Informal insurance: a regulator's perspective

March 2009

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micro insurance network

This document is focus note 10 in a series of 12 produced as part of a five country study on the role of policy, regulation and supervision in making microinsurance work for the poor. See page 7 for further details.

1 Introduction

Access to insurance may be an important strategy for reducing poverty. Financial markets, and particularly insurance services, can help poor people manage critical risks such as a death in the family, illness or loss of income or property. Despite the growing importance and expansion of microinsurance services geared to low-income people, microinsurance penetration remains limited, leaving the vast majority of poor people without adequate protection.

Evidence from a range of countries shows that much of microinsurance is provided in an informal and unregulated way. Informal markets can play an important role in servicing people ignored by the formal sector, but they also pose risks for consumers and can undermine the development of formal markets if they are not managed in the right way. How can regulators with limited capacity deal with informal markets in a manner that ensures consumers are

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protected and market development is facilitated?

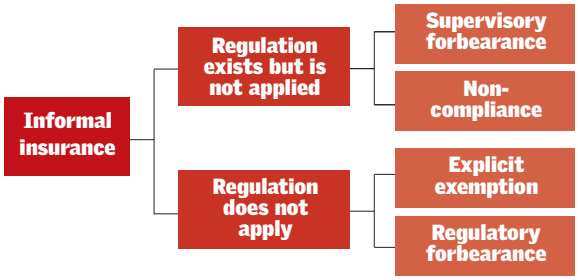
This focus note will explore these questions by considering the experience of five countries. It draws on the findings of a study by the IAIS/MIN Joint Working Group on Microinsurance[1] on the development of microinsurance markets in Colombia, India, the Philippines, South Africa and Uganda.

2 What is informal insurance?

"Informal"insurance can take many forms that require different regulatory responses, and defining it may provide insights into why informal markets exist. The World Bank defines formal financial services as those provided by financial service providers registered with formal regulatory bodies with the purpose of providing financial services.

This suggests two reasons for informality, as illustrated in the diagram below.

Regulation exists but is not applied. An



entity may be registered with a regulatory body but continue to operate informally if regulation is not enforced. This may be because it is:

- *Nominally regulated but not supervised in practice*, either because of a lack of supervisory capacity or because the supervisor regards its activities as very low-risk. The term "supervisory forbearance" has been used to describe such cases. Examples include the cooperatives, pre-need companies and health management organisations of the Philippines, which are registered respectively with the Cooperative Development Authority, the Securities and Exchange Commission and the Department of Health, but are not supervised for insurance purposes.
- *Non-compliant*, that is, operates in contravention of the law by not registering institutionally or for the purposes of providing insurance. Funeral parlours that offer self-insurance in South Africa are an example of this.

Regulation does not apply. Entities may also operate informally where there is no regulatory regime or regulation does not apply to a particular entity or product. This may happen because of:

- *An explicit policy decision by the insurance regulator.* After considering the risks, a regulator may decide that products of a certain type, such as those providing only non-guaranteed benefits or benefits in kind, or products provided by an organisation of a certain kind, may fall outside the definition of "insurance" and are exempt from insurance regulation. This is the case with informal risk-pooling in the Philippines and South Africa, as well as cover provided by funeral parlours in Colombia.

  Some entities, such as certain member-owned organisations, may also be exempted from registration because of their character and risk profile, or to accommodate limited regulatory capacity. Such"regulatory forbearance" applies to the market conduct regulation of burial societies in South Africa. They are, in effect, exempted from registration as intermediaries because they are classified as member-owned "group policy-holders".
- *Explicit exemption by other organs of government.* Certain entities or products may also be excluded from insurance regulation because of policy decisions by regulatory bodies other than the insurance regulator. The cooperatives regulator may, for example, allow cooperatives to offer insurance outside the insurance regulatory framework. This can cause complications, as a consistent approach to regulating insurance risks requires the alignment of policy objectives across different arms of government.
- *By "accident" rather than by design.* Sometimes, a regulator does not regulate a certain sector for historical reasons, or has yet to develop a framework. This is the case with health insurance in Uganda, which operates in a grey area in terms of

1 Bester, Chamberlain et al, 2008. Making insurance markets work for the poor: microinsurance policy, regulation and supervision. Report prepared for the IAIS/MIN Joint Working Group on Microinsurance. Available at: www.cenfri.org

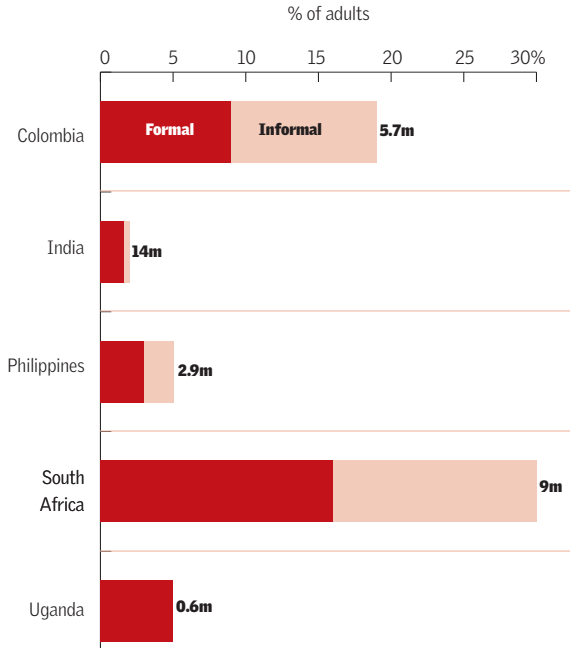
the Insurance Act.

The above analysis shows that the informal market is not necessarily illegal – informal activities may simply be unregulated. However, whether or not it is technically illegal, informality is likely to pose challenges for both the market and regulators.

3 Market experience

Informal markets are significant. In all the countries surveyed, except Uganda, it is estimated that the informal sector accounts for a sizable proportion of the total microinsurance market. This is shown in Figure 1.

Figure 1: Formal vs informal microinsurance uptake



(% of adults) across the five study countries.

Informal insurance accounts for 20% of the microinsurance market in India, 41% in the Philippines, 52% in Colombia and 46% in South Africa.

A variety of informal entities. Informal mechanisms take various forms in the countries that were studied, ranging from member-based funeral societies to formal, for-profit companies not registered for the provision of insurance.

- In *Colombia* the informal market largely consists of funeral insurance provided by funeral parlours that have obtained exemption from insurance regulation. This allows them to provide funeral service benefits in kind without having to register or comply with insurance regulation. Industry sources estimate that the informal market may comprise three million clients, or about 10% of adults.
- In *South Africa* informal insurance is provided by self-underwriting funeral parlours that are not authorised as insurers[2], but also, on a much larger scale, through informal risk-pooling burial societies. It is estimated that there are up to 100 000 burial societies providing funeral cover to more than four million people.
- In *India*, the informal sector comprises NGOs or cooperatives that provide health insurance without being registered for insurance purposes, the best known being the Yeshavini Trust, with 1.5-million clients. As they are usually facilitated or subsidised by the government or other donors, these are subject to some form of official oversight. But they are not supervised for insurance purposes.
- In the *Philippines* "in-house" insurance is very common in the cooperative sector –half of the country's 22 000 cooperatives are thought to provide some form of insurance to members without being licensed by the Insurance Commission. The importance of member-based entities with informal beginnings is illustrated by the evolution of informal insurance schemes into regulated microinsurance mutual benefit associations (MI-MBAs). Clients trust MI-MBAs, making it easier for them to facilitate insurance uptake than for commercial insurers.
- In *Uganda*, focus groups noted the existence of informal risk-pooling groups, but these are not reflected in the available data. This may highlight the limitations of the data rather than the absence of risk-pooling activities. However, the apparently low level of informal insurance may also indicate that because of Uganda's extremely low income levels, risk-pooling is largely ad hoc rather than provided by structured societies. Nevertheless, there is significant demand for informal health insurance, which is not explicitly included in Ugandan law as a category of insurance. The regulator considers it to be covered by

2 In contrast with Colombia, these activities are not covered by an exemption from insurance legislation and, therefore, contravene insurance laws.

the existing regulatory framework, but the fact that the legislation is silent on the issue has created a legal gap for the development of an unregulated health insurance market.

Filling the gap left by the formal market. Informal markets typically develop in the absence of formal providers to "fill the gap" for those whom the formal sector does not reach. In the absence of informal schemes, other institutions may not want or be able to serve this market, leaving many people without risk protection.

The informal may graduate to formality. Some informal schemes may gradually become formalised over time; others may remain completely informal. One example of gradual formalisation is South Africa's Great North Burial Society, which over 50 years developed from an informal burial society to a network of societies, ultimately becoming a registered friendly society. Some funeral parlours have also regularised their informal insurance business and registered their own insurers.

4 Observed regulatory responses

Concerns over an uneven playing field and lack of protection. High levels of informality are a concern for regulatory authorities and a frequent gripe of regulated industries arguing for level playing fields.

Limited information and capacity makes it difficult to clamp down. Despite these concerns, little action has been taken because such markets are mostly beyond the reach of regulators –and sometimes even beyond their regulatory remit. In some cases, regulators may tolerate informality, as it is seen as low-risk and as providing social benefits. In most cases, however, the regulatory approach is based on very limited information about the extent and operation of these markets.

A path to formalisation does not exist. While some regulatory approaches would like to clamp down on informal markets, these rarely offer a path for the formalisation of informal entities.Country approaches differ. Given the prominence of the informal markets in the sample countries, how have regulatory authorities approached them and what were the results? The five countries pursue formalisation in different ways and accord it a different priority:

- In *Colombia*, informal insurance provision through funeral parlours may have supported the development of the market. These entities account for half the microinsurance market and have played an important role in familiarising low-income clients with insurance. But as they are not subject to any form of financial regulation, there is a danger that consumers can be abused. While industry has often raised this in discussions with the regulator, no strategy has yet been developed to address the problem.
- Like Colombia, *India* has no explicit strategy to encourage formalisation. However, the informal market plays a relatively limited role. Where informal providers do exist –notably community health insurance schemes– the approach of the regulatory authority is one of benign neglect. Although it is not official policy, this approach is apparently based on the importance of such schemes to poor people and the low risk the regulator believes they pose. In addition, the microinsurance regulatory regime does not offer pathways for formalisation. However, it may incentivise some informal entities to register as microinsurance agents for distribution purposes.
- In the *Philippines* a regulatory space has been specifically created for microinsurance provision. The regime has its limitations, but it does facilitate formalisation. In the wake of the microinsurance circular of 2006, which carved out a space for dedicated microinsurance mutual benefit associations (MI-MBAs), six microinsurance MBAs were registered as of 2007 and more are being prepared for registration. A provision allows MBAs that cannot meet the minimum capital requirements to register and grow their capital over time – a useful device in formalising insurance operations. In addition, a shared resource centre, RIMANSI, has been created to bolster the compliance capacity of MBAs by providing actuarial and back-office support. This approach to formalisation has, however, not been comprehensive, as large-scale informal activity persists in the cooperatives sector.
- As in Colombia, informal funeral insurance in *South Africa* may have supported the develop-

ment of the microinsurance market. However, the potential risks posed by the size of the market and the threat of unfair competition to formal players required a regulatory response. A new regulatory framework has been proposed that will exempt burial societies from regulation if they are small and benefits are not guaranteed. The framework also proposes to reintroduce member-owned insurers to promote the formalisation of these societies. Funeral parlours will be required to formalise their insurance business with government support. The approach will combine lower barriers to formalisation, in line with risk, and better enforcement.

- While *Uganda*'s regulator has identified unregulated health insurance as a problem, no strategies have been developed to tackle it.

5 Implications for regulation

The country studies raise a number of issues for consideration in designing a regulatory response to informality.

Unnecessary regulatory barriers undermine formalisation and entry. Regulatory barriers may be the result of general conservatism, unintentional regulatory drift or deliberate regulatory strategies to address specific concerns of the regulator. For example, due to limited capacity, regulators and supervisors may be concerned about their ability to effectively supervise the sector and about the potential risk of insufficient supervision. Such supervisors may take a conservative approach and explicitly restrict entry through artificially high capital requirements. In isolation, however, limiting entry does not necessarily stop informal insurance activities for the very same reason that motivated this approach: the supervisor does not have the capacity to monitor and control these informal activities. Increasing entry barriers to the formal sector where the supervisor has limited capacity may, therefore, simply result in a larger informal sector, rather than a more limited insurance sector.

Unnecessary restrictions on institutional types may exclude legitimate providers and encourage informality. Some regulators limit underwriting and intermediation to particular, 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 "pick winners" by deciding which entities are better placed to serve the market. Institutional restrictions of this type do not always add value, as they are not based on clear risk considerations and may perpetuate informality. By raising barriers to the formal sector, regulators may unintentionally provide incentives for informality, particularly if theylack the capacity to police the barriers.

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

Tiering and graduation support formalisation. Tiering (lower capital requirements for entities providing microinsurance) and graduation (allowing entities to improve their capacity in line with their business activities) over time can facilitate entry while maintaining prudential standards. Such mechanisms support formalisation and the development of microinsurance-friendly providers. Tiering should, however, be tailored to the risk profile of the products provided so that consumers are not exposed to undue risk.

Regulatory uncertainty may undermine formalisation. Regulatory uncertainty discourages the entry of legitimate players into the market, because of the risk that the regulation may change or that new regulations may be introduced to close

down a specific model or space. If they are not monitored, models that operate in "grey" regulatory areas may pose a reputational risk for legitimate players. The Ugandan experience highlights the effects of regulatory certainty and uncertainty. After decades without any insurance regulation an insurance law was passed, and the resulting regulatory certainty encouraged a number of foreign insurers to enter the market. However, the new regulatory dispensation suffered from critical gaps and created uncertainty in some areas, for example on the exact treatment of health insurance. This discouraged a number of potential providers of health insurance from entering the market while leaving room for other models to operate unregulated.

Sound corporate governance allows the regulator to leverage non-traditional institutional types, facilitating formalisation. Weak governance in a particular category of institution means that a more intense regulatory effort is required to ensure compliance. However, excluding such institutional types may impede development. In cases where the regulator has introduced measures to improve governance structures rather than excluding such institutions, a whole new category of entities emerged to support market development. This is particularly relevant for member-based entities such as financial cooperatives.

Exemptions need to be monitored. Supervisory risk is the risk that, because of limited capacity, the supervisor cannot adequately police particular components of the market. All supervisors face capacity constraints, and these are particularly acute in developing countries. One way to deal with such constraints is to exclude, explicitly or implicitly, certain components from supervision. While prioritising high-risk activities is legitimate and, in some cases, the only possible response, it requires careful monitoring. An insurer or insurance product exempted because of low technical or underwriting risk may turn out to have a high risk for the system because it is not subject to suitable supervision. Such risk is exacerbated where legal entities have weak governance structures which make it difficult for the supervisor to rely on the information the entity provides and requiring additional monitoring capacity. Where exemptions are given, the supervisor should carefully monitor developments and react appropriately if the risk profile changes.

Support will be required. Supervisors may have to engage more actively with the informal sector, helping informal entities along the road to formalisation and working with other government agencies with the same responsibility. This may include extending amnesties or grace periods; capacity-building support, including the training of owners and managers; initiating consolidation activities; and partnering informal operators with formal underwriters.

Different entities require different responses. As demonstrated above, the definition of informality includes a variety of entities and reasons for informality, which require very different regulatory responses. In designing approaches to regulation, regulators should take care to understand all components of the informal market. This will make it possible to tailor the level of regulatory effort to the nature of the risk.

Enforcement coalitions to enhance capacity. Where space for formalisation has been created but players remain non-compliant, effective enforcement is important. A facilitative framework will not promote formalisation on its own –it must be backed up by an enforcement effort which makes it costly not to comply. Where supervisory capacity is limited or illegal intermediation of microinsurance products is widespread, effective enforcement can be achieved through inter-departmental cooperation, for example between the insurance and tax supervisory authorities, or, in the case of health insurance, with the ministry of health.

Market mechanisms may support formalisation. Market-based organisations such as microfinance rating agencies, which tend to reduce the ratings of microfinance institutions with self-insured insurance portfolios, and dedicated microinsurance support institutions can play an important role in formalising informal insurance operations. The rating penalty imposed on self-insurance by MFIs in India, for example, has been a key catalyst in regularising the provision of insurance through these entities. ■

The focus note series

Focus note 1: What is microinsurance and why does it matter? The rational for microinsurance from a regulator's perspective.
Focus note 2: The role of policy, regulation and supervision in making insurance markets work for the poor: Executive summary and emerging guidelines;
Focus note 3: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of Colombia;
Focus note 4: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of India;
Focus note 5: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of the Philippines;
Focus note 6: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of South Africa;
Focus note 7: The role of policy, regulation and supervision in making insurance markets work for the poor: The experience of Uganda;
Focus note 8: Risk it or insure it? Understanding the microinsurance purchase decision;
Focus note 9: Ensuring mutual benefit: The role and regulation of member-owned insurers;
Focus note 10: Informal insurance: a regulator's perspective;
Focus note 11: The impact of policy, regulation and supervision on the development of microinsurance markets; and
Focus note 12: Making a market for microinsurance: the success and failure of different channels of delivery.

About this document

To support the development of microinsurance markets, a project was launched under the auspices of the IAIS-MIN JWGMI[I] aimed at mapping the experience of five developing countries – Colombia, India, the Philippines, South Africa and Uganda – where microinsurance markets have evolved in varying degrees.

The objective was to assess how much regulation has affected the evolution of these markets and gain insights which can guide policy-makers, regulators and supervisors looking to support the development of microinsurance in their jurisdiction.

To disseminate the findings of this project, a number of focus notes have been written to highlight themes that emerged from it. This document is the tenth focus note in a series of 12 – six thematic focus notes and six notes summarising each country study.

The project was majority-funded by the Canadian IDRC[II] (www.idrc.ca) and the Bill and Melinda Gates Foundation (www.gatesfoundation.org), with funding and technical support from the South African-based FinMark Trust[III] (www.finmarktrust.org.za) and the German GTZ[IV] (www.gtz.de) and BMZ[V] (www.bmz.de). FinMark Trust was contracted to oversee the project on behalf of the funders. With representatives of the IAIS, the ILO, the Microinsurance Centre and the International Cooperative and Mutual Insurance Federation (ICMIF), the funders are also represented on an advisory committee overseeing the study.

I International Association of Insurance Supervisors (IAIS) and Microinsurance Network (MIN) Joint Working Group on Microinsurance
II International Development Research Centre
III Funded by the UK Department for International Development (DFID).
IV Deutsche Gesellschaft für Technische Zusammenarbeit GmbH.
V Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung - Federal Ministry of Economic Cooperation and Development

These focus notes and other material related to the project can be downloaded at www.cenfri.org.
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