CGAP WORKING GROUP ON MICROINSURANCE

Making insurance markets work for the poor:

microinsurance policy, regulation and supervision

Evidence from Five Country Case Studies

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This document presents the executive summary and guidelines based on five country case studies 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 have had on the development of these markets. This evidence was used to extract cross-country lessons 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 emphasised 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 emphasise the need for a comprehensive approach that is informed by, and tailored to, domestic conditions and adjusted continuously as the environment evolves.

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Authors:

- Hennie Bester
- Doubell Chamberlain
- Christine Hougaard

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- South Africa: Genesis Analytics (Hennie Bester, Doubell Chamberlain, Christine Hougaard, Timothy Hobden, Anja Smith)
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1. Background

This document contains the executive summary and emerging guidelines of the report titled *Making insurance markets work for the poor: microinsurance policy, regulation and supervision*. The full report is available on CD and also at www.finmark.org.za. It is intended to provide readers with a short overview of the content of the report and the emerging guidelines for the regulation and supervision of insurance markets.

The report presents an overview of the findings from 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 had 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.

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Please note that, although the IAIS was represented on the advisory committee of this project, neither the findings contained in the report nor the emerging guidelines have been officially endorsed by the IAIS. A separate document, based on the findings of the report, will be submitted to the IAIS structures for discussion and approval. Although the content of the report was discussed in various forums, the views expressed remain the full responsibility of the authors alone.

2. Executive summary

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

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

2.1. Salient features of microinsurance markets in the sample countries

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

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

Large proportion of the population falls into low-income categories: A large proportion of the population live on less than $2[4] a day. This ranges from 19% in Colombia to 96% in Uganda. The number of ultra-poor people, those living on less than $1 a day, is also significant. The low level of income has two immediate implications. Firstly, it suggests that microinsurance is not a peripheral topic but is the appropriate insurance category for a substantial proportion of the population. Secondly, it implies a limited disposable income for insurance products and a high opportunity cost of doing so.

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

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

Voluntary sales bundled with other products or services and/or through mutual/co-operative channels: Where there is voluntary take-up, it tends to be funeral insurance policies (South Africa and Colombia) or policies bundled with other products and services. The overwhelming majority of voluntary products are sold via client aggregators such as co-operatives/mutual associations, microfinance institution (MFI) networks, retailer networks (in the case of South Africa) or even utility companies (in the case of Colombia).

Microinsurance definitions vary but share low-risk features: The bulk of microinsurance products offered in the sample countries share features that help to limit the risk (prudential and market conduct) of these products. This includes limited benefits, short-term contracts,

[4] In 1993 dollars. Adjusted for purchasing power parity.

simplified products typically underwritten on a group basis and the coverage of limited risk events (typically high frequency, low impact).

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

2.2. Demand-side factors: understanding the insurance decision

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

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

2.3. Supply-side factors: making microinsurance markets

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

1. **Compulsion:** Compulsory insurance in the form of credit insurance on the back of loans is the single biggest category of microinsurance across the sample countries.
2. **Re-invention:** In the absence of formal insurance provision, or simply because they are unable to afford it, low-income communities develop informal risk pooling mechanisms to cope with risk events, thereby effectively re-inventing insurance.
3. **Derived demand:** This happens when the client does not set out to buy insurance, and may not even be aware of the existence of insurance products, but is induced to buy a product based on his or her demand for another product or service such as a funeral service.

4. **Passive aggregators:** Such models leverage existing client bases (e.g. retailers as aggregators) or reach out through low-cost passive sales strategies. Products need to be simplified to be sold through such channels.
5. **Individual agent-based outbound sales**: The traditional model where an individual agent sells insurance that is not attached to another product, typically face-to-face with the client, but it can also be done through out-bound call centres.

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

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

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

General features of the policy, regulatory and supervisory framework

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

Financial inclusion policy and regulation

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

Prudential regulation

- *Unnecessarily high regulatory barriers* undermine the entry and formalisation of potentially legitimate providers. As a strategy to compensate for limited supervisory capacity, prudential barriers are not successful as the supervisor does not have the capacity to enforce the regulations on all potential market participants. The result may often be to fuel the informal sector.
- *Tiering and graduation* have been used in the sample countries to facilitate entry, formalisation and growth while still maintaining prudential standards.

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

Product regulation

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

2.5. Impact of macro-economic conditions and infrastructure

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

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

3. Emerging guidelines for microinsurance policy, regulation and supervision

The following guidelines, for consideration by policymakers, regulators and supervisors looking to support the development of microinsurance in their jurisdictions, are based on the analysis of the experience of the sample countries. Before proceeding to the guidelines we outline the goal, purpose and principles such guidelines need to adhere to and also outline the general regulatory approach underlining the proposed guidelines.

3.1. Goal, purpose and objectives

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

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

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

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

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

- Facilitate both outreach and formalisation, ensuring a level playing field for big and small players where they seek to serve the same market;
- Promote products, providers and distribution channels that will trigger the favourable introduction of low-income clients to insurance and its benefits;
- Adopt risk-based regulation, tailoring regulation to the distinctive risks posed by microinsurance products and intermediation;
- Minimise the regulatory burden on underwriting and intermediation.

3.2. Guidelines relating to policy on microinsurance and financial inclusion

Guideline 1: Take active steps to develop a microinsurance market

Explanatory notes:

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

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

Guidance notes:

(1) Confer a market development mandate on regulators over and above their normal supervisory mandate. This enables regulators to initiate market development actions without falling foul of their statutory mandate. At the least regulators should be required to consider and minimize the negative impact of regulation on market development.

(2) Understand the existing as well as the potential market, i.e. both the served and unserved sections of the population.

(3) Consider both formal and informal providers. Informal products and providers usually indicate needs in the low-income market segment not being met by the formal market and reveal regulatory and other obstacles to formalising their operations.

(4) Place information, especially representative market surveys about the extent and characteristics of unserved market segments, within the public domain.

(5) Make a public commitment to the growth of microinsurance. Create general public awareness about the potential for and ways to secure microinsurance.

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

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

Explanatory notes:

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

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

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

Guidance notes:

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

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

3.3. Guidelines relating to prudential regulation

Guideline 3: Define a microinsurance product category

Explanatory notes:

Microinsurance products require small premiums to be affordable to low-income clients. Profitable microinsurance operations therefore depend on least cost underwriting and distribution[5].

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

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

The income level of the prospective policyholder is not considered a viable element of a microinsurance definition since the verification of individual or household income is too expensive and often of suspect integrity. The actual income levels of the policyholders will only become relevant if the policy premiums are subsidised by the state to a significant

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

extent. Under these circumstances governments will normally require more precise targeting of state support to the poorest sections of the community.

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

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

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

Guidance notes

(1) Determine the extent to which the current insurance regulatory burden inhibits the underwriting and/or distribution of insurance products that are appropriate for the low-income market segment. This includes the extent of informal insurance provision and obstacles to the formalisation of informal providers.
(2) If the regulatory burden inhibits the growth of microinsurance (and cannot be reduced across the board), define a microinsurance product category with systematically lower risk that will justify reduced prudential and market conduct regulation.
(3) Define the microinsurance product category as wide as possible (in terms of both risk events covered as well as maximum benefit levels) to enable maximum extension of insurance penetration and integration into the rest of the insurance market. Provide an easy mechanism to adjust benefit levels to keep track with inflation and market changes.

(4) Restrict the contract term of microinsurance policies, for example to twelve months. The actual term should be set in line with industry practices and client needs.
(5) Set requirements to ensure simplicity of terms and easy communication thereof in the languages used by low-income clients.

Guideline 4: Tailor regulation to the risk character of microinsurance

Explanatory notes:

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

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

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

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

Option 2, which usually requires more extensive regulatory intervention than Option 1, is to create a **second tier of insurance license** with entry and other regulatory requirements tailored to the provision of microinsurance (referred to as a microinsurance license). This option provides more scope than option 1 for regulatory intervention to promote microinsurance. Tailored capital, solvency and investment requirements can be stipulated to facilitate the entry of smaller institutions wishing to participate in this market. The regulator can prescribe risk management and underwriting systems that are less costly and within the capacity of smaller operators. Moreover, since life and non-life microinsurance business is often underwritten on the same short-term basis, and because single channel distribution reduces cost and promotes positive insurance discovery, some jurisdictions are moving towards the removal of the strict demarcation between life and non-life business in the microinsurance sphere. The same provider is then allowed to underwrite both life and non-life microinsurance policies.

Guidance notes:

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

Guideline 5: Allow microinsurance underwriting by multiple entities

Explanatory notes:

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

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

Some of the most successful microinsurance operations - run by large registered insurers – are those of secondary cooperatives, or insurers owned by primary cooperatives. They are able to leverage the networks and member-bases of their owner cooperatives for cost-effective distribution. In a similar manner member-based microfinance institutions utilise their networks and detailed client knowledge to develop and sell some of the most innovative microinsurance products around.

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

Guidance notes:

(1) Allow multiple legal forms to underwrite microinsurance. This must include not only share capital companies (stock corporations) or other legal forms appropriate for large commercial insurers, but also cooperatives and other mutual-type or member-based legal forms more suitable to smaller and community-based insurance operations.

(2) Ensure that institutions that underwrite the same products are subject to the same regulatory requirements (to ensure a level playing field conducive to a more competitive environment). This may require coordination with other government supervisors where the functional (insurance) supervision of the different legal forms falls under different supervisors.

(3) Ensure that all institutions underwriting microinsurance are subject to corporate governance, accounting and public disclosure standards that are adequate to ensure compliance with the applicable insurance regulations. Where the standards contained in the current regulation of the different legal forms are inadequate, the necessary standards can be included in insurance regulation. However note that, microinsurance programmes have unique characteristics which imply that they may not fit into traditional methods of accounting (IAIS, 2007). According to the IAIS (2007, par. 197): "This does not preclude the necessity of well considered methods for determining current and projected values of assets, liabilities, income and expense. Appropriate disclosures should be considered in the plan of operations. Regulators should consider the possibility of combining their regulatory approaches with other forms of general purpose accounting, especially those simplified methods permitted for small and medium size enterprises in their jurisdictions. Generally, the purpose of the accounts should be a conservative and prudent presentation with a primary focus on policyholder protection".

(4) Enable all microinsurance providers to access reinsurance.

Guideline 6: Provide a path for formalisation

Explanatory notes:

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

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

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

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

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

Guidance notes:

(1) Define an evolutionary path whereby informal insurers that have the potential to become registered entities for the delivery of microinsurance (refer Guideline 4) can formalise their operations. Such a regulatory framework for formalisation can include the following features:

- Allowing new institutional forms more appropriate for the informal provider's operations to underwrite insurance (see Guideline 5);
- Provide a tiered minimum capital and solvency structure, whereby insurers are also allowed to graduate to the minimum capital requirements over time at a prescribed rate. This will also help to avoid unintended regulatory drift;
- Mandatory underwriting of all or certain lines of business by larger insurers or re-insurers coupled with capacity building requirements pending the commencement of own underwriting operations.

(2) Take appropriate steps to both support and compel the formalisation process. This can include awareness campaigns, amnesties, capacity building and the catalysing or recognition of industry support organisations and market rating agencies.
(3) Coordinate the formalisation drive with other state agencies, for example law enforcement agencies and revenue authorities, whose support is required to ensure compliance with the formalisation regime.

3.4. Guidelines relating to market conduct regulation

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

Explanatory notes:

Low-cost distribution is essential to successful microinsurance development. However, cost is not the only criteria. Distribution channels should be able to actively sell policies to clients (see Guideline 8) and deliver policies as close as possible (geographically) to the normal locations of low-income clients. Experience also shows that microinsurance uptake increases with the level of trust that potential clients have in the distribution channel, be that a retailer with a trusted brand, a bank with which the person has an existing banking relationship, a public utility, or another institution such as a religious group or trade union of which the person is a member.

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

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

Guidance notes:

(1) Allow multiple categories of intermediaries. Particularly encourage models that are able to actively sell products (see Guideline 8) or at least are able to verbally disclose critical product information to the client.
(2) Avoid prescriptive regulation that restricts the design and nature of potential intermediaries beyond what is required for risk management purposes. Business models and technologies are changing at an increasing pace and regulatory systems need to be designed to accommodate changing models. Increasing monitoring and

reporting requirements can be utilised where the impact of models are not clear (see Guideline 9).

(3) The underwriting party must have a formal contractual relationship with the intermediary that outlines the respective obligations of the parties. This bestows joint responsibility on the insurer to ensure that its policies are sold without consumer abuse. An intermediary should however not be restricted to only one contractual relationship with a life or non-life insurer.

(4) There must be ease of consumer recourse. The underwriter/ intermediary must provide an acceptable consumer recourse option. At the very least the customer must be able to lodge a complaint and/or channel enquiries via the point of sale.

Guideline 8: Facilitate the active selling of microinsurance

Explanatory notes:

Microinsurance, similar to insurance in general, is sold rather than bought. Experience shows that voluntary microinsurance uptake is highest when it is actively sold, particularly with another product or service, such as credit, goods purchased on credit, future funeral services, mobile phones or other financial services such as banking services. In each of these cases, with the exception of compulsory insurance, the insurance value proposition has to be explained to the client and an active sale made in order to achieve take-up.

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

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

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

Guidance notes:

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

3.5. Guidelines relating to supervision and enforcement

Guideline 9: Monitor market developments and respond

Explanatory notes:

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

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

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

Guidance notes:

(1) Base the regulation and supervision strategy on a careful assessment of the areas of risk facing the consumer and the industry.
(2) Prioritise supervisory capacity according to this assessment – targeting high-risk areas and in line with the capacity of the supervisor.

(3) Complement this strategy with careful monitoring to ensure that supervisory forbearance or prioritisation can be adapted to changing circumstances and risk experience.

Guideline 10: Use market capacity to support supervision in low-risk areas

Explanatory notes:

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

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

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

Guidance notes:

(1) Where feasible according to the assessment of the risks posed by various spheres of underwriting and market conduct (guideline (9)(1)), delegate aspects of supervision of certain players (for example intermediaries) to certain other market players (for example insurers).

(2) Clearly delineate roles and responsibilities and ensure that delegated supervision is part of a coherent supervisory strategy rather than applied in an ad hoc manner.

(3) Ensure that the strategy followed limits the increase in regulatory burden for those entities entrusted with delegated supervision and that the strategy indeed decreases supervisory costs while remaining effective in communicating breaches to the supervisor.

(4) Monitor the situation and back it up with an effective consumer recourse mechanism (refer to guideline 7) to ensure that a delegated supervision strategy does not put the consumer at risk.

For more information please contact the project coordinator

Doubell Chamberlain
The Centre for Financial Regulation and Inclusion
41 7th Avenue
Linden
Johannesburg
2195

Tel +27 11 888 9548
Email doubell@cenfri.org