 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 features of the insurance product that impact on risk are: the nature of the risk event covered and its expected frequency and impact; the duration of the product contract; the benefit value; product 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*[95] 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 will be sold products that 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 (e.g. product complexity, level of cover provided), the nature of the intermediation process (e.g. 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 (e.g. 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.

Policy, regulation and supervision

Regulatory vs. non-regulatory drivers of market development

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

[95] 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.

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 impacted 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 impacting on 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 is poorly developed, will face different circumstances and goals than other countries.

The first challenge is therefore 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 followed 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.

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 the intermediaries themselves).

- *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 (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 is the case 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: where 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. Often, various objectives however mutually enhance one another.

<u>Public policy instruments</u>

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, be 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 even without regulation following from the policy. This may be the case particularly where 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*. It is 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 therefore 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 in regulation 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.

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 can be captured in the diagram below. The report uses this scheme to analyse the impact of policy and regulation on the development of microinsurance markets in the sample countries.

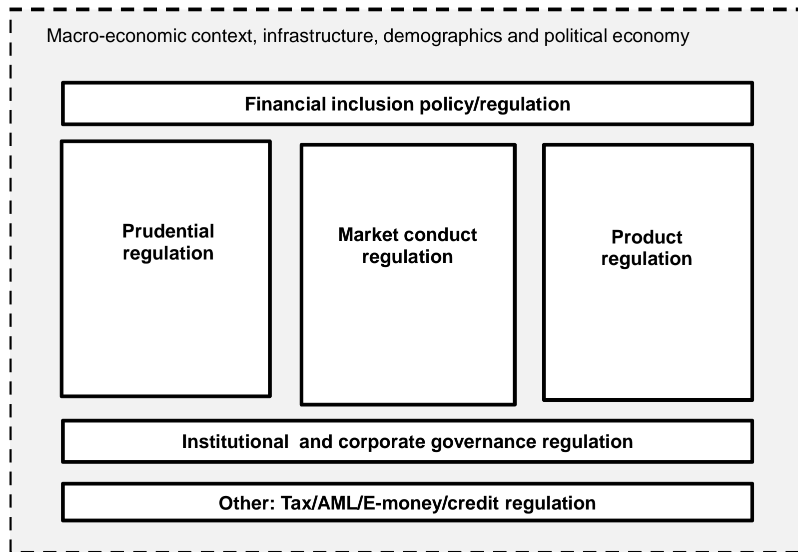

Figure 7. The insurance regulatory scheme

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 persons who are either excluded from or who do not use formal financial services (provided by registered/licensed and supervised financial institutions). Such regulation can take 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 will directly impact 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 rather to the product in question. While provisions relating to product regulation are usually contained within either prudential, institutional or market conduct legislation, it therefore represents 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 9. 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 time frame, the product is automatically approved. In other instances, explicit approval is required by the regulator before products may be offered. This may be used as a means 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 the provision of insurance products by particular players (e.g. non-corporates) or may determine that certain types of products may only be provided by 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 cooperatives 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 (although some countries have a tradition of passing specific statutes for individual insurance firms, especially mutuals), but generic across sectors.

Other regulation. A number of other regulatory requirements could also impact the development of the microinsurance market. Although not insurance-specific, they impact 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 *per se* that impacts 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.

7. Product case studies: short-term products

Appendix 2: Cre8 and iKhaya Protector

Creating a low-income product. The example of Cre8's iKhaya Protector illustrates the impact of distribution challenges on attempts by the industry to create innovative short-term products for the low-income market. Cre8 is the research and development division of Alexander Forbes, a large South African financial services company. Cre8 has for the last 18 months actively been trying to enter the LSM 1-3 market with an appropriate product. It designed a home owners' insurance product specifically for this market and has used local municipality facilities to assist with the placement. The main challenge has been successfully distributing the product and very few policies have been sold.

Product features. The product, iKhaya Protector, is specifically targeted at the owners of government subsidised entry-level homes with a minimum insurable value of R30,000 ($4,200) and a maximum insurable value of R100,000 ($13,975) (Cre8, 2005). The iKhaya Protector provides insurance for house structure only, as the risks associated with this product first need to be thoroughly tested in the low-income market before venturing into other insurance product categories (such as household content). Whereas two years ago, the owners of government-subsidised housing still had to pay a certain percentage of the market value of the house to purchase it and therefore had to have some source of income, payment is no longer required (Botha & Small, 2006). In many cases, the owners are unemployed and often also unbanked.

Distribution challenges. Originally the product was distributed through the KWASA Development & Housing Resource Co. that acted in the capacity of a brokerage. In order to limit sales and transaction costs, the product was sold at local ward meetings, allowing brokers to reach many individuals in one location (Botha & Small, 2006). However, the brokers had limited success as the policies have to be paid upfront and in cash. Upfront meetings was problematic as ward meetings were held in townships and all attendees were aware of the fact the brokers carried cash with them (Botha, 2006a). After consultation with various municipalities, this distribution channel is no longer utilised. Another key obstacle in distributing the product to lower-income clients was the absence or limited realisation (due to limited financial education) by low-income individuals that the product offers them real value (Botha, 2006c).

Cre8, subsequently, entered into negotiations with the national government's Department of Housing about the possibility of the Department purchasing the product on behalf of government subsidised homeowners (Botha & Small, 2006). As the houses only officially belong to the individuals/owners after they have resided in it for five years, the houses remain the asset of national and provincial government for the first five years. Government thus has an insurable interest in these houses for their first five years of existence, which would gradually be transferred to the owners, who would by then be more familiar with the product and will be on Cre8's database. However, Cre8 was recently informed that the

Department of Housing will not be making any financial contribution to the rollout of this insurance product (Botha, 2006b).

Cre8 is continuing its search for appropriate distribution channel(s) for iKhaya Protector.

Appendix 3: Santam Multihome

Santam, the largest short-term insurer in South Africa, was the first large short-term insurer to launch a product aimed at the low-income market as part of its Charter obligations (but also in a drive to unlock new markets). The Multihome product, offering structural and content insurance for low-income houses, was launched in one province in 2006 and is to be rolled out to other provinces in 2007. As expected in such "unchartered territory", take-up has been very low and the product is being redesigned to better meet customer expectations. Marketing, in terms of making consumers aware of the need for formal insurance, has been a challenge. Furthermore, only debit order payments were allowed initially, which proved an obstacle for clients without a bank account, or who distrust debit order systems. Prospective clients also indicated that they prefer face to face interaction and an explanation of the product, whereas the Multihome model was based on marketing through a variety of channels, relying on customers to phone the call centre to buy the policy.

Subsequent innovation to better align the product with the needs of the market include an initiative to have payments made in cash at a large retailer network and other outlets. Prospective clients and also send a toll-free "please call me" to the call centre so that they do not need to incur the cost of making a phone call to buy a policy.

Unlike long-term micro-insurance where the event is defined and once-off and leads to a defined payment to the beneficiary, short-term insurance costs are increased by the need to assess claims and determine pay-outs that are appropriate to the damage experienced.

Regulatory uncertainty relates largely to distribution. Santam aims to sell its Multihome product through three distribution models:

- Firstly, they have a network of *tied agents* who will also sell this product and provide advice to clients (i.e. they are registered financial service provider representatives). Given the generally low value of premiums, this model can however only be profitable to the individual agent if he or she sells a range of products, also to the higher-income market. The relative incentive to sell the Multihome product will however be limited.

- In the *referral model* no advice is provided. Brochures are simply left at small retail outlets and staff do not actively sell the product, but just refer them to the call centre.

- Lastly, they are implementing a *broker and runner model*. At this stage, two large brokers have been signed up, between them with around 200 runners. The runners actively sell the product (e.g. in shopping malls), but do not provide advice; should advice be needed a registered representative of the brokers, called a supervisor, is close by (as a rule, there will be about one "supervisor" for every five runners). Brokers are thus FAIS accredited, as are supervisors, but runners do not need to be. Though Santam feels that this model falls within the parameters allowed under the FAIS Act, some regulatory uncertainty remain and the repercussions of a regulatory clamp down could be severe. Regulatory uncertainty also impacts product design as it is important to strike the fine balance between when advice is provided, versus merely disclosure.

Appendix 4: Legalwise legal insurance

Legalwise is the largest player in the legal insurance market, a market which is aimed at that proportion of the population too affluent to be allowed access to state-provided legal aid, but too poor to be able to make payments for legal council as and when needed. According to Legalwise, expressed demand for such insurance is quite high. Two products are sold: one provides R42,000 worth of cover per legal matter for R42 per month, while the other provides R75,000 cover at R60 per month. In both instances, actual expenses incurred are covered, rather than the full benefit being paid out (according to the same principle as medical aid). Clients are only allowed to use a designated network of legal service providers, who are reimbursed directly by Legalwise. Typical cases include labour disputes, debt related cases, or childcare or other maintenance matters.

Premiums are paid largely via payroll deductions (as the target market is not the poorest of the poor, they are more likely to be in formal employment), or via the post office or EasyPay (a system that allows utility and other bill payments at retail outlets).

Distribution takes place through an agent selling force. Such agents are not FSP-registered (a fact which they have cleared with the FSB): they are specially trained to provide disclosure, without giving advice. Their branches give legal advice, which is the type of advice customers typically want, rather than advice on the most appropriate insurance product to purchase. They also do telemarketing, media campaigns and referrals. They do however consider FAIS a burden to distribution.

8. Product case studies: long-term products

Appendix 5: Opportunity International's Micro-Insurance Agency

Opportunity International. Opportunity International is a network of microfinance organisations assisting low-income individuals in the elimination of poverty through the provision of financing for income-generating activities. It has operations in 29 countries in Africa, Asia, the Americas and Eastern Europe and has managed to reach 850,000 borrowers (Leftley, 2006). In 2002, Opportunity International started developing insurance products as a response to the needs of MFI clients in Africa (Leftley, 2006) and in 2005 it established the Micro Insurance Agency, with offices in a few countries, to act as intermediary/broker between micro-finance institutions and insurers to ensure that appropriate products are developed and sold. The South African office is currently being set up, though there has not been much progress recently, as pressing developments elsewhere enjoyed priority.

MIA to position itself as innovative intermediary focused on low-income market. The Micro Insurance Agency in South Africa will facilitate the brokering of deals between micro-finance organisations and other commercial organisations wishing to provide insurance to their clients, and insurance companies. South African microfinance organisations often find it difficult to negotiate directly with insurers due to limited experience in the insurance industry and/or lack of insurer intent. However, MIA's function will not be limited to mere negotiations. It will also be involved in the market research process to identify the insurance needs of various organisations' clients and to, with the cooperation of the insurer, create products able to fulfil these specific needs. In addition, it will handle all policy administration, removing the administrative burden from both the MF or other organisation and the insurer. Possible clients for the Micro Insurance Agency include the NGO micro-finance sector, commercial micro-finance houses, as well as retailers and cell phone banks.

Competitive advantage. Opportunity International has invested in the development of a sophisticated management information system (MIS), that facilitates the easy and central management of all policies issued to MFIs and other partners through an eMerge server placed in Denver, with smaller eMBU servers placed in the country of operation.

Treatment of FAIS. It seems as if MIA, like most of the retailer insurance models, will be relying on the regulatory space that has been created for tick-of-the-box selling. However, this selling approach and thus also the viability of the MIA's partnerships are at risk until the regulatory uncertainty around tick-of-the-box selling has been resolved.

Appendix 6: Metropolitan's retail enhancement initiative

Metropolitan is one of South Africa's three biggest insurance companies. It provides life insurance, employee benefits, asset management and health management services. The retail division of Metropolitan Life, a wholly-owned subsidiary of Metropolitan, recently launched a Retail Enhancement Initiative (REI), which subsequently attained Zimele accreditation. *This is one of the only examples of products aimed at the low income market yet based on advice-based selling*.

REI process and characteristics. The REI, the first such initiative in the world, provides call centre support during the sales process to brokers and agents selling Metropolitan Life products. It assists agents and brokers in registering a client's acceptance of a policy quote at head office and collecting detailed client information. The request for a new policy is made telephonically by the broker or agent phoning the Metropolitan Area for Customer Enrolment (ACE) Centre. The ACE Centre captures all policy details through information provided by both the intermediary and the client. This process takes place at no cost to the intermediary. Therefore the intermediary need to dedicate less time to each policy application and can dedicate the time available to conduct a financial needs analysis for the prospective client. It is expected that the required time per policy could reduce by up to 40% and could increase business volumes per broker by up to 10%. It will also enable brokers to reach into more rural areas. Therefore the low-income market can be served more cost-effectively.

Implementation challenges. With the initial implementation of the REI in Metropolitan Life's *direct writer distribution channel*, the REI had a negative impact on direct writer business volumes. This is thought to be the result of change resistance and implementation challenges and it is expected that as REI stabilises, sales will increase. REI was only incorporated in the *general intermediary channel* during the first quarter of 2006 – it is expected that the general intermediary channel will have the same initial negative sales experience as the direct writer channel (Metropolitan Holdings Limited, 2006).

Assessment. Although the REI does not reinvent the role of the agent, it assists agents in more easily complying with FAIS requirements. This allows agents to spend less time processing each client's policy application and, consequently, to see more prospective clients. Should it be successful, it will therefore be a pioneer in finding a way to balance the provision of advice (by providing a financial needs analysis) with cost-effective selling.

Appendix 7: Standard Bank Insurance

Standard Bank's sales of funeral insurance provide another example of advice-based selling to the lower-income market.

Standard Bank Insurance Brokers (SBIB) distributes short-term, funeral and credit-life insurance. SBIB sells short-term insurance directly to customers in the high-income market, whereas funeral and credit-life insurance are sold in cooperation with Standard Bank branches and are generally targeted at the low-income market. Credit life insurance is a compulsory product sold to individuals that have loans from Standard Bank's Low-income Housing unit (though by law clients may choose the insurer from which to buy the insurance). For the purpose of this discussion, we focus on the distribution of funeral insurance.

Distribution to low-income clients. Standard Bank actively targets funeral insurance at the low-income market. Its funeral plan is sold to Standard Bank clients that have E Plan and Plus Plan accounts. E Plan and Plus Plan accounts are targeted at individuals in LSM 4-7, earning an income between R1,200 to R6,500 (Jawuna, 2006). Since this product is only offered to individuals with bank accounts, SBIB is guaranteed a premium collection mechanism (debit order). In 2006, there were approximately 860,000 active policies (Jawuna, 2006a) and on average about 1,500 policies are sold daily.

The funeral insurance sales process. The funeral plan is sold by consultants, normally responsible for the opening of accounts and general retail banking queries, working in Standard Bank's branches. The consultants are trained to ensure that they understand the products assessed and, if proven competent, are accredited to sell and provide advice on funeral and credit life products sold directly to customers. The staff members are registered as Representatives, which means that they meet the necessary FAIS Fit-and-proper Requirements applicable to Category A[96] agents. When clients open an E Plan account at the bank counter, they are offered the option of purchasing the funeral plan. Upon finalisation of the sale, the client receives a policy membership card with the call centre number printed upon it. Bank branch distribution and cross-selling significantly lowers the cost of providing insurance.

In addition to in-branch sales, the call centre also undertakes outbound telephone campaigns during which it attempts to sell the funeral plan to existing E Plan clients who have not yet purchased the policy (Jawuna, 2006b). All contact centre agents are registered as representatives of the FSP (Jawuna, 2006b).

Assessment. The bank model is only able to reach banked individuals. However, it has quite an extensive geographic reach and infrastructural spread in urban and peri-urban areas due to Standard Bank's network of 746 branches (Standard Bank, 2005). The easy access to individuals' bank accounts provides Standard Bank with a convenient and inexpensive

[96] The FAIS Act distinguishes between various categories of insurance intermediaries. Category A is subject to the lowest fit-and-proper requirements, but with severe restrictions on the type of products that can be sold (only funeral insurance).

premium collection mechanism – the debit order. Furthermore, clients are provided some advice (covering both needs analysis and disclosure) upon the purchase and can also contact the call centre for additional product and process disclosure. Although this model is limited to individuals banking with Standard Bank, the inclusion of advice on sales makes this an appropriate model for selling to the lower-income market and the combination with bank processes makes this cost-effective for the intermediary.

Appendix 8: Discovery Life Pre-Paid Funeral Plan

Discovery Life, a large South African long-term insurer, launched its pre-paid funeral plan in November 2006. The product is based on a joint venture agreement with Smartcall, a division of South African cellular network Vodacom[97]. While Discovery Life is the product provider and carries all underwriting risk, Smartcall provides the technological platform and access to the vendor and retailer network on which distribution is based. The basic premise for the product is affordability and distribution that is convenient to potential clients, even should they have no bank account. After minor adjustments, the product obtained Zimele accreditation in February 2007 (thereby enabling Discovery to earn charter points).

Distribution network. Smartcall provides a technological platform for vendors and retailers to sell airtime. Through the joint venture, this platform can now also be used to sell insurance based on the same principles as pre-paid airtime. In this way, Discovery gains access to a wide distribution network including spaza shops (small informal shops that are widely found in more informal settlements in South Africa) and other vendors selling airtime (often outside of formal retail infrastructure). The network is soon to span Vodacom outlets countrywide, as well as all outlets of large supermarket groups (where airtime is already sold by cashiers). The JV is furthermore considering the use of affinity groups (e.g. church groups) for distribution purposes and plans to eventually create a website where, for example, employers can buy insurance for their domestic workers using a monthly debit order.

Product features. For a monthly premium of R40 ($6), the main member and spouse are afforded R10,000 ($1,398) cover each, with cover decreasing for children (in line with Zimele product standards). Vendors selling the product receive a free starter-pack (basically, an information packet containing information brochures, claims procedures and the policy document). The starter pack instructs the prospective policy holder on how to register with Discovery (all processes are conducted via the cellular handset, by means of the policy holder inserting his/her identify number, the pin contained in the starter pack, the nominated beneficiaries, etc). Once registered, prospective policy holders buy a voucher from the vendor. When the voucher number is submitted via the handset, the policy is activated. All of this works on the same principle as buying pre-paid airtime (a process with which this market is very familiar). Thereafter, a voucher needs to be bought each month to "recharge" the policy, once again much in the same way as air-time will be recharged regularly.

The concept is that the cover is "pre-paid"; one payment affords you 28 days worth of cover. In line with Zimele standards, clients have a grace period of three months, i.e. are allowed to miss payments for three months per year (be they consecutive or not). During these months, no cover will be provided, but the policy will also not be cancelled and hence policy holders will not need to go through a waiting period again upon resuming monthly payments.

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[97] Smartcall however also renders services to MTN, another of South Africa's three cellular operators. Thus clients of both Vodacom and MTN would be able to buy the Discovery PrePaid Funeral Plan.

Registration and claims process. No telephonic or face to face communication is required when the client registers for the policy, as all contact is via SMS. Should there be a problem with activation, an outbound call will be made to the client. If a client has any questions on the product or the registration process, he or she can phone a share-call line (where the JV carries part of the call charges). When a policy holder wants to claim, she or he will need to phone the call centre, which will then fax or email them a claim form. Once submitted, claims are either paid directly into a bank account or via a Mzansi money transfer (a money transfer product that does not require a bank account and which is aimed at the low-income market). It is also possible for a client to nominate a relative or friend's bank account, should they not have an account of their own.

No explicit commission is paid. Rather, the vendors buy the vouchers from the JV (also on a "pre-paid" basis), and are then allowed to sell the vouchers at a mark-up.

Dealing with regulation. The PrePaid Funeral Plan is offered as an assistance business product under the Long-term Insurance Act of 1998. Discovery Life has entered into a group insurance contract with Smartcall. The only parties to this contract are Discovery and Smartcall. Consumers are entitled to the benefits created in terms of this contract only by acceptance of such benefits. These they accept by activating the vouchers they have purchased (Discovery Life, 2007).

The main area of regulation to be dealt with is that regarding the provision of financial advisory and intermediary services (FAIS Act, 2002). The product is sold on the basis of non-advice based selling (allowed under the FAIS Act and guidance note issued under the Act). Furthermore, as the product is only activated once the voucher number is submitted electronically (a transaction between the policy holder and Discovery), the vendors or retailer staff are not involved in an intermediation transaction and therefore do not need to be registered as representatives for FAIS purposes. Call centre staff, who deal directly with customer queries or complaints, will be registered financial service provider representatives.

Appendix 9: Hollard insurance sold to Edgars and Jet account holders

A number of South African retailers offer insurance products to customers when they become accountholders and are thus, by definition, able to buy clothing and/or other goods on credit. It must however be noted that the purchase of insurance is not linked to the purchase of any other product – the insurance is a standalone product. The monthly premium of the insurance policy is added to the balance of the customer's account and the premium is payable as part of the monthly instalment on the balance of the account.

Most retailers that offer this type of insurance policy also offer an affinity club membership to accountholders. Club membership entails a fixed monthly fee, for which the accountholder receives a package of benefits, which may, for example, include funeral cover.

The best example of this model is Edcon Insurance Services, a joint venture between Edgars Consolidated Stores Ltd (Edcon), the largest clothing, footwear and textiles retailing group in South Africa (and also the largest credit retailer in Southern Africa) and Hollard Insurance. Through this joint venture, insurance policies are offered to all accountholders in Edgars and Jet clothing stores. Credit and other financial services are offered to about 3.5m active account holders across Jet's 280 and Edgars's 150 stores in South Africa. Of the two, Jet is more explicitly targeted at the low-income market.

Edcon and Hollard Insurance Ltd established a joint venture, *Edcon Insurance Services*, in June 2001. In terms of the agreement underlying this venture, the Edcon group sells a wide range of insurance policies underwritten by the Hollard Life Assurance Company Ltd and Hollard Insurance Ltd.

The insurance policies have store branding (i.e. not that of the insurer) and are only sold to accountholders. They are provided to affinity club members as part of a package[98]. Customers do not require a bank account to be eligible for a store account. Eligibility is determined by a scientific score card applied to the information contained in each application. At the end of the 2004/05 financial year, Edcon customers owned a total of 1.1m financial service products sold through Jet and Edgars stores (Edcon, 2005b).

Policies are sold over-the-counter and are also available via the internet. Sales personnel provide the insurance as a tick-of-the-box offering and therefore, as they are not actively providing advice to clients, fall outside the Financial Advisory and Intermediary Services (FAIS) Act requirements[99] and are not trained to be FAIS compliant (O' Neill, 2005).

Premium collection and payouts. Edcon Insurance Services is responsible for the marketing and sales of the policies, while Edcon is responsible for premium collection and paying over the premiums to Hollard. Hollard manages the policy and claims administration and also handles the actual payment of claims. The rationale behind the store-card model, as used

[98] Only accountholders can join the store affinity clubs as the monthly member fee is charged to customers' accounts.

[99] The Financial Advisory and Intermediary Services Act requires all financial service providers dispensing financial advice or providing intermediary services to be suitably licensed. Licensing requirements include, amongst other things, the financial service provider to meet certain "fit and proper" or learning standards.

here, is that monthly premiums can be more easily collected if they are simply added to the store account balance and paid as part of the monthly installment.

A drawback of this approach is that customers that do not qualify to become accountholders will not be able to purchase insurance through this method. This model of insurance will therefore exclude individuals that would potentially be able to afford a small monthly insurance premium, but do not qualify for consumer credit.

Cost to cover. The Edcon/Hollard model provides accountholders and club members with a wide variety of insurance products at competitive prices. The cover provided by the Edcon/Hollard model significantly exceeds that of other models evaluated and survey data indicate that they do manage to reach into the lower-income market.

Appendix 10: Pep and Hollard Insurance

Pep Stores (a wholly-owned subsidiary of Pepkor) is a cash clothing retailer targeted at the low-income market with a branch network of 942 stores across South Africa (Müller, 2006). Through a joint venture, Pep has partnered with Hollard (a holding company with two insurance companies specialising in respectively long and short-term insurance) to provide insurance to its customers. Their products and joint venture were formally launched on 21 March 2006 (Gunnion, 2006a). After the launch of Zimele product standards in February 2007, the Pep/Hollard products obtained Zimele accreditation. At the beginning of 2007, around 100,000 policies had been sold on a one month renewable basis, of which around 30% had not been renewed.

Target market and products offered. Three products, specifically targeted at individuals in LSM 2-6, were launched in the form of insurance “starter-packs”. The products have a monthly premium of R19.99 each and are not bundled (therefore clients do not have to purchase all three products). The initial product offering (it is possible that it will be expanded) includes the following products:

- Family funeral insurance (R5,000 cover for the main member and spouse, less for children and double the benefit in the case of accidental death).

- Family personal accident insurance (R5,000 cover for the main member and spouse, less for children)

- Cell phone insurance (only available if the cell phone was purchased at Pep; the phone is replaced with the same model, up to a value of R1,000).

Marketing and sales. The insurance policies, with similar packaging to cell phone “starter packs”, are simply placed on the shelves of all Pep stores. When the customer pays for the package, the cashier captures the policy number and a telephone number for the client. As the cashier is simply performing an administrative duty, he/she is not required to be a FAIS-registered agent. The Hollard call centre will phone the client within 36 hours to capture and verify all client information. During this interaction with the call centre, a financial needs analysis is not completed, but the client can request disclosure or explanations on certain aspects of the policy. The client is also able to phone the call centre on a call share number (at the cost of a local call). The cell centre/helpline is staffed by FAIS compliant personnel that are able to disclose product and process information upon request. A cool-off period of 30 days applies during which the client can still decide to cancel the policy and claim the first premium back.

The model is thus based on non-advice based selling. While this reduces costs (it would have been prohibitively costly to train and register all Pep staff members), market research has shown that customers value face to face interaction and would like a policy document to be mailed to them. Furthermore, it creates risk for Hollard as underwriter of the policies, should staff members provide unauthorised advice that may lead to misselling.

Premium Collection. Clients receive a policy card with their purchase and are required to pay their monthly premium at a Pep store. During the transaction, the card with the policy

number has to be displayed by the client and the cashier collects the money, while also recording the details of the client. If premiums are late, customers receive an SMS reminding them to pay their premium. The policy number is contained on the SMS and this can also be presented, should the client have lost the policy card. A 30-day grace period is provided.

Claims payment. Though premiums are currently payable exclusively at Pep Stores and in cash only, Hollard insurance will pay all valid claims on the funeral or personal accident insurance products to a nominated bank account or via a Mzansi money transfer redeemable at a post office. All claims on the cell phone insurance product are settled through Pep stores. When the claim has been assessed and deemed valid by Hollard Insurance, the claimant can collect a replacement phone from their nearest or most convenient Pep store. The cell phone insurance policy does not offer the option of a cash payout as the intention behind the insurance is to ensure that the claimant is in exactly the same position after the loss as before it. Initial indications have been that the R1,000 benefit may be too high compared to the average value of clients' phones and that there may be scope to reduce cover, leading to reduced premiums.

Assessment. Pep's infrastructural capacity allows it to collect premiums in cash at any Pep store. The model is characterised by low distribution costs, as the only real cost associated with the roll-out of the insurance product is the one-time addition of the three products to Pep's inventory of products. The model is structured in such a manner that disclosure is provided upon request, i.e. the client has to contact the call centre to clarify confusing aspects of the policy. Due to the fact that premiums are paid in cash, the onus of payment is placed on the client by expecting him/her to come in-store to pay the premium.

Appendix 11: “My funeral card” insurance underwritten by Hollard

In a recently launched initiative, Hollard Insurance underwrites a product launched by Shared Phone. The unique feature of this product is that it is sold by agents who use their cell phones to sign up clients (much in the same way that each individual client would sign up in the Discovery Life PrePaid Funeral Plan model). The main distinction between My Funeral Card and the Discovery Life product is that it is sold through an agent network rather than a retailer network. R38 per month affords the policy holder and their spouse R10,000 of cover each. R5,000 cover can be bought for R18/month.

FAIS is complied with in the same way as other “tick-box” models and, as the product was launched so recently, it is too early to gauge its success or possible regulatory issues arising.

Appendix 12: The Small Enterprise Foundation

Nature of the organisation. The Small Enterprise Foundation (SEF) is a non-profit microfinance institution based in Limpopo (one of South Africa's most rural and poor provinces). It is focused on the elimination of poverty and unemployment through the provision of micro-credit. This is achieved through two programmes – the Micro-credit Programme (MCP) and the Tshomisano Credit Programme (TCP). While the first targets micro loans at very small, but existing enterprises, the second programme targets women who live below half the poverty line and are not already involved in business, but who want to start their own enterprises. Loans are then provided to them based on the Grameen Bank loan methodology. Until recently, SEF also offered a funeral insurance product aimed at its credit client base (largely concentrated in the LSM 1-3 categories).

The need for insurance. Through focus groups with SEF clients, it was identified that the primary insurance need of SEF clients is for funeral insurance. It was discovered that although clients require emotional and non-financial support (such as assistance with food preparation) at the time of a family member's death, they also require a cash payout. Whereas burial societies do provide a small cash payout in the event of death, their main function is the provision of emotional and other support, while a funeral parlour policy provides for the funeral services. As households often need cash for the funeral itself or to sustain them after a breadwinner's death, it was thought that a formal funeral insurance policy would help address this need (Lampe, 2006). Such a product would however need to be affordable, and provided on flexible terms.

Linking with an insurer. SEF experienced many difficulties in finding the right insurer to offer products to low-income groups. After a lengthy process, SEF decided to partner with KGA Life, an assistance business insurer. The product, as negotiated with KGA, offers five levels of cover in two categories, one for the core family (member, spouse and all legal children) and another for a single individual (member and children). Cover ranges from R3,000 (at a premium of R20) to R10,000 at a premium of R45. Distribution is through SEF's loan officers and premium payments are made in cash at SEF's monthly centre meetings. Claims payment is either through the Post Bank or a money transfer redeemable at the Post Office. As SEF is a not-for-profit trust that wants to provide an added value product to its existing clients, it receives no surplus profits from the insurance scheme. Field agents also receive no commission for selling policies.

Dealing with FAIS. SEF merely "presents" the product to its clients rather than actively selling it (it will not be providing any advice). The funeral product is sold under the insurer's Financial Service Provider (FSP) license and, consequently, SEF did not need to register as a financial service provider. All loan officers involved in the sales process were registered as Category A agents of the FSP (and had to write tests to demonstrate their knowledge of the policy). Since SEF opted to partner with an existing insurer (with SEF acting as the administrator and selling policies through an agent force), few regulatory problems were experienced.

Limited up-take leading to discontinuation. Based on post-launch focus group sessions it was found that the product did not meet the needs of the targeted African family. Families wanted the insurers to continue covering their children when they passed the age of 21

which the product didn't offer. Also, clients wanted to cover all the members of the household, not only *family members*. An extension of this was that clients wanted cover for relatives, such as aunts or grandchildren, who weren't living in the household and who could be living in distant areas. The policies also do not cover people over the age of 59. Even though persons of this age do not comprise the majority of SEF's micro-insurance clientele, if they are part of a grouping then they are the most respected in the group and other members are far less likely to take the insurance if the 'leader' does not. Thus, though the product has not proved to be very price sensitive, take-up has been extremely poor due to *product characteristic constraints*. As a result, SEF discontinued its insurance offering at the end of 2006 until a more appropriate product design can be implemented.

Lessons from the SEF experience. While the provision of insurance through an MFI is laudable, international experience has demonstrated that MFIs often fail as insurance intermediaries due to the difficulty of integrating insurance processes with credit processes and management. The absence of advice also does not augur well for the fulfilment of client needs. Even though the products were only arrived at after consultation with SEF clients and negotiations with insurers, success was not achieved and the SEF board decided to discontinue insurance provision and rather focus on its core business, micro-credit. This illustrates the difficulties experienced in serving the low-income market and the importance of really understanding the market dynamics of the particular target group. SEF realised that more emphasis needs to be placed on the sale process. It was found that field agents were reluctant to market the product effectively and so the use of brokers or incentivisation of field agents will be pivotal for future product roll out. Clients also did not view the product as a replacement for burial societies, but rather as an additional safety net.

Appendix 13: Shoprite/HTG Life funeral policies

Checkers and Shoprite, which are part of Shoprite Holdings Limited, the largest supermarket retailer operating in Africa, offer funeral insurance products at in-store "money market" counters. These counters are intended to increase shopping convenience, facilitate customer loyalty and provide a range of transaction services, including payment of television licenses and municipal accounts with approximately 220 third parties represented at the counters. During the financial year of 2004/05, the number of transactions conducted at Money Market counters increased to 21m per month (Shoprite Holdings Limited, 2005a). In total, Shoprite Holdings has in excess of 700 money market outlets. Funeral policies underwritten by HTG Life have been sold at these counters since 1999.

R5,000 policies (for member and spouse, reducing for children) are provided at R25 per month (increasing to R42 if members are between 56 and 68 years of age – no members older than 68 are allowed). The policyholder receives a three month grace period (if payments were missed) during which the policy is put on hold (rather than cancelled) to catch up with late payments.

Premium collection. Shoprite is responsible for the marketing, selling and premium collection (in cash at the money market) associated with the policy, while HTG Life handles policy administration and claims management and payout. Shoprite earns commission on each policy sold.

Policy payouts. In the event of a claim, the beneficiary may choose to receive the policy payout either in the form of a discounted funeral service provided by a member of the HT group, or in cash (deposited into a bank account). Should a beneficiary not have a bank account, cash could be paid out at a funeral parlour, though this is not a preferred option of HTG. Thus the flexibility regarding cash premium payments may be undermined by the need for bank account claims payment. This problem is however not unique to Shoprite/HTG, but is prevalent across the micro-insurance market in South Africa

Passive sales model limits take-up. Despite its potential appeal as distribution channel, uptake has been limited. The main reason for the low take-up has been noted is that the product is not actively sold by Shoprite staff but rely on the customer approaching the counter and inquiring about the product. A need for greater cover has been identified and HTG Life is planning to introduce a second funeral policy with greater cover ($1574 for the main member and spouse) early in 2006. The Money Market management is also negotiating with other insurers for the introduction of a broader range of insurance products. This includes funeral insurance and some general insurance policies. The key objective in these negotiations is to identify affordable policies that will suit the needs of current customers.

Retailer network not utilised for claims payment. One of the primary benefits of the retailer distribution model is its ability to reach retail customers in geographical areas where insurance companies do not have physical reach. While Shoprite/HTG has utilised the retailer's distribution advantage for selling the policies and collecting the premiums, it has not utilised this on the claims payment aspects of the policy. The policyholder or beneficiaries have the option of receiving the claims payment in the form of funeral services

at a participating funeral parlour or as a cash payment into a bank account. However, if the policyholder or beneficiaries do not have a bank account, the cash amount is paid out at the nearest participating funeral parlour. Management indicated that this option is, where possible, discouraged as large cash amounts held at funeral parlours pose a security risk. It is possible that this payout option can lead to a number of administrative delays, thus not fulfilling the policyholder's need for speedy processing of claims and almost immediate access to finance for the funeral. This may limit the usefulness of this model as speed and ease of claims payment is a key feature to potential low-income clients.

The association with Shoprite allows the insurer to utilise the brand awareness and trust vested in the Shoprite brand. At the same time, however, potential problems arising on claims payment may pose a risk to the Shoprite brand.

Appendix 14: Ellerine Holdings credit life insurance

Ellerine Holdings (a large furniture retailer) offers *credit life insurance* to clients who buy furniture on credit in order to cover the value of the loan in the event of death (an almost standard feature where furniture or electronic goods are bought on credit). Cover is only provided over the duration of the repayment period and the benefit payable will be only the outstanding amount on the loan. In effect, no benefit will be paid out, but the beneficiary will be exempted from further repayments on the good purchased. In some instances, credit life insurance may be expanded to credit insurance[100] which includes credit life insurance, as well as a number of riders such as asset insurance and life insurance (e.g. funeral cover).

The JD Group and Ellerine Holdings Ltd are two examples of holding companies that utilise the above insurance model in their furniture stores. Both these companies own a number of furniture and household appliance stores targeted at markets across the whole LSM spectrum. As both companies offer consumer credit as an option to pay for purchased items, credit insurance forms an integral part of the package of services offered. Of these two examples, Ellerine Holdings was selected for a more in-depth discussion due to the interesting relationship with its insurance companies. While Ellerine Holdings owns all three its insurance companies[101], the JD Group utilises an external insurance company.

Distribution network. Ellerine Holdings owns a total of 1,220 stores, located across South Africa, which could all potentially sell insurance products[102]. Policies are sold in-store upon the credit purchase of a product and have the branding of the relevant Ellerine insurance company. Claims are lodged at the insurer and the financial payout, except for instances of funeral cover and personal accident insurance, is paid to the relevant store. All policy administration and claims management are handled by the relevant insurance company.

Basic features of insurance product. A typical credit life policy sold with the instalment purchase of furniture or other household goods at an Ellerine Holdings store was obtained for the purposes of this study. The policy contains four main types of insurance

- *Asset insurance* provides for the replacement or repair of the purchased item in the case of it being damaged, lost or stolen. Depending on the discretion of the insurer, the policyholder can also receive cash compensation.

- *Credit life insurance* provides for the full repayment of the outstanding balance of the loan if the policyholder dies, is injured and/or retrenched.

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[100] The second relevant definition is for specifically credit life insurance. It is defined as including “cover payable in the event of a consumer’s death, disability, terminal illness, unemployment, or other insurable risk that is likely to impair the consumer’s ability to earn an income or meet the obligations under a credit agreement”. Other contingencies (riders) not mentioned in the definition of credit life insurance but often covered in credit life policies include material damage to the product in question and loss of income due to reduced working hours (employer’s decision).

101 The fact that there are three insurance companies in the group is the result of mergers over the last five years. It is expected that the insurance components will eventually be reduced to one life insurer and one short-term insurer.

102 Not all currently sell insurance products as the recently acquired Wetherly’s only sell furniture on a cash basis.

- *Life insurance* provides a fixed payout in the case of accidental death and/or a defined funeral benefit for the policyholder (i.e. not for the family of the policyholder) (any outstanding debt is deducted from the value).

- *Health insurance* provides benefits if the purchaser discovers that he or she is HIV positive during the term of the policy, but only if he or she undergoes immediate treatment for HIV/AIDS. This cost of the treatment, which may include the provision of anti-retrovirals, is also covered by the health policy and paid for by the insurer.[103]

The four types of insurance contained in the policy overlap in a variety of ways. This overlap tends to limit the final liability of the insurer and, by implication, the policyholder's ultimate cover. Overlap, for example, occurs if the policyholder dies in an accident. In this scenario, the outstanding balance on the policyholder's account will be covered by funeral insurance (a form of life insurance) if it is less than the defined monetary benefit, while the beneficiaries of the policy will also be entitled to a pre-defined lump sum through personal accident insurance (also life insurance). If the outstanding debt, however, is greater than the defined funeral benefit, the excess of the debt (i.e. that part greater than the defined funeral benefit) will be covered by the credit life insurance. In most of the above-mentioned cases, the standard term applies that the policyholder must not have fallen behind with monthly instalments.

Enforcing the right to choose insurance provider. The National Credit Act of 2005 holds that, where credit life insurance is required, the client be granted the option to choose the insurer. Most lower-income South Africans, especially those that reside in townships, have difficulty obtaining household insurance due to the high risk profiles associated with these areas. If they are indeed able to obtain the insurance, premiums are high. Because of an inability to obtain credit insurance through the normal channels, the customer is then "forced" to buy the insurance from the retailer. Due to the opaque nature of the credit agreement and disclosure, many customers do not realise that they have the option of buying insurance from other providers. This creates a captive market, allowing the retailer's insurance company to charge higher premiums and add a number of riders to the insurance policy.

Awareness of insurance product. The "tick-of-the-box" method employed in the selling of the policy also creates a distinct possibility that many customers will not be aware of the fact that they actually own a policy covering a specific contingency. This finding has emerged from the Finscope Survey, were the vast minority of people indicating that they regularly make repayments at furniture retailer outlets were aware that they had insurance.

Opaque and complicated pricing structure. Market research has indicated that a product of about $550, when bought on credit, can amount to a total of $816, paid over 12 months.

[103] Payment is made directly from the insurer to the supplier of the medical service, not the client. In terms of the acts governing insurance contracts in SA law, a health policy cannot contemplate the ongoing payment of an unquantified sum to a medical service provider. This is the right only of medical schemes who are governed by separate legislation. The insurer in this case uses a technical loophole around this demarcation by offering the policy not as health product, but as a disability product, which does not attract the same restriction i.e. contracting HIV/AIDS is viewed as a disability.

Insurance levies (payable upfront and hence capitalised on the loan) amount to $142.70. Given the bundled nature of the product, it is difficult to asses the overall value of cover relative to the premium charged. However, as noted, the overlapping nature of cover means that the total cover for all the insurance elements is limited to the maximum value of the outstanding loan or the funeral benefit. The effective cost to cover ratio is not improved by the multiple riders included and questions can be raised about the value for lower-income customers. At $142.70 for the year, the insurance charge is almost 25% of the purchase value of the product (including value added tax). If for simplicity, the full amount is assumed to go towards the risk charge[104], this suggests that up to one in four clients is expected to claim on this policy. Industry information, however, suggests that claims are fewer than 2 per 100 policies sold in practice.

Cover ceases on repayment of credit: The repayment period for store credit is up to 36 months. At the end of the period, all the cover provided as part of the bundled product ceases. While this may be appropriate for the credit life component of cover, its appropriateness is questionable for the funeral, health and asset cover provided. The consumer does not have the option of extending these components of cover beyond the repayment period.

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[104] Given the low administrative burden of selling credit insurance policies bundled with credit purchases, the contribution of administrative costs to the premium is expected to be low. This assumption may, therefore, not be too far removed from reality.

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This document was adapted from:
Chamberlain, D., Bester, H., 2006. Guidelines for creating a facilitative regulatory environment for microinsurance – a cross-country review. Proposed analytical framework and methodology. Genesis Analytics research document prepared for the IAIS - CGAP Joint Working Group (JWG) On Microinsurance. (v7.2)

The Initiative is a partnership between:

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Federal Ministry for Economic Cooperation and Development

International Labour Office

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