The role of insurance in inclusive growth: Introduction to the series

Note 1

December 2018

Authors:

Christine Hougaard
Mia Thom
Jeremy Gray
Albert van der Linden
Kate Rinehart

Centre for Financial Regulation & Inclusion

Tel. +27 21 913 9510
Email: info@cenfri.org
The Vineyards Office Estate
Farm 1, Block A
99 Jip de Jager Drive
Bellville, 7530
South Africa

PO Box 5966
Tygervalley, 7535
South Africa

www.cenfri.org

The World Bank

Tel. +01 202 473 1000
1818 H Street NW
Washington, DC 20433
United States of America

www.worldbank.org

DFID has partnered with the World Bank, FSDA and Cenfri to conduct a series of diagnostics to understand how insurance market development can contribute to sustainable and inclusive growth.

Table of contents

Abbreviations

Cenfri	Centre for Financial Regulation & Inclusion
DFID	Department for International Development
FSDA	Financial Sector Deepening Africa

1. About this note

DFID partnered with the World Bank, FSDA and Cenfri to conduct a series of diagnostics to understand how insurance market development can contribute to sustainable and inclusive growth. The diagnostics explore the insurance sector's role from three perspectives: (i) in building household resilience, (ii) in supporting business resilience and enterprise development, and (iii) in capital market development. The notes in this series are summaries of larger studies that explore the development path and present state of the insurance market in four countries: Ghana, Nigeria, Kenya and Rwanda.

The series is organised as follows:

- Note 1 introduces the series and positions the scope of the diagnostics.
- Notes 2 to 5 respectively present the findings for each of the case study countries.
- Note 6 synthesises key themes across the case studies and draws conclusions and recommendations on how to further develop insurance markets to support sustainable growth and economic development.

This note introduces the linkages through which the insurance sector affects sustainable and inclusive growth. It also unpacks the nature and development of the insurance market itself. Finally, it sets out the research approach and scope of the diagnostics.

2. Insurance for development and growth

There is a strong theoretical and empirical research base to show that insurance matters for public policy objectives[1]. Insurance can help to combat poverty and to advance development and growth goals by providing finance for resilience, prosperity and growth. The linkages through which the insurance sector affects sustainable and inclusive growth are illustrated in Figure 1 on the next page.

[1] As quoted in Chamberlain, D, Coetzee, L & Camargo, A., (2017). Funding the Frontier. Role of inclusive insurance markets in economic growth and poverty reduction. Available at: https://cenfri.org/publications/role-inclusive-insurance-markets-economic-growth-poverty-reduction/.

Figure 1: Insurance-for-growth transmission mechanisms

***Source**: Adapted from Chamberlain, Coetzee and Camargo, 2017*

Three focus areas. The three main transmission channels identified in **Figure 1** form the focus areas for the diagnostics:

- *Improving individual and household resilience.* Insurance can contribute directly to individual welfare by providing a mechanism for households to build resilience in the face of financial shocks and by ensuring peace of mind even if no risk events occur. By providing an injection of funds, insurance can greatly reduce, if not totally alleviate, the risk of poverty when risk events occur. By transferring risk to an insurer, individuals and households can concentrate on their productive expertise, thereby allowing them to invest and grow their incomes. Insurance also plays an indirect role by enabling households to access other services, such as credit, but also health and education.
- *Improving business resilience and productivity*. Insurance can contribute to business development in at least three ways:
  - *Risk transfer to enable entrepreneurship and trade.* Entrepreneurs can transfer the financial impact of a risk occurring from their own account to the insurance industry, which may bolster their survival rate. Insurance also covers risks related to cross-border trade, which facilitates exports and imports and enables foreign investment.
  - *Risk management to mitigate risk and enable more efficient resource allocation*. Enterprises can use the tools and techniques created by insurers to develop risk management plans and mitigation strategies to prevent risks from occurring. Moreover, insurers may oblige enterprises to put such plans and strategies in place before they agree to cover certain risks, which incentivises enterprises to change their behaviour and to adopt better risk management practices.

- *Access to credit and financing*. Insurance helps to ensure the availability of many forms of business lending, mortgages, project finance and leasing. Insurance reduces the risk of borrower default or provides alternatives to collateral to reduce lender risk, which allows for more credit to be extended on better terms. Insurance markets are skilled at the pricing of risk, and their exposure-identification and exposure-mitigation skills and tools may enhance credit providers' ability to lend on terms that are commercially viable.

- ***Supporting capital market development.*** The insurance sector can play a role in the deepening and efficiency of capital markets to support growth objectives. Four main channels are considered:
  - ***Mobilising capital.*** The insurance sector can mobilise capital through premium collection and pensions. It can also mobilise capital by enabling business investment referred to above.
  - ***Pooling capital for efficiency and diversification.*** Insurers are able to pool savings from numerous small investors and, in the process, accumulate significant investable funds. Larger funds are more efficient to manage and invest, and they allow greater diversification of investments.
  - ***Allocating capital to more productive opportunities.*** Insurers can allocate capital more effectively to productive opportunities than individual investors can, as they can invest over longer time-horizons and are able to build professional skills and data to manage assets. Transacting at scale with greater efficiency allows insurers to reduce the unproductive contingency capital that investors need to hold as a precautionary measure to potential risks.
  - ***Building institutions for governance and investor confidence.*** Institutional investors, including insurers, grow the professional investment industry. A strong professional investment industry, in turn, can advocate for reforms in governance, auditing and accounting practices. Such institution building is critical for investment decisions and domestic and global business confidence.

3. Understanding insurance market development

To explore the various roles of insurance in sustainable and inclusive growth, it is important to first understand the nature and development of the insurance market itself. Only then can conclusions and recommendations be made on the role it currently fulfils and how to move it forward to the next stage of development.

The development of insurance markets occurs at various tempos and at different trajectories**.** Insurance markets take time to develop in size and sophistication, and this development follows a unique path in every country. However, typically four stages of insurance market development are observed. Each stage is roughly correlated with economic development, with countries at lower levels of GDP per capita typically resorting to an earlier stage of development[2]:

- ***Stage 1: Establishment and corporate assets.*** Corporate asset insurance dominates, such as in large extractive industries. Insurance contracts in the market cover mostly short-term liabilities, which are annually renewable. Investment portfolios of insurers typically consist of real estate and bank deposits.
- ***Stage 2: Early growth and compulsory.*** Compulsory retail, credit insurance and some group-based retail products emerge. As economic welfare increases, the increase in number of cars on the road often sees the introduction of compulsory motor third-party liability insurance. The development of the formal credit market drives the need for credit insurance, and group-based employee benefit products start to gain traction. Risk cover is still mostly short term. There is limited diversification in investment portfolios of insurers, which still mainly consists of real estate and bank deposits with some allocations to shorter-term government securities.
- ***Stage 3: Retail expansion.*** Generally, limited individual retail sales still exist in the market, but voluntary sales and life insurance start taking off as consumers become more aware of the value of insurance offers. Furthermore, as the middle class grows, income levels can support insurance purchases. The uptake of longer-term insurance contracts emerges as the popularity of life insurance and contractual savings increases. The investment portfolios of insurers become more diversified with greater allocations to government securities. Substantial allocations to real estate and bank deposits remain.
- ***Stage 4: Diversified retail.*** Stage 4 sees the development of a diversified retail insurance market across income segments, distributed through group and individual sales, with an increasing contribution by voluntary sales. The market share of domestic insurers improves, and niche insurance products emerge. Investment portfolios become more diverse. Competitive allocations across equity, corporate bonds and government bonds result in efficient and diversified investment portfolios.

Figure 2, on the next page, depicts these stages visually.

[2] These stages are not universal, but rather form a heuristic of common identifiable characteristics that is a useful frame of reference. Not all countries will neatly fit into a single stage. The stages are based on the work of Lester (2014) and USDAID (2016) as analysed in Chamberlain, Coetzee and Camargo (2017). For a detailed discussion on insurance market development and drivers of insurance market development, see: https://cenfri.org/publications/role-inclusive-insurance-markets-economic-growth-poverty-reduction/.

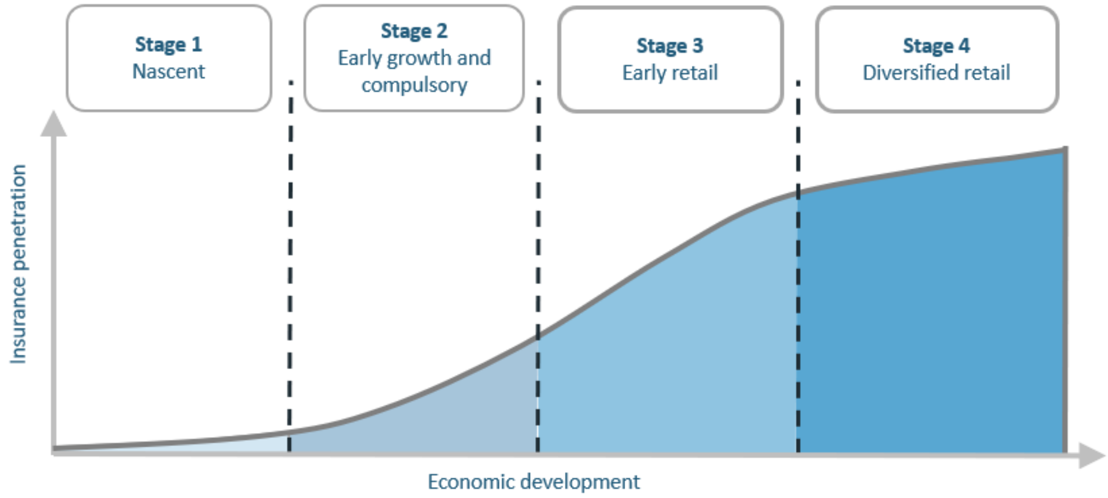

Figure 2. Stages of insurance market development

Source: Adapted from Chamberlain et. al (2017)

The ability of the insurance market to contribute towards development objectives varies depending on its stage of development. Thus, the diagnostics focus on unpacking the features and performance of an insurance market relative to the country context, as basis for identifying new opportunities to move the market forward in terms of the role that it plays in sustainable and inclusive growth.

4. Research approach and scope

The diagnostics were informed by extensive in-country consultations, desktop research, as well as analysis of available industry and demand-side datasets. The research followed a market systems approach whereby the key features of the insurance market were mapped out to conclude on the sophistication of the market and to highlight pertinent market development challenges and opportunities. The key features mapped included the landscape of providers, products and distribution channels, as well as premium trends and key market performance indicators. Given the interplay between the stage of market development and the economic environment, each study also takes stock of the context drivers of market development, as well as the policy, legislative and regulatory frameworks that set the parameters for market participation. On this basis, key market development imperatives are identified to help unlock the full potential role of insurance in sustainable and inclusive growth.

About Cenfri
Cenfri is a global think-tank and non-profit enterprise that bridges the gap between insights and impact in the financial sector. Cenfri's people are driven by a vision of a world where all people live their financial lives optimally to enhance welfare and grow the economy. Its core focus is on generating insights that can inform policymakers, market players and donors who seek to unlock development outcomes through inclusive financial services and the financial sector more broadly.

About DFID
The Department for International Development (DFID) leads the UK's work to end extreme poverty. It is tackling the global challenges of our time, including poverty and disease, mass migration, insecurity and conflict, with the aim to build a safer, healthier, more prosperous world for people in developing countries and in the UK.

About the Centre for Disaster Protection
The Centre for Disaster Protection finds better ways to stop disasters that devastates lives and economies. It does this by supporting countries to better manage disaster risk.

About FSD Africa
FSD Africa is a non-profit company that aims to increase prosperity, create jobs and reduce poverty by bringing about a transformation in financial markets in sub-Saharan Africa (SSA) and in the economies they serve. It provides know-how and capital to champions of change whose ideas, influence and actions will make finance more useful to African businesses and households. It is funded by the UK aid from the UK Government. FSD Africa also provides technical and operational support to a family of 10 financial market development agencies or "FSDs" across SSA called the FSD Network.

About the World Bank
The World Bank Group is a global partnership of five institutions that are working for sustainable solutions that reduce poverty and build shared prosperity in developing countries. It is one of the world's largest sources of funding and knowledge for developing countries.