What is microinsurance and why does it matter?

The rationale for microinsurance from a regulator's perspective • March 2009

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micro insurance network

This document is focus note 1 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 5 for further details.

1 Introduction

This focus note explores the concept of microinsurance and why it deserves support as a way of improving the well-being of low-income households.

Poor people face many risks that are beyond their control. They are often unable to cope with the financial implications of the death of a family member, illness or loss of income or property, and this perpetuates poverty and undermines asset formation. High-income markets use insurance as one way of managing such risks. Is it possible to design and deliver insurance products that will do the same for low-income households?

This note draws on the findings of a study by the IAIS/Microinsurance Network (MIN) Joint Working Group on Microinsurance[1] on the development of microinsurance markets in Colombia, India, the Philippines, South Africa and Uganda. The project

1 Bester, Chamberlain et al, 2008. Making insurance markets work for the poor: microinsurance policy, regulation and supervision. Report prepared for the IAIS/CGAP Joint Working Group on Microinsurance. Available at: www.cenfri.org. Note that the Microinsurance Network was previously known as the CGAP Working Group on Microinsurance

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was initiated with a view to supporting the development of microinsurance internationally by examining its role and regulation in these five countries. The ultimate aim is to extend the coverage of microinsurance.

2 What is microinsurance?

Defining microinsurance: The IAIS defines microinsurance (2007[2]) as "insurance that is accessed by [or accessible to[3]] the low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which should include the Insurance Core Principles). Importantly, this means that the risk insured under a microinsurance policy is managed based on insurance principles and funded by premiums". Microinsurance, therefore, excludes social welfare and emergency assistance by governments, "as this is not funded by premiums relating to the risk, and benefits are not paid out of a pool of funds that is managed based on insurance and risk principles" The definition is based on three concepts: "insurance", "accessible to/accessed by" and "low-income population".

Insurance: Microinsurance forms part of the broader insurance market, but is distinguished by its focus on the low-income market, which often needs specific distribution methods and products. Insurance generally denotes a contract whereby an insurer, in return for a premium, undertakes to provide specified benefits[4]. Insurance is distinguished from, for example, social welfare in that it is funded by premiums relating to the risk, and benefits are paid out of a pool of funds managed according to insurance and risk principles[5]. With an insurance product, risk is transferred from the policyholder to the insurer, who guarantees the insurance benefit if premiums are paid. Benefits may include one or more sums of money that may be fixed or may indemnify a specific expense or loss, services or other benefits, including an annuity. Benefits may also be provided in kind, for example by replacing a product or providing a service.

Accessible to: Microinsurance products should be accessible to low-income people. FinMark Trust defines "financial inclusion" as meaning a system in which consumers, particularly low-income consumers, have access to and can sustainably use financial services appropriate to their needs.

Factors that restrict access (*access factors*) include affordability, physical proximity, regulation and eligibility requirements imposed by the insurer.

In addition, there may be *usage factors* that discourage people from taking up the product even if they have access, including the availability of informal alternatives, fear of officialdom and the paperwork required by insurers, and distrust of the formal sector.

Both access and usage factors have been shown as important in developing a financial market.

Financial inclusion is also defined in terms of *appropriate products*. Products for the poor must have value for them and be useable by them. In the case of microinsurance, this means paying attention not only to sales but to claims, as this is where the value of the product is delivered.

Low-income population: The study does not propose an income cut-off for microinsurance clients; indeed, it suggests that overly strict income limits may be inappropriate. The target market should be carefully defined in the context of the country and other priorities.

It is important to draw a distinction between *relative and absolute poverty*. Microinsurance is not necessarily restricted to those who fall below the national poverty line. Poverty lines are designed to highlight society's most vulnerable members as potential targets for state assistance, but many other low-income households above the national poverty line may earn very little, may be vulnerable and may not be served by the formal financial sector. In Uganda, 96% of the population earn less than $2 a day and, therefore, clearly qualify as "low-income". Yet social security cannot cater for a such a large part of the population, and the national poverty line may be set at a much lower level. In South Africa low-income households for financial inclusion purposes include families that earn between $5 and $10

2 International Association of Insurance Supervisors (IAIS), 2007. Issues in regulation and supervision of microinsurance. Available at: www.iaisweb.org
3 Authors' own insertion.
4 Note that, sometimes, these benefits need not be a payout, but can take the form of a defence made on your behalf by the insurer.
5 Whereas social security is directly funded from government's annual budget.

a day, in recognition of the fact that they are still vulnerable and inadequately served by the financial sector.

The very poorest may be *beyond the reach of insurance products* that require the payment of premiums. They must remain the responsibility of the state social security system.

Strict income caps for microinsurance are generally required only when *subsidies* are provided and the government wants to restrict them to a particular social group. If no subsidies are provided, the target market should not be defined too restrictively. Insurance products have low penetration even at the higher end of the market. Given that most people in developing countries have low incomes, any extension beyond this small base is likely to require low value insurance products with small premiums.

Do we need a definition of microinsurance? While a specific income definition may not be needed, it may still be useful to define microinsurance in the country context. This is a new field for market players and regulators, and providing a definition would help them to work together in building the market. A definition may be useful in limiting microinsurance to lower-risk products that would allow for an appropriate regulatory response. It would also promote consumer education, protection and recourse, which will be important for this market segment. A further advantage is that a definition would support the coordination of different levels of government in developing the market, as well as reassure potential industry players in cases where regulatory frameworks may not yet exist.

3 What does this mean in practice?

Regulatory definitions: Any definition based on clients' income levels would be difficult and costly to implement. As a result, regulators mostly define microinsurance by setting benefit or premium limits, ensuring that they mostly target the poor. This also allows regulators to limit the risk underwritten, which is particularly important in allowing smaller microinsurers to enter the market.

Other criteria used in regulatory definitions, almost always in combination with a benefit cap, typically include:

- product categories that reflect the needs of the poor, for example funeral insurance or insurance on motorcycles or cell phones;
- distribution channels, especially channels accessible to the poor;
- simplicity of terms, conditions and processes; and
- certain contract stipulations, such as restrictions on exclusions that may be difficult for clients to understand, or clauses allowing clients to catch up on premiums they may occasionally miss without the policy lapsing.

Market definitions: There is some similarity between the microinsurance products, even informal products, researched in the five sample countries. There is also some correlation with the regulatory criteria mentioned above. Typical features of these products were:

- *small benefits and premiums* to suit the needs and resources of the market;
- *simplicity*, so that the products are easy for clients to understand and for sales representatives to sell; and
- *short-term contracts.* Given the low premiums, microinsurance policies cannot be individually underwritten in the same way as long-term life policies. The risks are assessed on a group basis rather than in relation to the individual client. Because there is no individual risk assessment, policies are written as short-term renewable contracts, with premiums priced according to the profile of a group and adjusted periodically based on the experience of the group.

4 Why does microinsurance matter?

Why does microinsurance matter, and what policy priority should be given to it?

Potential to improve socio-economic well-being. Microinsurance can improve the well-being of poor people by enabling them to manage their material risks and gain access to vital services, such as funeral and health services, based on the monetary security insurance cover provides. To deliver value, low-income insurance products should be affordable and appropriate to the needs of the poor, who must be able to claim on the policies. If low-

income clients find it difficult or impossible to make legitimate claims on their policies, they will derive no value from them and remain vulnerable.

Microinsurance is relevant to a large part of the population. Insurance markets in developing countries are generally small and much of the unserved market is poor. A large proportion of the population in the sample countries – ranging from 19% in Colombia to 96% in Uganda – lives on less than $2[6] a day. This suggests that microinsurance affects the bulk of the potential market, and that the market can only be developed through it. It should, therefore, be a priority for the industry and governments (see Table 1).

Development can support market stability. It has been suggested that market development and market stability are conflicting policy goals. In fact, they should complement each other. In developing countries, the insurance sector is often very small and depends on a few large commercial policies and a retail book which serves a small group – often less than 5% of the population. Given the size of their markets, insurers lack critical mass and typically have to place most of their risk with reinsurers. The result is a rather unstable environment in which relatively small events can have a major impact on the insurance portfolio. Expanding the insurance portfolio could enhance the sector's stability.

It is already happening. Registered and unregistered providers are already delivering various kinds of microinsurance. Regulation, therefore, needs to keep track of this development and ensure that space is created for the market. Three elements that require consideration are: informal provision, compulsory formal products and government support.

Informal provision and intermediation: Case studies show that much microinsurance in developing countries may be informal – that is, provided by entities which are not registered as insurers with the regulator, or intermediated through informal entities. They may include small funeral societies as well as formal, for-profit funeral parlors which are not registered as insurance providers. Not all informal activities can or should be formalised. Often, they are informal because the regulator does not have the capacity to control them, and introducing more regulation will not change this. But these markets cannot be ignored. To develop them over the longer term, the regulatory framework should be designed to facilitate formalisation.

Compulsory formal products: The largest current form of microinsurance is compulsory credit life, which exists in most countries. The credit-based distribution channel has great potential to expand the microinsurance market, but where uptake is compulsory, there are concerns about the value and protection consumers receive. From a regulatory point of view, the key requirement is transforming this channel into one that delivers good value to clients.

Government support: Formal insurers are increasingly interested in exploring voluntary products in the low-income market and many have launched pilot projects. Governments can lend support by removing potential regulatory obstacles, helping develop the infrastructure needed for microinsurance and providing appropriate consumer protection.

	Colombia	India	Philippines	South Africa	Uganda
Population	46-million	1.1-billion	89-million	47-million	29-million
<$1/day	8%	40% rural; 20% urban	14%	23%	82%
<$2/day	19%	88% rural; 61% urban	44%	36%	96%

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

Source: World Population Datasheet, 2007; World Bank World Development Indicators, 2007[7]; country studies

6 Adjusted for purchasing power parity.
7 World Bank, 2007. World Development Indicators. Poverty statistics and other data extracted from: http://iresearch.worldbank.org/PovcalNet/jsp/CChoiceControl.jsp?WDI_Year=2007 (accessed March 2008)

5 What does this mean for regulation?

What are the implications for policy, regulation and supervision?

Policy priority: Microinsurance can improve the well-being of the poor and should be accepted as a policy priority. It can help poor people manage important risks and facilitate the delivery of vital services. Regulation that unnecessarily impedes the delivery of microinsurance undermines the well-being of the poor. One example of this is regulation of market conduct that is so onerous that it prices providers out of the low-income market. Protecting the poor is a laudable aim – but leaving them without cover to manage their own risk is not protection.

Development cannot be stopped: The fact that large informal microinsurance markets exist reflects the capacity constraints of the supervisory authorities. In the past, regulators tried to limit the number of new entrants to the sector – for example, by setting artificially high capital requirements – because they feared they would not be able to manage the growth in activity. But access restrictions alone cannot put an end to informal insurance, for the very reason that the supervisory authorities lack the capacity to control it. It will become increasingly difficult for policy-makers to justify this approach if the bulk of the population is left to find insurance cover in the informal sector. At the same time, existing insurers are seeking ways of serving the poor and are already serving a large number using compulsory models. Regulators, therefore, face the tough task of supporting and helping to formalise the market within their resource constraints. New regulatory frameworks that are easier to enforce and follow must be developed.

New products, new players: Much attention is currently being paid to the use of existing networks to provide innovative, low-cost microinsurance to the poor, including utility infrastructure, mobile phone networks and input suppliers to agriculture. Future microinsurance markets may look very different to traditional insurance markets typically served by brokers and agents. Regulatory frameworks must develop ways of accommodating new products and models and adjust to this rapidly changing market.

Starting point for sector development: Retail insurance markets in developing countries are very small. In addition, the bulk of the unserved market is likely to be low-income. This suggests that microinsurance may be a useful starting point in building the insurance industry as a whole, both for regulators and industry players. The short-term and simplified nature of microinsurance products may allow for easier management, delivery and regulation with available resources.

The focus note series

Focus note 1: What is microinsurance and why does it matter? The rationale 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.
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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 first 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 Wirstschaftliche 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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