

Report of the 8th A2ii – IAIS Consultation Call

Formalisation

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The A2ii consultation calls are organised in partnership with the IAIS to offer a platform to exchange experiences and lessons learnt in expanding access to insurance. **This call focused on formalisation.**

The call was hosted by Marike Brady (Executive Director, A2ii), and was supported by Conor Donaldson (IAIS Secretariat), with expert technical inputs by Michael Hafeman and Martina Wiedmaier-Pfister. Country experiences were shared by the insurance supervisory authorities from the CIMA region (West Africa), Ghana, Colombia and Brazil.

Formalisation: what is at stake and what should the game plan be?

Formalisation is a core topic for supervisors the world over seeking to facilitate an inclusive insurance market. Informality creates prudential risks, consumer protection risks, as well as the risk of regulatory arbitrage. Informality raises a series of regulatory considerations: how to apply proportionality in practice in order to create a regime based on which commercial insurers can reach down-market, mutual insurers can prosper and informal providers can formalise. It also confronts supervisors with the need to design supervisory systems and enforcement strategies that deal with providers and intermediaries often falling outside of their jurisdiction, stakeholders that might look very different from the typical commercial insurer that they supervise or intermediary type they usually deal with.

Informality can take on many shapes and sizes. The common faces of informality in inclusive insurance markets include:

- Service providers (MFIs, cooperatives, retailers) who run an in-house insurance scheme for clients or members
- Funeral homes who carry risk without an insurance license
- Master policyholders who avoid an agent license
- Government schemes without an insurance license in health, agricultural or disaster insurance
- Pilot projects that are unlicensed in health, livestock, or any other risk area

The IAIS Application Paper on Regulation and Supervision Supporting Inclusive Insurance Markets is clear about the need for formalisation: if an organisation provides insurance, it should be subject to licensing. The IAIS however recognises that its membership needs support in strengthening their understanding of key steps and challenges facing formalisation. What are the issues at stake with regards to formalisation and how should supervisors address the topic?

There are three key steps to formalisation:

- 1. Identify:** The first step is to obtain a clear picture of existing informal activities and who is involved in them. This includes entities underwriting insurance risks without a licence, as well as entities that are involved in the delivery chain without explicit licensing as insurance intermediaries. It is important to understand the form, ownership structure, management, scope of activities, and scale of the various types of entities in the market that are engaging in informal insurance activities. Imposing an initial registration requirement (without any substantial compliance burden) may aid in the identification process.
- 2. Set the goal posts:** The next step is to identify possible and preferred outcomes of the formalisation process. Do you want licensing of providers and/or transfer of risks to licensed entities at all costs? If so, should this be a regular or a special dispensation licence? Will such licensing be possible without changes in the current business models of the entities involved? If not, what changes would be required and are such changes realistically possible?

In defining the desired outcomes, consider implementation issues such as the number of entities to be reached, the industry structure, supervisory resources and available structures for enforcement. Also consider in what ways the desired outcome will promote consumer protection in practice.

- 3. Implement:** The final component is to take active steps to achieve acceptable outcomes. Consider specific actions needed to get from the current state to various outcomes and then develop clear processes and realistic timeframes to get there,

noting that formalisation will not happen overnight and that certain players or areas (for example, where particularly serious consumer protection concerns exist) may need to be prioritised. Consider who may be able to assist in these efforts, such as apex organisations, industry bodies or regulatory authorities with institutional oversight over entities that need to come under the insurance

regulatory framework. Equally important is to create contingency plans, noting that the most desirable scenario may not always turn out to be feasible. Lastly, it is important to define an appropriate transition process towards formalisation (for example, in the case where only nominal registration was required initially) and then to enforce compliance with such process.

The formalisation process followed in the Philippines provides an important case study:

Philippines case study

The first microinsurance regulations were instituted in 2006. Informal activity consisted largely of cooperatives self-insuring their members and MFIs self-insuring their credit clients. The initial framework dealt largely with the formation of microinsurance mutual benefit associations (MBAs) as a formalisation vehicle for MFI insurance provision, as well as microinsurance agents to facilitate distribution. Over time, it was however realised that a more holistic approach was called for and that such an approach, in turn, would require coordination with relevant authorities outside of the insurance field.

In 2010, following a microinsurance strategy and regulatory roadmap process, the Insurance Commission joined hands with the Central Bank, the Cooperative Development Authority and the Department of Finance-National Credit Council. Amongst the various actions taken, a joint memorandum circular was issued to prohibit informal insurance activities. The Central Bank also issued a circular to allow rural banks to act as insurance agents.

Informal players were provided with a number of formalisation options: they could partner with a licensed underwriter (that is, become an agent), they could form an insurance entity such as a microinsurance MBA. Commercial companies and cooperative insurance societies are also allowed as institutional forms. Or, they could have their members join an existing authorized cooperative insurance society or microinsurance MBA.

Important elements in the success of the strategic frameworks and formalization approach have been the definition of an appropriate transition process and the fact that formalisation was pursued as a joint effort among various authorities. More recently, dedicated capacity (in the form of a microinsurance department) was created within the Insurance Commission. Documented outcomes by 2013 include the licensing of 40 rural banks as microinsurance agents (25 of which are active), as well as of 20 MBAs serving more than 7.5 million members. Importantly, the process also saw greatly enhanced interest by the commercial insurance sector in the lower-income market, thereby increasing competition from formal players to put pressure on informal provision. However, a number of supervisory challenges remain, notably that the extent of informality remaining in the market is not known, because there the IC has evidence that still, some level of informal insurance is taking place. Currently, under the guidance of the DOF and IC, the authorities are dealing his issue again.

Regulatory and supervisory implications

It is clear from the experience shared by supervisors on the call that different countries and regions face different formalisation challenges:

In Latin America, as the experience shared by Colombia illustrates, the challenge relates largely to the prudential and consumer protection risks arising when in-kind funeral assistance services are carved out from the definition of insurance and therefore fall outside the jurisdiction of the insurance supervisor. The challenge is therefore not one of formalisation per se, but rather of effective coordination at government level, debate and engagement on the mandate and jurisdiction of insurance supervision, and how to create a level playing field between insurers and those allowed to operate outside of the regulated insurance regulatory sphere.

Elsewhere, most of the emphasis so far has been on creating a regulatory framework into which informal entities are able to formalise. A multi-pronged approach is called for that spans those who wish to obtain a license as insurer (in different forms), as well as those more suitable to become an intermediary. The first involves a transition path and a, sometimes different, licensing process if the license is dedicated to a specific sub-set of operations. The latter involves a training/capacity building component to support formalisation. Both approaches also include coordination with other relevant authorities. Building dedicated supervisory capacity to deal with the topic of microinsurance and formalisation was also highlighted.

The most prevalent supervisory challenges include:

→ *Identifying the extent of informality and knowing the nature of abuse among those that choose to remain “outside of the radar screen”.* For example: the CIMA insurance supervisor is developing a microinsurance regulatory framework and considering the treatment of new generation providers and agents such as MNOs. Although there is a common agreement on the fact that “whatever is informal is illegal”, there are reasons to believe that most insurance business is likely to happen informally at the low-income end

of the market, including through small community-based mutual entities. Knowing the nature and extent of this market and the actual consumer protection risks posed is therefore a key need that was identified. Once the final microinsurance framework is adopted, a suitable transition period will be allowed for all players to comply with the new regulations.

→ *Knowing how to respond to different kinds of informality, for example with regard to mutual/community-based schemes vis-à-vis for-profit providers.* Different types and sizes of entities have different modes of operation and may require a tailored response. Often, member-based entities do not even consider what they are doing to be insurance. When member-based entities are required to obtain underwriting from a commercial player, it is furthermore likely that challenges will arise. Ghana, for example, highlighted the challenges in getting insurers and member-based entities to “speak the same language”, as each is used to applying their own terms and conditions.

Another important consideration, raised by India, is that it may be necessary to learn from informal providers and channels: they are often close to their members or clients, use local resources and operate at local level, and manage to provide their services at low cost. Does this perhaps call for supervisors to also explore alternative models or devise a proportionate response to accommodate such players? To answer this question, it is imperative to understand the business models of informal providers and the nature and implications of the compliance burden associated with a formalisation process on such business models.

Swaziland raised the issue of “ownership” of the client relationship. For example, if informal providers of microinsurance transfer their book of clients to a licensed insurer and become agents of that insurer, what happens if they subsequently want to move the clients to another insurer? The “ownership” of clients is often a difficult issue. The policyholder has a contractual relationship with the insurer, not with the agent. Also, an agent represents an insurer, not the policyholder. So even though the

personal bond might be strong between an agent and a policyholder, it is very difficult to make a case that an agent has the right to move policyholders, especially as a block, to another insurer. This would probably be a breach of the agent's contract with the insurer, and such a provision might even survive the termination of the contract.

Designing appropriate enforcement strategy given available supervisory capacity and the extent and nature of informality in the market. Brazil raised an important question regarding how to incentivise formalisation and/or oblige informal entities to be formalised. A country may institute regulation for alternative distribution channels, simplified requirements for insurance plans, and other measures to promote an inclusive insurance market, but may then find that that is not enough to reach informal schemes and lead to a significant shift in the formality of the market. What should the enforcement response be and what are the capacity implications? Swaziland raised the question of whether a dedicated microinsurance unit is necessarily required. The answer will depend on the context, the court system of each jurisdiction, supervisory capacity realities and scale of informality in the specific market.

What can the A2ii and IAIS do to support supervisors in their formalization strategies?

Participants in the call agreed that formalisation remains a key topic on which further guidance is needed from the IAIS. In particular, the need was highlighted for case studies and cross-country synthesis of experiences to build a clear picture of informal activities in various regions, and approaches taken. Supervisors should then be helped to build this picture in their own jurisdiction, so that they can know the nature and extent of the formalisation challenge that they face, and implement appropriate solutions.

Another important question on which further deliberation and guidance is needed is how to judge the formalisation imperative. Informal insurance is more often than not filling the gap left by the formal sector in relation to servicing the insurance needs of

the lower income population. Where the pathway for formalisation is likely to eliminate some of the players in the informal insurance sector, should the regulators give consideration to providing them with exemptions and, if so, what if any issues would this raise for market development and consumer protection?

An equally important consideration relates to what is defined as insurance or not. The answer will help to set the boundaries for what is considered to be informal insurance, which would require formalisation. For example: would a funeral fund that does not guarantee a benefit with a specific monetary value, but instead promised services in kind, be considered as informal insurance? Some jurisdictions might consider this insurance, others might consider it insurance but require a monetary value be specified rather than providing services in kind, while still others might not consider it insurance at all – perhaps regulating it in another manner, such as through the regulation of funeral providers.

There is also a need for training on the formalisation process itself: the various supervisory considerations arising in practice and how immediate and longer-term priorities can be defined and implemented.

Specific guidance is also needed on how to deal with regulatory arbitrage, especially in circumstances where certain activities are by law carved out of the definition of insurance, thereby confronting supervisors with entities and activities that are not explicitly informal, yet provide insurance services without meeting the functional regulatory requirements for insurance provision. In some instances, it may be a matter of legal interpretation and supervisors need further guidance regarding how to respond.

Over the coming year, the A2ii will conduct a series of thematic studies for the IAIS on proportionate approaches to insurance regulation and supervision. This call has confirmed that the topic of formalisation warrants further investigation as part of this process.



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