Ensuring mutual benefit

The role and regulation of member-owned insurers • January 2009

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micro insurance network

This document is focus note 9 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 14 for further details.

1 Introduction

Access to insurance is an important strategy for reducing poverty. Financial markets, and particularly insurance services, can help poor people manage risks that threaten their well-being, such as the sudden death of a family member, illness, or the loss of income or property. Despite the growing importance and rapid expansion of microinsurance services geared to low-income people, microinsurance penetration remains limited, leaving the vast majority of the poor without adequate protection.

Member-owned organisations such as mutuals

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and cooperatives have played a critical role in developing insurance markets and furnishing risk mitigation services to poor people. In this way, they provided "microinsurance" before the term was coined – indeed, in several jurisdictions insurance originated in the member-owned/mutual form. As a later section will show, member-owned organisations still play a significant role in providing risk cover for the poor.

This focus note explores the role and regulation of member-owned insurers in the microinsurance field. Much of the evidence is drawn from a study of five countries –Colombia, India, the Philippines, South Africa and Uganda – which looked at the development of microinsurance markets, and specifically the impact of regulation. Supplementing this was information gathered by a recent IAIS survey[1] of members on the nature and role of mutual and cooperative insurers in their respective jurisdictions. The full analysis based on the country case studies and the individual country reports can be accessed at www.cenfri.org. As it relies on the five national studies, the analysis of member-based insurers is not comprehensive. However, the aim was to develop an analytical framework that can be deepened by further research.

Scope. The main research on which this focus note was based, namely the five country studies, did not cover health insurance. However, we believe that many of the same factors apply in the health field. The IAIS member survey included health cover.

2 Defining characteristics

This focus note deals with all member-owned organisations that provide a form of risk pooling or insurance coverage to members, including cooperatives and mutual insurers. There is no clear consensus on how to distinguish mutual, cooperative and other community-based organisations or how to give them precise legal definitions. This note does not set out to reconcile the various definitions or develop a single legal definition. It seeks, rather, to explore the common characteristics, the varying features that affect how such entities operate and their risk management practices, and how regulation should deal with them. We examine all institutions with the following characteristics[2]:

- They are *member-owned*;
- They were created to serve the *common interests* of their members;
- Any *surplus or loss* made by the institution *accrues to members*;
- Final *decision-making* is by democratic vote of all *members*, even if aspects of management are delegated to particular members or professional managers; and
- Some form of *risk pooling*[3] *or insurance coverage* is provided, but such cover is available *only or predominantly to members*.

Entities of this kind have different names in different jurisdictions, including mutuals (for example, mutual insurers or mutual benefit associations), cooperatives (for example, cooperative insurers or cooperative insurance societies), friendly societies, burial societies, community-based organisations and self-insuring schemes. They can also take different legal forms, generally of three types:

- Voluntary member-owned institutions *recognised only under the common law* –that is, no specific legislation or regulation exists to define the particular legal personality or determine how it should be governed and managed. Insurance legislation also does not provide for such organisations. The bodies in question are generally small and informal.
- Cooperatives or other member-owned organisations *recognised as a specific legal form by a country's laws*, even if they are not distinguished for insurance purposes.
- Mutual insurers *recognised by a country's insurance laws*. These can be large (for example, Avbob, the only surviving mutual insurer in South

1 IAIS/CGAP Joint Working Group on Microinsurance, 2008. Survey of the role of mutuals, cooperatives and community-based organisations in microinsurance.Note that the joint working group has since been renamed the IAIS/Microinsurance Network (MIN) Joint Working Group on Microinsurance (JWGMI).

2 These are the principles for considering an organisation as a mutual, cooperative or community-based body, as contained in the IAIS/MIN JWGMI survey on the role of mutuals, cooperatives and community-based organisations in microinsurance administered in 2008. The last principle was, however, changed for the purposes of this focus note to apply to members only. As the discussion to follow will indicate, selling insurance to non-members drastically alters the risk characteristics of an organisation from a regulator's point of view.

3 Risk pooling does not strictly qualify as "insurance", because benefits are not guaranteed. But we believe it deserves inclusion, if only to demonstrate that it should not be regulated for insurance purposes, as in many jurisdictions.

Africa), or small (such as mutual benefit associations in the Philippines).

For simplicity's sake, we will use the inclusive term *member-owned organisations* for all entities falling into these categories.

3 The role of member-owned organisations in the microinsurance market

Community risk pooling as an intuitive response. People from all walks of life are exposed to risk, even if there is no insurance market to cover it. When the risk is too large for individuals to bear on their own, the centuries-old, wordwide response has been to pool it, often among people who live in close proximity and know and trust each other. People's intuitive response is to share risk, even at the informal level of giving support to someone who has suffered a loss in the expectation of reciprocal support in the future.

Such intuitive, informal risk pooling gives rise to more formalised products, for example where each member contributes a monthly sum to a fund which pays out to those who suffer misfortune, such as a death in the family. Ultimately, it develops into the provision of insurance products by formal insurers. Regulation develops in tandem with this evolution of the informal into the formal, culminating in the sophisticated regulatory regime we see today[4].

Significant players in the microinsurance market. The development of insurance markets served by formal, corporate insurers has not removed the need for community-based risk pooling. Where formal insurance markets are not prepared to serve poor people (either because they can only afford very low premiums, or because they are not within easy reach for intermediation purposes) or where the formal insurance sector itself is in the early stages of development and unable to serve low-income clients, the poor have no choice but to turn to one another for support. Therefore, in many countries member-owned, community-based institutions still play an important role in tiding poor families over in difficult times. The five country case studies confirm this. The share of member-owned insurance in the formal microinsurance (MI) market is as follows in the five countries:

- *Colombia:* Two large cooperative insurers pioneered microinsurance and account for 62% of the total microinsurance market.
- *South Africa:* Funeral cover[5] is the largest category of voluntary risk management products in South Africa. Some 60% of low-income funeral insurance clients obtained all their cover from completely informal mutual burial societies.
- *Philippines:* Member-based insurers, referred to as mutual benefit associations, provide about 30% of formal microinsurance. If the informal market is included, in the form of self-insuring cooperative insurance societies outside the jurisdiction of the Insurance Commission, this increases to 60%.
- In *India*, informal insurance adds about 20% to the size of total formal microinsurance market. The informal market largely comprises member-based community health insurance schemes.

	Colombia	India	Philippines	South Africa	Uganda
MI policyholders (% of adults)	19%	2%	5.4%	30%	5%
Member-owned organisations' share of formal MI	62%	Largely distribution	32%	<10%	n/a

4 This phenomenon can be termed "regulatory drift", the trend that regulation follows in becoming increasingly sophisticated and tailored to providers and customers already in the market. Often, it results in higher entry barriers and regulatory costs, making it difficult to serve those who are excluded, particularly low-income clients. For a more detailed explanation see 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

5 We deliberately do not refer to insurance here, as the reference includes both products defined as insurance and non-guaranteed products provided by informal burial societies, which are not considered insurance. Both categories of cover have their place, however, in the risk management continuum. See Bester et al (2008), unpublished South African case study prepared by Genesis Analytics for a more detailed discussion.

- Although research on the size of the formal microinsurance market in *Uganda* picked up no member-based activity, there are indications that Ugandans do pool risk informally through groups.

The IAIS member survey also found that various forms of member-based insurance are common and play a significant role in a number of jurisdictions. Of the 57 responses received, 41 from regulators and 16 from organisations, 28 confirmed that such entities actively supply insurance services to the low-income market in their jurisdictions. A further 29 respondents, mostly from developed countries, indicated that member-owned entities exist but do not provide *microinsurance* in their jurisdictions. In many cases, the regulator may simply not be aware of insurance provided through member-based organisations.

4 The member-owned advantage

It is often argued that member-owned organisations enjoy a comparative advantage in providing microinsurance and that regulation should treat them differently from corporate insurers. The argument rests on the three factors of *simplicity*, *trust* and *cost*.

Simplicity of form. The member-owned structure is the simplest and most intuitive form of organisation. It requires little technical or legal understanding to run, and follows governing principles which come naturally to groups and communities. This is reflected in the natural evolution of such structures out of community support systems, as described earlier.

Ability to engender trust. A key reason for the success of member-owned organisations in low-income markets is their ability to engender trust[6] in the entity providing insurance cover. Members participate directly in decision-making and poor households understand and appreciate the concept of social solidarity. This is why member-owned structures often evolve spontaneously in lower-income communities. By contrast, for-profit insurers are often viewed with scepticism and mistrust, being perceived as exploiters[7] who delay the settlement of claims and reject them for spurious reasons, and as institutions "meant for the rich" with little sympathy for poor people.

Ability to provide low-cost insurance tailored to the community's needs. Member-owned organisations may in some cases be able to provide insurance at a lower cost than corporate insurers would for comparable groups. There is often a closer relationship between them and their members and among their members, who often come from the same community. This enables member-based insurers to tailor products to members' needs and manage claims fraud. Knowing the group also facilitates pricing and removes many of the information asymmetries facing corporate insurers. Furthermore, member-owned organisations do not have to generate profits for third party owners who are not policy-holders, and can, therefore, set lower premiums. It must be noted, however, that pricing will ultimately also be impacted by the size and profile of the group covered and the nature of cover provided.

5 The relevant risks facing member-owned organisations for insurance purposes

Like corporate insurers, member-owned organisations are exposed to insurance risk. The fact that they are member-owned, however, enables them to deal with it in a different way. The present study highlights three types of risk: prudential, market conduct and governance/institutional risk.

Prudential risk This is the risk that the insurer will become insolvent and unable to meet its obligations to policy holders, as well as the impact that insolvency may have on the wider market and the financial sector. Regulation that seeks to manage

6 The importance of trust is emphasised in focus note 8, which explores the factors which influence consumers' risk management behaviour and, in particular, whether and when they opt to take insurance or avoid taking it.

7 By referring to "perceptions" we are not suggesting that these perceptions are necessarily valid or fuelled by the insurers' behaviour. We are are merely emphasising that perceptions, rather than factual evidence, drives behaviour.

such risk is referred to as "prudential regulation". It typically covers various categories of risk, including underwriting, credit, market and operational risk. Member-owned organisations, where policyholders, members and management are the same individuals, provide an incentive for sound prudential management. As owners and managers, members do not have a motive to cut corners in a way that negatively affects their benefits as policyholders. In theory, member-owners are liable in the final instance for the organisation's liabilities , which encourages good prudential management.

However, such incentives do not necessarily mean that members have the required technical skills. Furthermore, while members remain liable in theory, in practice they may not have the means to contribute funds if the organisation runs into financial trouble. The level of prudential management, and the skills required for it, also depends on the complexity of the products provided and the extent to which benefits are guaranteed:

- *Unguaranteed benefits.* In informal risk pooling arrangements where benefits are variable and not guaranteed, member-owned organisations face very limited prudential risk. Their liability is limited to their available cash or assets, rather than being dictated by defined contractual obligations. Guaranteed benefits, by contrast, create the risk that the insurer's liabilities in respect of future claims may exceed the assets available to meet them. It is because they are based on informal risk pooling that organisations like the "damayan funds "[8] in the Philippines, and burial societies which offer simple products and non-guaranteed benefits in South Africa, are generally seen as standing outside of the scope of insurance regulation.
- *Product simplicity.* Among organisations which provide guaranteed benefits, the complexity of the products offered also determines the required prudential skills and the degree to which member-owned organisations can minimise prudential risk. Two key factors relating to product complexity drive insurers' risk exposure:
  - *Technical risk.* The nature of the insurance product determines the character of the risk taken on by the insurer. In turn, two factors directly linked to the way the product has been written drive the product risk: uncertainty about the claim event and the size of any claims. Products with the following features tend to carry lower prudential risk than more complex products:
    - A limited contract term;
    - Coverage only of more predictable events, for which sufficient incidence data is available;
    - Not providing indemnity cover;
    - Low benefit values;
    - A simple structure and formulation; and
    - The exclusion of complex elements such as long-term savings.
  - *Management capability.* The second major determinant of the insurer's risk exposure consists in how well this risk is quantified and provided for – in other words, the ability of management and governance to handle risk.

For these reasons, member-ownership does not automatically guarantee lower prudential risk. The skills available and the nature of the products play a fundamental role.[9]

Market conduct risk.[10] This is the risk that clients do not receive fair treatment and/or fair payouts on valid claims. Effectively, it arises when clients are sold products they do not understand, are unsuited to their needs, and/or on which they cannot claim. Among the factors driving such risk are:

- *the nature of the product*, including product complexity and the level of cover provided;
- *the nature of the intermediation* process, including whether the purchase is compulsory or voluntary, whether the product is stand-alone or embedded, the level of disclosure or advice and the nature of the claims process; and
- *the nature of the client*, including his or her level

8 "Damayan" is a Filipino word meaning "to console," "to empathise with the other" or "to be a part of" an unfortunate or unforeseen event. Each individual in a damayan fund voluntarily pledges and contributes to a fund that pays out to someone who has suffered misfortune, who is likewise a contributor. Membership is voluntary and the benefits are not pre-determined but contingent on the funds collected.

9 The case of CARD MBA in the Philippines illustrates this. Initially providing insurance in an informal way as part of its MFI operations, CARD decided to formalise itself by becoming a mutual benefit association bound by prudential requirements. It did this after being threatened with bankruptcy when its pension offering, a more complex product than credit life only, proved to be under-capitalised.

10 Market conduct concerns may have an impact on prudential risk, in that reputational damage, for example, may drive an insurer to insolvency.

of sophistication and financial literacy.

Member-owned arrangements provide an incentive for the fair treatment of policyholders, as members have no reason to exploit or mistreat themselves. Because of the group policy nature, cover becomes standardised and individuals are less likely to be deceived. Furthermore, members are often sold policies by fellow-members – "sales agents" come from the same community and often know the purchasers. As they know that they can be held accountable at the claims stage, they have a strong incentive not to mislead buyers.

But such advantages tend to fade as organisations grow and members become less familiar with one another. The dynamic also changes dramatically when a member-owned institution starts to sell to non-members, as is the case for the two cooperative insurers in Colombia[11], both of whom are regulated the same way as corporate insurers.

Governance/institutional risk flows from the relationship between the principal and the agent. It is the risk that the actions of management are not in the best interests of owners and policy-holders. For this reason, governance structures seek to align owners, management and policy-holders. In member-owned organisations, self-interest and governance are more closely aligned, as members have an interest in mitigating their individual risk and derive personal benefit from the surplus generated by the enterprise as a whole. Where the common bond between members does not originate in the desire to mitigate risk or obtain another form of financial service, but from a source such as common employment, the alignment between self-interest and good governance is even stronger, as other incentives and sanctions can reinforce those applying to the risk mitigation instrument or institution. As surpluses accrue to members, the fiduciary challenge to risk management posed by having to pay profits to third-party owners is absent. This reduces governance risk.

However, once member-owned organisations expand, governing arrangements designed to facilitate risk management may grow weaker. Members are less able to take part in decision-making, and risk management becomes more complex, developing beyond mere cash flow management and the collection of contributions after the risk event[12]. When membership and management diverge and benefits are guaranteed, more formal governance arrangements are needed. The following conditions tend to dictate whether the governance requirements of member-based insurers succeed:

- Whether the institutional form of the member-based body, be it a society, a cooperative or mutual organisation, is recognised in domestic law. This will determine whether a uniform set of governance requirements or principles applies;
- Whether governance principles are sufficiently spelt out and match the risk management the organisation provides; and
- Whether supervision and capacity-building ensure that governance sanctions can be enforced.

Incentives for member interest-driven management depend on the type of member-owned entity. As shown by the above discussion, member-owned bodies have an inherent advantage in terms of institutional governance and market conduct risk. However, these benefits are not automatically transferred to prudential risk management. Experience shows that member-owned organisations are not inherently better equipped to manage insurance risk than other institutional forms. Furthermore, while relationship-based governance incentives seem to work well in some member-owned organisations, they tend to break down when management diverges from membership. The incentives –and particularly market conduct incentives – also break down when non-members are allowed to become policy-holders. However, as long as their defining feature is that they only serve members, market conduct risk in member-owned organisations is less important for regulators than prudential and governance risk.

As member-owned organisations progress from informal risk-pooling groups to larger and more sophisticated entities, regulatory support may be needed to compensate for structural change. Below, we consider the criteria for classifying the various member-owned organisations observed in the country studies, and the regulatory response to each.

11 However, as most of their insurance is indeed offered to members, they are not completely excluded from the analysis.

12 In other words, the organisation is not conducting insurance business by collecting regular premiums, but instead collects contributions once the risk event has occurred, to lighten the burden of those who have suffered loss.

6 Criteria for categorising member-owned organisations

The institutional/governance and prudential risk profile of member-owned organisations –the key risks from a regulator's standpoint – can be unpacked using three classificatory criteria.

The nature of the risk pooling undertaken by the organisation. Two issues are relevant here:

- whether they provide guaranteed benefits; and
- the risk inherent in the products they provide.

As shown by the earlier discussion, these have direct implications for the prudential risks incurred and whether the member-owned structures and skills are sufficient to manage them.

The nature of the common interest. A defining feature of member-owned organisations is that they are created to serve the common interests of members. From the institutions surveyed, common interest can arise in three ways:

- *Employment, military service or another strong common interest other than the need for risk mitigation, which binds people together over a long period.* This emerges most clearly from the IAIS member survey. Examples are the self-management entities for employee groups in Brazil; societies for teachers, policemen, soldiers and public employees in Fiji; fire and foresters' societies on Guernsey; insurance societies for various trades in the Netherlands; church groups in Uganda; and fraternal benefit societies in the United States. In such cases, the common interest is not the demand for risk mitigation or another financial service. It is a deeper bond, reinforced by an organisation such as a profession or trade guild, which provides far stronger governing discipline.
- *The need for risk mitigation* is the most frequent source of common interest. People come together or join existing institutions because they face prohibitively high risks, and it is the management of these, over and above social cohesion, that binds them together. Some of the best examples are the burial societies found in many jurisdictions.
- *Another financial service, notably credit.* Often, the common interest arises from the fact that members of the insurance/risk-pooling groups are prior consumers of another financial service. This is most notable in the MFI sphere. For example, the largest microinsurance provider group in the Philippines, Mutual Benefit Associations (MBAs), originates in MFIs, which form such member-based associations to provide credit life cover. Often, credit unions or savings and credit cooperatives (SACCOs) also begin pooling risk or offering insurance. According to the IAIS member survey, credit life cover is offered by member-owned organisations in India, the Philippines, Bangladesh, Pakistan, Fiji, Peru, El Salvador, South Africa and Cameroon.

The quality or degree of management accountability to members. A final classifying criterion is the degree to which the organisation is truly member-managed, which speaks both to governance and the relationship between size and prudential risk. When management becomes removed from ownership, member-owned structures may be less able to ensure adequate governance, and the incentives for sound prudential management in the owners' best interests are eroded. Examples are South Africa's large burial societies, which are threatened by insolvency, and cooperatives in the Philippines, where more than 65% of all cooperatives registered with the Cooperative Development Authority have stopped operating because of mismanagement, weak governance and, most importantly, inadequate rules and regulations.

7 Categories of member-owned organisations for insurance regulatory purposes

The five country studies and the IAIS member survey underscore the wide variety of member-owned organisations that provide some sort of risk cover to members. Based on the criteria above, they can be broadly grouped in four categories. Strictly, these are not a prerequisite for designing regulatory frameworks, as the criteria and risks identified should suffice. Nevertheless, the groupings relate the criteria and risk categories to the examples of member-owned organisations found by the IAIS survey

and the country studies, giving regulators and policymakers a handle to conduct diagnostic exercises in their own countries.

The categories are: risk-pooling associations, self-insurance societies, common bond societies and member-owned (mutual) insurers. These are not standard terms, but are based on what the case studies and survey observed. The list is not exhaustive, and should be extended by further research.

Risk-pooling associations are organisations that *do not provide guaranteed benefits*. Their members come together for risk mitigation purposes. They are generally small, informal and characterised by member management, implying a high degree of management accountability to members. In most cases, the legal form is that of a voluntary society recognised as a legal personality under the common law. Such societies adopt an implicit or explicit set of rules that govern the association's operations.

The damayan funds of the Philippines, the informal burial societies which are not considered insurance providers in South Africa and Malaysia, and the informal risk-pooling groups reportedly found in Uganda are examples of risk-pooling associations. Such associations often pose an interesting challenge to banks asked to open accounts for them. Where the institution is not formally registered under national legislation, banks sometimes accept a formally adopted constitution containing operating rules and specifying the office-bearers' responsibilities.

Self-insurance societies. In contrast with risk-pooling associations, self-insurance societies provide *insurance* – that is, they guarantee the benefits provided to members. This substantially heightens the prudential risk carried by the organisation.

Self-insurance societies are characterised by some common interest, usually based on the need for risk mitigation or another financial interest, such as prior membership of an MFI or SACCO. Members might also have joined a cooperative for other purposes, such as trading or agricultural production, and now want to use the resource pool for risk mitigation. The key feature is that of *voluntary* combination, generally based on the need for a service. This distinguishes self-insurance societies from the common bond societies, which are defined below.

The level of management accountability to members varies, but in general the larger the society, the more removed management is from individual members and the stronger the institutional or governance risk becomes.

Self-insurance societies can take various forms depending on what national legislation allows, ranging from common law voluntary societies to registered cooperatives which are not supervised for insurance purposes. Examples from the country studies include burial societies that provide guaranteed benefits under an exemption to insurance legislation in South Africa; certain self-insuring groups in India; cooperatives in the Philippines that provide "in-house" insurance without being registered with the Insurance Commission; and the insurance cover provided by some savings and credit cooperatives in Cameroon.

This is the most problematic category from a regulatory perspective, as it encompasses a fairly broad range of organisations, frequently with large memberships. Often, they are regulated by an institutional regulator – such as the registrar of cooperatives, who may report to the agriculture ministry –rather than the insurance regulator. This suggests difficulties in regulating insurance provision, or simply that such provision falls in a regulatory void. Cooperative insurance societies in the Philippines are a good example. Though they self-insure, they are regulated by the Cooperative Development Authority and do not fall under the jurisdiction of the Insurance Commission or the Insurance Code.

Common bond societies. These are insurance societies that provide guaranteed benefits and that are set up exclusively by members brought together by a non-insurance tie. Most often the bond is employment by the same public or private institution. They cater for the common insurance needs of their members and normally operate through structures created by the employer or legislation. Members, therefore, come together for insurance purposes on an *involuntary* basis, for example in a group life scheme to which all employees must belong. Their involuntary nature distinguishes them from self-insuring societies, where members with a pre-existing common interest decide whether they also want to take part in risk-pooling. The employer or relevant legislation ensures strong management accountability to members, reducing prudential and governance risk. A true common bond society is not interested in competing in the financial services market, as its insurance services are limited to members

with a pre-existing common bond.

As shown by the earlier discussion on classificatory criteria, common bond societies are the most widespread member-owned organisations found in the IAIS member survey. However, because of the restricted nature of their membership, they play a very limited role in insurance market development and microinsurance. Friendly societies also qualify as "common bond" societies, and have deep roots in countries in which they are recognised.

Member-owned (mutual) insurers. The final category to emerge from the country studies and the classificatory criteria is that of member-owned insurers, commonly termed mutual insurers. These are small or large insurers whose membership derives purely from the need to purchase insurance. This distinguishes them from friendly societies, where the governing legislation, such as South Africa's Friendly Societies Act, often requires or assumes the existence of a common bond over and above the desire to take out an insurance policy[13]. Such insurers may have their origins in another shared interest – the MBAs in the Philippines, for example, grew out of MFIs[14] – but they have evolved beyond that stage. Legislation permits them to sell policies of all kinds, and they mirror commercial insurers in every way except for ownership. Accountability is exercised in a similar way to that of insurance companies, generally through an independent board on which members may be represented, which holds professional management accountable. For this reason, mutual insurers are usually subject to similar corporate governance arrangements and prudential requirements as corporate insurers.

The most notable examples of mutual insurers from the country studies are the two large cooperative insurers in Colombia: Solidaria and La Equidad[15]. Each has individual cooperatives as members. In the Philippines, two cooperative network insurers, CLIMBS and CISP, currently exist, although the latter is under curatorship. In South Africa, the two largest corporate insurers developed as mutual insurers, but grew so large that they formally demutualised a decade ago, becoming listed public companies which provide a range of financial services. Today, only one mutual insurer, Avbob, remains in South Africa. Further examples from the IAIS member survey include Torreon and PRYBE in Mexico, health mutual insurance companies in Niger, Surco in Uruguay and various insurers in Pakistan.

8 Observed regulatory responses

The regulatory responses to member-owned organisations which provide some form of risk-pooling or insurance vary considerably, but a number of common approaches can be identified. In general, they did not grow out of a comprehensive system of insurance regulation, but are the product of historical developments. As a result, member-owned organisations are often poorly integrated into the insurance system. Although they often enjoy special dispensations, by design or default, they may find it difficult to graduate into fully-fledged insurers.

The various approaches to regulation are outlined below. It is important to note that the development of member-owned insurers relates not only to insurance regulation, but also to other regulatory regimes. Of particular importance is institutional regulation, including cooperatives legislation, friendly societies regulation and corporate governance rules. Though less important, other forms of regulation, such as anti-money laundering controls and payment system regulation, can also have an effect. However, they are not the focus of this analysis. Furthermore, the approaches listed below are not mutually exclusive and can co-exist in the same jurisdiction. We group them in four categories, loosely corresponding to those in the previous section.

Risk-pooling associations. In most countries, insurance is defined as the provision of a defined benefit on the occurrence of a specific event in return for the payment of a set premium. Given that there is no contractual guarantee in risk-pooling associations, there is effectively no transfer of risk beyond the funds available. In some jurisdictions, business of this kind is seen as falling outside the def-

13 Although this is not strictly enforced.
14 The MFI would typically form an MBA for its members in order to provide insurance cover. The latter is then a separate legal entity from the MFI.
15 Though they are also allowed to sell to non-members, and so do not strictly qualify as member-owned organisations in our definition, the bulk of their business is with members,distributed via their cooperative member networks. For the bulk of their operations, therefore, the market conduct advantages of member-owned organisations apply.

inition of insurance and is exempt from regulation. The challenge is to define the point at which the benefit becomes de facto guaranteed, as members no longer accept the "flexible" management approach.

Examples include risk-pooling burial societies in South Africa (burial societies are only required to register for insurance purposes if they provide guaranteed benefits); damayan funds in the Philippines, which do not fall under the definition of insurance; burial societies in Malaysia, which, unlike insurers, are not regulated by the Central Bank; and informal risk-pooling in Uganda, which the authorities have not brought into the insurance regulation fold. If such associations are cooperatives in form and the country has legislation regulating cooperatives, their institutional and corporate governance dimensions are regulated. However, this does not mean that they are regulated for insurance purposes.

Mutual insurers. Standing at the other end of the spectrum, these provide the full gamut of products and are treated like any other commercial insurer in regulation. The only distinction is in their legal form –prudential and other requirements are the same as for commercial insurers. The regulatory response to mutual insurers has the following features:

- The legislation provides for mutual insurers where members are also policy-holders and where people become members when they take out policies, regardless of whether the institutions are large or small;
- The institution's main function is to provide insurance benefits to members; and
- The risk management function is regulated by the relevant legislation or regulation.

Until recently, mutual insurers were the dominant legal insurance forms in many countries and their regulation developed over time alongside that of corporate insurers. Indeed, many of the latter were formed by demutualisation.

This is the regulatory response to cooperative insurers in Colombia, to the one remaining mutual insurer in South Africa, to cooperative insurance societies in Uganda (which must register as insurers without a special regulatory dispensation) and to cooperative insurers in the Philippines. In the latter case, the insurance regulator has the discretion to lower the minimum up-front capital requirement by up to 50%, apparently based on the argument that member-owned entities have an advantage over their corporate counterparts in terms of governance and prudential risk management. This discretionary power has, however, not been invoked and the two cooperative insurers are currently subject to the same requirements as their corporate counterparts.

Common bond societies. In the case of all common bond societies, as defined in this focus note, regulation requires a pre-existing common bond unrelated to insurance. This is the main feature that distinguishes such organisations from the alternative forms discussed in the section on categories of member-owned organisations. Societies of this kind are then generally subject to a lower regulatory burden and restricted in the products they can offer. The key legal prerequisite for such a special dispensation is that they can offer insurance only to people who are members because of a common bond –for example, employment, military service or guild membership – not to people who become members by purchasing policies. In Fiji, for example, mutual insurers that only insure members are not deemed to fall within the scope of insurance regulation, as they do not serve the general public.

However, regulators have run into difficulties when they have tried to apply regulations covering common bond societies to self-insurance societies. Some of the biggest problems relate to competition and level playing fields. Because their common interest flows from the demand for a financial service, self-insurance societies such as burial societies often compete in the financial services market. The restrictions imposed on common bond societies – and they accept these because providing a financial service is not their primary purpose - often do not sit well with self-insurance societies. In South Africa, for example, burial societies are restricted to the friendly society form in providing insurance. If they want to sell insurance rather than merely pool risk– in other words, act as self-insuring societies –this undermines their competitiveness vis-à-vis corporate insurers[16]. They cannot sell products to non-members or conduct marketing and the products and benefit levels they can offer are restricted. Instead of treating such organisations as common bond societies, regulation should recognise self-insuring societies as legal entities that can provide insurance and are treated as a second tier of insurers.

16 To the extent that there is a natural evolution, it should be from a self-insurance society (category 2) to a mutual insurer (category 4) and not from a common bond society (category 3) to a mutual insurer (category 4).

A second tier of insurers. This is a regulatory response to member-owned institutions whose activities are seen as posing less risk than full commercial insurance. Such regulation may be relevant to self-insurance societies, but also some mutual insurers. Importantly, however, it excludes the special regulatory dispensation granted to common bond societies, as this is based on a different premise. Strictly, second-tier institutions are subject to less onerous compliance requirements because they carry lower prudential risk, not because there is a prior common bond.

Regulatory approaches relevant to a second tier of insurers include the following;

- *Exclusion from insurance provision.* South Africa and India do not allow member-owned institutions to register as insurers. If these organisations want to provide insurance, it happens either through informal risk-pooling, or, in South Africa's case, through an exemption under insurance legislation for friendly societies which offer limited products. If a cooperative wants to provide insurance, for example, it must register as an insurer. This means forming a public company for insurance purposes, in effect sacrificing its member-owned form. Such restrictions usually prompt such institutions to operate informally beyond the law, as in the 20% of the microinsurance market served informally in India.
- *Regulation, not supervision.* Most countries have comprehensive insurance legislation that requires the registration and supervision of all institutions which provide guaranteed benefits in some form. However, in many countries smaller institutions provide self-insurance without complying with the relevant legislation. The supervisor either turns a blind eye because they pose limited risk, as in the market conduct regulation of burial societies in South Africa, or lacks the capacity to oversee such institutions, or both. Another example is that of cooperative insurance societies in the Philippines, which provide insurance without registering for insurance purposes with the Insurance Commission, as they lie outside its jurisdiction.
- *Activities are exempted* from otherwise applicable regulation. Exemptions can be based on:
  - *Size, in terms of turnover or number of members.* In the Netherlands, non-life mutual insurers with annual gross premiums of less than €5-million must register but are exempted from much insurance regulation, while in Germany, member-owned societies are exempted from the bulk of insurance regulation if they have fewer than 750 members or an annual turnover of €5-million. The argument for such exemptions is primarily that smaller institutions pose less prudential risk to the stability of the sector. Often, also, it is implicitly recognised that such institutions have a limited ability to comply with regulations and that the regulator has little capacity to enforce them. This approach does not take particular account of market conduct risks, and information on the volume of insurance business conducted is often not available (and much larger than expected).
  - The *nature of the product*. A Colombian court has found that funeral cover offered in kind by the country's funeral service providers lies outside the definition of insurance. Similarly, funeral cover products in Brazil which only provide benefits in kind are exempted from some aspects of insurance regulation. While benefits in kind reduce the insurer's exposure, as they are paid according to cost to the company rather than at the sales value of the product, which may be much higher, it does not remove it completely. In addition, benefits in kind may raise consumer protection issues, as it is harder to judge the value received if it cannot be taken in cash.

  Exemptions may also be driven by the kind of insurance that member-owned organisations are allowed to write. In the Philippines (MBAs), member-owned insurers are not fully exempt from regulation, although a second tier has been created based on a restricted set of products they may offer. If calibrated appropriately, this is consistent with a risk-based approach to regulation.
- *Sector in which they operate*, for example, health or agriculture. Often, member-owned organisations fall under the jurisdiction of a different regulator, implying that they are exempt from insurance regulation if they self-insure. For example, agricultural cooperatives in Brazil are allowed to conduct some agricultural insurance business free of the insurance regulator's supervision. This approach tends to be driven by historical jurisdiction, rather than explicit considerations of risk management.

- *Dedicated regulation is applied or a second tier of insurer is created.* The aim is to create a lower compliance burden than for formal commercial insurers, linked to the member-owned form and/or offering products with a lower risk. The main example is the treatment of MBAs and cooperatives in the Philippines. A further example is Uganda, where insurance legislation provides for a second tier of insurer, namely a mutual insurance company limited to between 25 and 300 members and subject to less onerous minimum upfront capital requirements. There are, however, no such insurers in Uganda at present.
- Apart from the response of regulators and supervisors, *market-based institutions* can also play an important, sometimes indirect, role in supervising member-owned insurance. For example, apex bodies or development institutions can play a role in enhancing risk management or developing capacity, so that member-owned institutions can comply with regulation. An example is Rimansi in the Philippines, which provides back-office support and actuarial resources to MBAs.

9 Developing a regulatory response to insurance by member-owned organisations

The previous section showed a variety of regulatory responses to member-owned insurers. While in some cases the response was designed based on the nature and risk of these entities, the responses often do not reflect an understanding of the risk profile of such institutions and are often poorly integrated into the broader insurance regulatory framework. How should country regulators approach the regulation of member-owned insurers in their jurisdictions in a more consistent and integrated manner? In this section, we offer some preliminary guidance on the steps to be considered in developing a framework for member-owned regulation.

Step 1: *What role is played, or could be played, by member-owned organisations?* It is important that policymakers, regulators and supervisors investigate and develop an understanding of existing and potential markets – the served and unserved sections of the population, their insurance needs and the challenges of serving them. It is important to consider both formal and informal, corporate and member-owned providers. The existence of informal products and providers, which are normally member-owned, is a sign that formal markets are not meeting the needs of the low-income market and that there are regulatory and other obstacles to formalising their operations. Thorough research is required. The fact that such organisations are off supervisors' radar screens does not mean that they do not exist. Telltale signs may include complaints, including complaints by NGOs serving poor communities, and the account-opening experience of banks, especially in respect of group accounts.

Step 2: *What is the distinctive risk profile of insurance-type operations conducted by member-owned organisations in the country?* From the discussion above, it is clear that market conduct risk is generally substantially lower for member-owned organisations – but also that such risk, along with prudential and governance risk, can vary according to the type of organisation, its size, the complexity of the products provided and the degree to which management is accountable to members. Regulators should determine the level of risk posed by the various member-owned organisations in their countries, so that they can tailor prudential, governance/institutional and market-conduct regulatory requirements accordingly. A lower compliance burden may sometimes be essential to ensure the viability of member-owned microinsurance operations, but if the latter fail because of insufficient regulation, including inadequate solvency requirements, this will undermine the growth of the microinsurance market. Caution must be exercised as reduced regulatory attention may leave member-based structures vulnerable to abuse. Even where a lighter regulatory burden is justified, the situation has to be monitored and adjustments made where vulnerabilities are identified.

Step 3: *What policy objectives should be achieved through member-owned insurers?* Public policy expresses the intentions of government, and public and private sector actors both take their cue from it. Declared policy objectives give market players the security and guidance to invest with confidence when the regulatory framework is uncertain or is still being developed. This is often the case for microinsurance. Clarifying policy objectives will high-

light the appropriate regulatory response to member-owned organisations. For example, how does risk-pooling or member-owned insurance organisations fit into the country's larger policy goals, such as social protection and access to financial services?

Step 4: *How can existing regulation accomodate the regulation of member-owned organisations?* As explained in the section on the role of member-owned organisations in the microinsurance market, formal insurance developed out of informal member-owned risk pooling. As institutions grew, the sophistication of the regulatory framework grew with them. In many low-income communities, this process is repeating itself. However, the "new" member-owned organisations must find their way within a sophisticated regulatory framework that imposes high compliance barriers. This can be referred to as "regulatory drift"[17] . Existing regulations which govern entry, and set institutional and compliance requirements, often make it too onerous for member-owned organisations to register as formal insurers or progress to formal status.

For this reason, it is critical to assess the existing regulatory framework for insurance in general, and member-owned insurance providers in particular, in the local context. Regulators can then decide whether to consider an exemption or a second tier, or even to refuse preferential treatment. For example, if significant prudential risk is found, a second tier may be a better option than exemption. It is important not to lose sight of the need for sound corporate governance, determined by the extent of management accountability. If the assessment shows that legislation does not adequately provide for this, it may be necessary to include minimum requirements in insurance regulation.

Step 5: *Can regulation provide a graduation path for member-owned institutions that want to grow and potentially become large commercial insurers?* Informal insurance by member-owned groups normally emerges in response to a real need for risk mitigation in poor communities and enjoys the trust of poor clients. Yet informal operations may fail because of inadequate risk management, leaving members vulnerable. For this reason, formalising these operations is in the public interest. However, given the limited resources of insurance supervisors, this is difficult to achieve.

Experience shows[18] that the best approach is to define a clear evolutionary path allowing informal member-owned organisations, gradually and in a realistic way, to meet minimum regulatory requirements, including minimum capital requirements. As our discussion has shown, the friendly society is not a good stepping-stone towards formalisation, as it essentially anchors the institution in a form that does not anticipate growth into a fully competitive market provider.

In all likelihood, supervisors will also have to engage informal sector operators in a more entrepreneurial way, to help them towards formalisation and work with other government agencies which share this aim.

Step 6: *What are the pitfalls?* Before taking a regulatory stance, it is important to determine the possible unintended consequences. For example, would a second tier or exemption for member-owned organisations create an uneven playing field, where they enjoy an unfair advantage vis-à-vis other insurers in the same market?

Step 7: *Consider the supervisory capacity requirements of the proposed regulatory regime.* Before implementing a new regulatory dispensation, it is important to determine whether the existing supervisor can enforce it. If not, what additional resources are required and how can these be found and used? Such questions should serve as a reality check on proposed regulatory changes.

Limited capacity may also mean that some market segments remain completely unregulated. The only way to deal with this may be to focus capacity on high-risk areas while monitoring unregulated areas for changes in risk profile and abuse.

Step 8: *Can market-based institutions support the formalisation of member-owned organisations?* If supervisory capacity is limited, it may be possible to enhance it by drawing on the capacity of market participants and other entities. This could take several

17 See Bester et al, 2008. Making insurance work for the poor: microinsurance policy, regulation and supervision. Report prepared for the IAIS/MIN JWGMI. Available at: www.cenfri.org.

18 For example, microinsurance MBAs in the Philippines are allowed to build up their capital gradually to reach the minimum required level of existing MBAs.

forms, and should take account of market conditions and actors. For example, the supervision of certain market players, such as primary cooperatives, could be delegated to entities such as secondary/umbrella cooperatives which provide services to cooperatives.

However, delegated supervision is not the same as self-regulation. In the former, the regulator retains authority for regulation and supervision, with only certain functions delegated to the support agency. Self-regulatory systems are more complicated to design and require specific criteria and incentives to ensure effective supervision.

Step 9: *Monitor market developments and adjust regulation accordingly.* The supervisor must perform a balancing act, by enforcing regulations and responding to abuse without making conditions too onerous for market players. Any risk-based regulatory strategy for member-based organisations should be coupled with careful monitoring to ensure that supervisory forbearance and priorities are adapted to changing circumstances and risk experiences. For this to happen, minimum levels of information must be submitted to the supervisor.

10 Going forward

This focus note offers some preliminary proposals on the regulation of member-based insurers, based on the country case studies and the IAIS member survey, which need to be assessed in the light of further research. Other questions may also have to be considered, and these will be pursued under the new Access to Insurance Initiative (A2II).

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 9th 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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