
5.2 An enabling regulatory environment for microinsurance

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The cases analysed in this book demonstrate that low-income persons are insurable. Furthermore, there is evidence that microinsurance business operations can be sustainable. However, the question that needs to be raised is whether microinsurance operations are supported by a regulatory framework that is conducive to protecting policyholders and developing insurance markets that include the low-income segments of the population.

The primary function of insurance regulators and supervisors¹ is to protect consumers. This is manifested in at least three ways:

1. **Protecting policyholders in general** by ensuring the solvency of the insurers, which includes determining that insurance products may only be offered by licensed entities (both insurers and intermediaries) that remain financially sound and meet their obligations.
2. **Protecting individual policyholders**, including prospective policyholders, from mis-selling and improper handling of claims, and ensuring that their grievances are redressed in a timely fashion.
3. **Developing insurance markets** by improving market efficiency and including persons who currently have no access to or are unable to afford insurance through appropriate product design and delivery mechanisms.

Insurance authorities do not attach equal importance to these three aims. Much of their work is concentrated on the first two. Although improving market efficiency by correcting market imperfections is a classic task of supervisors, not all insurance authorities agree on a market development function. An analysis of the International Association of Insurance Supervisors (IAIS) database of national insurance regulations reveals that few member countries have an official development mandate. To fulfil this develop-

¹ The authors use the term “insurance supervisor” to refer to the authority responsible for regulating the conduct of insurance business – both insurers and intermediaries – to protect policyholders’ interests in a particular jurisdiction.

ment function, authorities can mandate insurers to serve the low-income market, use moral suasion to impress upon insurers the need to widen their reach, or decide on a middle course. Supervisors increasingly realize that an enabling regulatory environment and better appreciation of the dynamics of the insurance market could help remove the perceived obstacles that normally discourage insurers from serving the low-income markets.

This chapter describes what supervisors have done, or can do, to support the growth of microinsurance by adapting their regulations. The chapter limits itself to the regulatory aspects of the insurance market.² The first section provides some background information on the regulatory environment for microinsurance. Section 2 summarizes the main regulatory barriers, which vary depending on whether one is creating a microinsurance institution or distributing microinsurance products. The third section describes the experiences in India, South Africa and the Philippines, where insurance authorities and policymakers have tried to make insurance markets more inclusive, but have chosen very different solutions. The last section summarizes the major challenges and lessons learned, and suggest possible next steps.

I Background

I.1 Inclusive financial systems

A key strategy for enhancing economic development and alleviating poverty is to make financial systems more inclusive, for example by improving access to savings and credit services for un- and under-served markets. In part, poverty stems from the fact that low-income households and markets do not have the same opportunities to finance investments, accumulate capital or protect assets (including human assets). The poor's heavy reliance on informal financial services – such as moneylenders, under-the-mattress savings and mutual assistance societies – can be inefficient and expensive, and may even exacerbate poverty.

An inclusive financial system makes insurance available to low-income persons. However, many commercial insurers and policymakers believe that providing insurance to the poor is the responsibility of the state. Although many governments have social protection programmes, the targeting of these schemes is often ineffective. The poorest segments do not always benefit from

² This chapter does not explore supervisory aspects of microinsurance, which are important but have not yet been sufficiently analysed since microinsurance is relatively new. It also does not consider non-insurance regulations or related policy areas that might affect microinsurance, such as the regulation of the healthcare industry or social protection policies, which are beyond the scope of this chapter.

the subsidy, while people who can afford insurance often find ways to access these benefits. In general, governments have made little effort to shift the burden of risk-pooling to market-led schemes; and the private sector (commercial insurers) seems to have little incentive to seek out this market segment.

1.2 The informality of microinsurance

In the absence of social protection and commercial insurance coverage, many informal microinsurance schemes have emerged, operating without an insurance licence. By staying small and keeping quiet, these informal providers hope that supervisors will not react. This has been the approach of many microfinance institutions that have provided insurance coverage to their members on a self-insurance basis. However, there are also large microinsurance schemes (*see Box 90*) outside the realm of prevailing insurance laws.

Another way to circumvent insurance regulations is to declare microinsurance services to be a non-pecuniary benefit. In many countries, healthcare facilities allow free or discounted access to healthcare in exchange for regular payments (premiums). Even though these schemes have a risk-pooling element, they are often called pre-payment schemes to disguise the fact that they are some form of insurance. Yet because the schemes are not licensed, the customers have little recourse if the hospital does not to keep its promises. Many credit unions or cooperatives also avoid insurance regulations by offering informal insurance as a member benefit.

Box 90

Informal insurance in South Africa

In South Africa, a number of schemes offer products that closely resemble life insurance. In the informal sector, there are an estimated 8 million members of informal burial societies contributing in excess of US\$1 billion per annum in “premiums” towards coverage for the risk of death. Some of these schemes are quite large. The Great North Burial Society, a registered Friendly Society, has more than 20,000 lives covered, but has no access to reinsurance as it is not a licensed insurer.

As the Insurance Amendment Act (2003) prohibits the use of the words insurance, funeral, burial or derivatives thereof in the description and marketing of these products, they go under different names, such as “bereavement benefits” or “death benefit plans”. It seems that the Amendment Act was intended to prohibit the underwriting of funeral cover without a short-term insurance licence, but legal loopholes continue to allow such informal insurance to be sold under different names.

Source: Adapted from Genesis Analytics, 2005.

1.3 The implications of the lack of a regulatory framework

Not having to comply with regulations has some advantages for microinsurers. Informal providers do not have to adhere to regulatory standards and do not have to comply with the supervisory burden (i.e. comprehensive reporting, internal controls and actuaries). They have more freedom to innovate and can potentially offer cheaper products, which may ultimately appear to benefit their clients.

However, the informal nature of these schemes also has serious drawbacks. The most obvious one is that it leaves policyholders unprotected against opportunistic behaviour. In the absence of supervision, customer protection is a serious concern. The long-term viability of these schemes is uncertain since their premiums may not have any actuarial basis, or their management may not be sufficiently skilled. Microinsurance schemes are also subject to greater covariant risk and are unlikely to have reinsurance protection. A catastrophe can pose a serious threat to the solvency of local microinsurance schemes. Finally, the growth of informal schemes can pose a threat to sustainability, e.g. when burial societies become larger, the effectiveness of the member-governance system is undermined and a separation is required between management and ownership. At this point, the burial society also accumulates substantial assets, which increases the risk of fraud or theft to a degree that member governance cannot control (Genesis Analytics, 2005).

The positive effects of providing microinsurance beyond the radar of insurance supervisors have to be weighed against its negative effects on institutions and markets, as well as on the economy. As far as the institutions are concerned, many microinsurance providers currently have no choice. If they could get a licence, they would have the chance to improve their operations, grow and attract investors. It is realistic to expect that many would opt to become a part of the formal insurance industry.³ As a result of regulatory barriers, existing and potential microinsurance providers have remained excluded. Consequently the market remains less developed – low-income segments are not protected, government budgets are not relieved, insurance markets are not inclusive, financial innovation is sluggish and deeper penetration of financial services does not take place.

However, formalization can also be accompanied by a number of problems for insurers targeting the low-income segment. One problem is that the social orientation of some microinsurers may fade away when they become licensed. This can create new problems, such as those experienced by ALMAO (*see Box 91*).

³ In India and Sri Lanka, microinsurers have lobbied for lower entry requirements, so far unsuccessfully.

Box 91

Formalization of ALMAO

ALMAO in Sri Lanka, which uses credit unions as its main distribution channel, changed from an informal scheme to become a regulated insurer in 2002. When subjected to regulation as a fully-fledged insurer, the organization felt compelled to change its product line. Instead of continuing to focus on the funeral policies and other simple, low-cost products it offered as an informal insurer, ALMAO introduced endowment policies that have not sold well, perhaps because the premiums are much higher than the target market was used to, and the marketing of these more complicated products required better-educated and trained staff in the credit unions. It is also possible that the professional insurance management brought in to run the new insurance company unintentionally steered the organization away from its core market, or did not consider the priorities of the credit unions and their members. The general difficulty of committing credit union staff to insurance marketing may also have increased because ALMAO became a more distant, commercial and professional organization.

Source: Adapted from Enarsson and Wirén, 2006.

1.4 Insurance supervisors and microinsurance

Some insurance supervisors are becoming more interested in and sensitive to the challenges and potential of microinsurance. In line with global efforts to increase the outreach of financial and insurance services, supervisors are increasingly mandated to facilitate their governments' efforts to relieve themselves of funding insurance and social protection schemes through public budgets, and transferring part of the basic safety net for low-income populations to the private sector. As a result, some supervisors support initiatives to make the insurance market more inclusive, so that formal insurance companies can take advantage of this new market opportunity and informal schemes can integrate into the formal insurance sector, as illustrated below in Section 3.

However, in general supervisors lack information on and experience with microinsurance and are unaware of alternative legal and regulatory regimes that encourage insurance for the poor. In some cases, policymakers believe that poor people do not want insurance or cannot honour financial obligations,⁴ and that they must therefore be covered by the state or through social

⁴ The experience of microfinance has shown just the opposite; often, loan default rates are much lower for the low-income market than for larger companies or the higher-income market.

security schemes. They do not as yet appreciate the role of microinsurance in financial sector development. Another widespread assumption is that existing insurance laws and regulations are non-discriminatory, which therefore ensures that low-income people have equal access to insurance – an assessment that does not stand up to scrutiny.

Even if supervisors have taken notice of microinsurance schemes, they do not see the necessity to react due to other priorities. They are often under pressure to focus on supervising commercial insurers that are a greater threat to the stability of the financial system, instead of licensing and supervising additional, often small, insurance providers that have a negligible market share, and which may require a completely different supervisory approach. Also, supervisors often do not know how they can fulfil their developmental role because innovative regulatory solutions for microinsurance remain scarce. Last but not least, in many emerging markets supervisors are often not interested in microinsurance because the insurance industry itself is still in an infant stage and they are under heavy pressure to regulate and supervise that properly.

The area of responsibility is an additional problem. Although insurance supervisors are responsible for implementing insurance regulations, microinsurance providers often operate under other authorities, such as a cooperative commission, the NGO Bureau or the health ministry. Consequently, these schemes are not seen as part of the insurance sector, even though they clearly provide insurance services. Moreover, the people responsible for supervising them generally do not have the expertise and systems to perform such supervision (*see Box 92*).

Box 92

Insurance cooperatives in Malawi

In Malawi, the Supervision Department of the Reserve Bank of Malawi is entrusted with the task of regulating and supervising the insurance sector. The Department has limited resources; its main supervisory approach is to scrutinize reports from insurance companies. It is aware that the credit union association Malawian Union of Savings and Credit Cooperatives (MUSCCO) provides life insurance to more than 55,000 low-income persons, but claims that since MUSCCO is registered as a cooperative, it does not have the jurisdiction to support or control its activities. However, the Registrar of Cooperatives under which MUSCCO operates lacks resources, skills and interest to supervise insurance activities.

Source: Adapted from Enarsson and Wirén, 2005.

The very existence of informal insurance suggests that existing laws and regulations in some ways impede the inclusiveness of the formal insurance market. The question for insurance authorities and policymakers is: what should they do to remedy this situation? Leach (2005) identifies the balancing of stability and access as a regulator's dilemma.⁵ Should they try to formalize informal schemes to enhance consumer protection, which could stretch supervisors' resources to the breaking point? Should they shut down informal schemes since they are essentially illegal? If informal schemes are allowed to operate, how should they determine the threshold that triggers regulatory intervention? Or is there some middle ground that could expand access to insurance with some degree of consumer protection?

2 Barriers in existing regulatory frameworks

There are conflicting views among insurance supervisors on the extent to which regulations should be adapted to the specific characteristics of microinsurance. According to a survey conducted by the IAIS, the majority of supervisors believe that the existing laws and regulations in their jurisdictions do not discourage microinsurance. However, very few jurisdictions have laws or regulations adapted to encourage microinsurance. This section considers the regulatory barriers that limit the creation of microinsurance companies as well as those that impede the proliferation of microinsurance products.

2.1 Regulatory barriers to creating formal microinsurance institutions⁶

A cautious approach treating microinsurance on a par with commercial life and non-life insurance actually discourages the development of microinsurance. Such a "one-size fits-all" policy makes the job of the supervisor easier, but lacks a convincing rationale. The insurance requirements described below are barriers to microinsurance formalization.

Where there is only one institutional option, **high capital requirements** can impede the establishment of regulated insurance institutions dedicated to the low-income market since amassing the volume of small policies required to generate a return on such an investment could take years, if it ever occurred at all. Furthermore, imposing high capital requirements designed to

⁵ Leach (2005) identifies three dilemmas for financial sector regulators: 1) the trade-offs between stability and access (which only partly relates to the issue of regulating informal providers), 2) managing innovation and 3) handling international pressure to conform to standards and codes.

⁶ Formal microinsurance entities can be either companies (first-tier institutions) or member-based institutions under a lower tier.

protect the financial system seems inappropriate for such small policies – a capital sledgehammer to crack a solvency nut. The current trend toward raising capital requirements in many countries may force existing microinsurers to close down (*see Box 93*). Their existing policyholders, in the absence of alternative sources of coverage, risk having no protection in the future.

Box 93

Capital requirements in Peru

In Peru, the insurance law issued in 1993 did not promote insurance products for the low-income market. Higher capital requirements were introduced and caused some insurance companies to merge, while others left the market altogether. From October 1994, SEGUROSCOOP, a low- and middle-income segment insurer, had to cease operating as an insurance company. However, it found a solution: it formed a new company called ServiPerú that offered social security services, i.e. health and funeral services. It also created a subsidiary insurance brokerage and transferred its insurance portfolio to an insurer. As an insurance broker, ServiPerú is supervised by the Banking and Insurance Superintendence. As far as the social security services are concerned, ServiPerú is under the control of the Supervisory Commission for Enterprises and Securities (not governed by the insurance law). Although not an ideal solution, the former insurer found a new way to operate (new company structure, new products, and new distribution channel), stayed in the market and continued to serve its clients.

Source: Adapted from Rodriguez and Miranda, 2004.

There are a number of other requirements in insurance laws and regulations that prevent microinsurers from getting a licence, such as the high **requirements for key management**. Highly-qualified insurance managers are unlikely to opt to lead a microinsurance organization, which generally offers a lower salary and fewer career options than a commercial insurer. Obviously it is necessary to have qualified people running the company, but should the qualifications be relaxed for microinsurers?

Complex reporting requirements can make the cost of management and administration prohibitively expensive for small microinsurance operators. If reporting and disclosure requirements, originally designed for large insurance companies with complex structures, are imposed on microinsurers with simple procedures, costs will rise. Similarly, the **requirement to have an actuarial review** can be expensive and difficult to fulfil in some jurisdictions. This regulatory burden, perhaps coupled with a **premium tax**, adds to the cost of the product and leads to a reduced level of access for the poor.

These aspects need to be analysed to appreciate where entry barriers can be lowered to promote microinsurance. Certainly, supervisors appear justified in not licensing insurance entities with weak management and low capital. However, it is questionable whether organizations which are often locally-based and oriented towards the low-income market should be denied a licence on the basis of requirements that are neither relevant nor appropriate for the types of services that they offer. This is particularly true for mutuals and friendly societies, for which a long legal tradition exists of requiring no capital at all since risk is borne by the membership.⁷

Without a licence, the microinsurer is trapped in a vicious circle: no access to sources of additional capital or reinsurance, which ultimately means no growth for a prudent operator. If these schemes cannot grow, then it will be difficult for them to achieve economies of scale and extend coverage to the vast unserved market. In such an environment, policyholders are not protected⁸ and the institutional learning curve is not inspired by external control (supervision) and high standards (regulation). The only advantage that supervisors enjoy is that they do not have to deal with many small insurance schemes.

2.2 Regulatory barriers to distributing microinsurance products

As mentioned in numerous chapters, one approach to expanding microinsurance services is for a regulated insurance company to offer a product line that reaches the low-income market through alternative distribution mechanisms, including community organizations, banks, retailers, cell phone companies and others. However, regulatory barriers can also inhibit the use of these distribution channels even though they might be effective in reaching low-income markets. Supervisors need to monitor trends to ensure that regulation is not restraining the innovation by distribution channels in a way that is detrimental to market development (Leach, 2005).

Microfinance institutions (MFIs) are a key distribution channel for microinsurance because they already engage in financial transactions with the low-income market. However, in some jurisdictions, MFIs – and other institutions that work closely with the poor – cannot distribute insurance without conforming to stringent **licensing requirements for agents or brokers**. For example, the requirement that an agent has to be a private person may

⁷ This is the case in Belgium, France, Germany, Ireland, Japan, United Kingdom and United States (practically all states), as well as Belize, India, Mali, Martinique and South Africa among others.

⁸ Commercial insurance regulations often stipulate cumbersome practices that are inappropriate for low-income customers, who may be illiterate and understand little of insurance. This result is ironic since this target market requires even more consumer protection.

not allow MFIs to sell insurance. The requirement for specialized staff to sell insurance undermines the efficiencies that are possible by selling insurance through loan officers and tellers. Some jurisdictions prohibit lending organizations from selling insurance altogether, citing conflict of interest.

Furthermore, the training requirements to become a licensed agent may be excessive given the simplicity of microinsurance products. Should a poor housewife who wants to sell US\$500 endowment policies to her friends and neighbours have to go through 100 hours-worth of training? In some jurisdictions, the licensing requirements for agents are not strictly enforced, allowing MFIs and microinsurers to sell insurance, albeit in a potentially vulnerable legal situation (*see Box 94*).

Box 94

Requirements for agents and brokers

In the **Philippines**, the Insurance Commissioner (IC) licenses agents that have fulfilled certain criteria (e.g. payment of a registration fee, passing an exam, and no criminal record). An agent has to be a private person. However, several MFIs in the Philippines collaborate with Cocolife to insure more than 300,000 poor households – although these MFIs are not registered as agents. They sell Cocolife’s products, but do not receive a commission. Instead they load the net premium charged with an administration fee that is paid by the client to the MFI at the start of each loan (Leftley, 2005).

AIG Uganda has a partnership with 26 MFIs in three countries to cover over 1.6 million lives. In Uganda, any individual selling insurance as an employee of an MFI would technically need to be licensed, though in practice none are. As a consequence, the MFIs’ credit officers often lack the skills to sell insurance and to advise customers (McCord et al., 2005a).

In **Bangladesh**, insurance agents also need to be licensed. This may help to ensure a minimum level of agent quality; however, it may also make it difficult to serve the rural poor. Delta Life, for example, certifies the agents for its mainstream products that target middle- and higher-income persons in urban areas. However, it calls its microinsurance agents “organizers” to avoid licensing requirements. Another complication is that agents are eligible to continue to earn commission on renewal premiums even after they have left the insurance business, which creates additional administrative complications when dealing with hundreds of thousands of very small policies, and thousands of organizers (McCord and Churchill, 2005).

Restrictions on the amount of agency commission that can be offered by an insurer to the agent may also hinder microinsurance provision. The justification behind this clause is to protect the life fund from becoming depleted due to expensive distribution structures. However, such clauses

may create a problem for microinsurers, since low-income markets are more expensive to serve and may justify a higher cost structure.

Where microinsurers offer long-term policies, the prescribed commission structure may not be appropriate. For example, the commissions approved by the Insurance Board of Sri Lanka (IBSL) pay 30 per cent in the first year, but drop off to 5 per cent after Year 4. In an environment where banking or postal payment systems are not widely used, the agent is responsible for collecting premiums, often by going door-to-door. Given the required commission structure, Enarsson and Wirén (2006) argue that the retention rate is likely to go down drastically when the agent's commission is reduced since it is much more attractive to recruit new clients than to collect premiums from old ones. Therefore, one can expect a high lapse rate that will undermine the credibility of insurance among the low-income market.

Another product-related regulatory barrier is the fact that insurance companies cannot underwrite **composite business**, even though it might be an appropriate product structure for the low-income market.⁹ In many jurisdictions, licensing requirements do not allow the formation of composite insurance companies, but require separate companies for life (long-term) and non-life (short-term) business. The protection achieved by not mixing long-term and short-term liabilities is justified for commercial lines of insurance or for policies with large sums insured. However, the same logic does not apply to microinsurance, where policies generally do not go beyond five-year terms, and the vast majority are for one year or less (*see Box 95*).

Box 95

AIG Uganda

AIG Uganda covers many microfinance borrowers, but with a non-life licence, it can only provide accidental death and disability insurance. However, the poor do not differentiate between different types of death. It does not matter whether one dies in a car accident, or from malaria or a heart attack. These microfinance clients want protection regardless of the cause of death. AIG Uganda cannot legally provide life coverage even though most terms are only four or six months (corresponding to the MFIs' loan terms).

Source: Adapted from McCord et al., 2005a.

As regards **suitable types of products for low-income segments**, it appears that group products are the most appropriate. It is unclear whether endowment policies should be recommended for microinsurance clients at all. Endowment policies require a savings discipline that low-income segments often do not have due to fluctuations in their household cash flow,

⁹ Arguments for and against composite or basket covers are presented in Chapter 3.1.

which leads to high lapse rates (*see Chapter 2.2*). Furthermore, endowments may actually be a poor form of savings for these households due to the insurer's high cost structure and taxation requirements.¹⁰

Policy wording requirements are sometimes unsuitable for low-income clients, who are often illiterate (even educated people cannot understand most insurance contracts!). Insurance policies for the poor should be written in very simple language without legalese, so as to ensure that the terms and conditions are easily understood.

In jurisdictions where a **tariff regime** is in vogue, the rates, policies, terms and conditions are standardized either through industry practice or regulation. Although such a regime may appear to have several advantages, it can also hamper innovation and competition, which are particularly important for microinsurance.

2.3 Macro-level barriers

There are other barriers related to policy and legal framework, the implications of which are not yet properly understood, but which are nevertheless worth identifying. Firstly, some jurisdictions may face **over-regulation of the insurance sector in general**. For example, some countries restrict foreign investments in the insurance industry, which makes it difficult to transfer know-how to make delivery of microinsurance products and services more effective and efficient. Furthermore, protectionist policies may require the purchase of over-priced and/or low-quality domestic reinsurance.

Secondly, **overlapping regulations** can create complications for microinsurance design and delivery. For example, in South Africa, a large burial society needs to have a legal personality (registered with the Department of Trade and Industry), be registered as an insurer (financial services regulator), may be supervised by an apex or self-regulatory body,¹¹ and if providing an in-kind benefit (funeral services), be regulated by the Department of Health.

Thirdly, when **governments maintain or launch subsidized insurance schemes**, they do not usually consider whether these schemes could be offered via market mechanisms. An analysis of whether these schemes could be maintained without a subsidy is not carried out. Instead of popularizing the existing schemes, such government action undermines microinsurance

¹⁰ For example, low-income households are often tax-exempt, implicitly or explicitly, while the insurance companies pay corporate taxes on the investment returns, and therefore the return to the policyholder is net of tax.

¹¹ Among mutual institutions, apex organizations often play an important role as regulators, not only in insurance but also in the savings and loans market.

providers as policyholders migrate to the subsidized scheme. As a result, the strains on budgetary resources remain and the subsidies are often not employed or targeted properly.

3 Country experiences – preliminary insights

Despite the wide-ranging and complicated regulatory barriers, there are solutions, some of which are actually being implemented. Several countries have adapted their regulatory frameworks to microinsurance.¹² This section describes the experiences in India, South Africa and the Philippines, which employ different strategies to overcome regulatory obstacles to the expansion of microinsurance.

3.1 India

India's Insurance Regulatory and Development Authority (IRDA) has taken a proactive approach in promoting microinsurance by obliging insurance companies to serve the poor in the hope that this forced familiarity will help insurers see the potential of the low-income market. In what is essentially a quota system, all insurance companies are obliged to underwrite business in pre-defined rural areas¹³ and in the social sectors.¹⁴

The evidence from these quota requirements is mixed. Failure to attain the targets has resulted in financial penalties for some insurers, and repeated violations could cause an insurer to lose its licence. Some insurers perceive the requirements as a cost of doing business and dump poorly-serviced policies on the market. Other insurers like ICICI-Lombard and Tata-AIG now consider the poor to be a viable market opportunity and have voluntarily exceeded their quotas, so the forced familiarity approach could be paying off. The extent to which this quota system is replicable in other countries remains doubtful since it is not in line with market-led policies for financial systems development.

¹² India, Morocco, Trinidad & Tobago, the Philippines and Japan are among the few countries where regulations have been adapted to microinsurance. South Africa has adaptations in progress.

¹³ Rural areas are defined by the Census of India as places which simultaneously satisfy or are expected to satisfy the following criteria: (i) a minimum population of 5,000, (ii) at least 25 per cent of the male working population engaged in agricultural economic pursuits and (iii) a population density of at least 400 per square kilometre (1,000 per square mile). In these areas, life insurance must account for 5 per cent of total policies in Year 1, rising to 16 per cent from Year 5 onwards and general insurance must be 2 per cent of total gross premium written in Year 1, rising to 5 per cent from Year 3 onwards (IRDA, 2002).

¹⁴ The social sectors are defined as "unorganized workers, economically vulnerable or backward classes in urban and rural areas". Here, each insurer has to maintain at least 5,000 policies in Year 1 rising to 20,000 in Year 5, for both life and general insurance. This is regardless of the size of operations (IRDA, 2002).

To assist insurance companies in complying with these requirements, the IRDA has recently issued new microinsurance regulations to actively facilitate partnerships between regulated and unregulated entities (IRDA, 2005). These new requirements are designed to ensure that risk carriers remain supervised, but allow them to explore different distribution channels to extend insurance to the poor.

The regulation creates a new intermediary, the microinsurance agent, which can be an NGO, MFI or other community organization appointed by an insurer to distribute microinsurance through specified persons. Microinsurance agents enter into a “deed of agreement” with the insurer. They abide by the code of conduct defined by the IRDA and attend 25 hours of training (down from 100 hours for conventional insurance agents) in the local language at the expense of the insurer. There is no qualifying examination, as is the case with ordinary insurance agents. A cap is put on commission, between 10 and 20 per cent of premiums per year according to type and mode of insurance payment, which is in excess of what conventional agents would normally earn.

The new regulation also allows for the bundling of life and non-life elements in one single product provided there is clear separation of premium and risk at the insurers’ end. Parameters of the microinsurance product are also regulated (see Table 48) and are subject to actuarial sign-off and “file and use” requirements. Products beyond the prescribed sum insured do not qualify as microinsurance and therefore the licensed agents would require more expertise.

Table 48

Definition of microinsurance in India

<i>Product line insured (Rs.)</i>	<i>Minimum sum of cover (years)</i>	<i>Maximum sum</i>	<i>Term insured (Rs.)</i>
Life	5 000 (US\$113) ¹⁵	50 000 (US\$1 130)	5
Non-life	5 000 per asset	30 000 (US\$678)	
Health	5 000	30 000	1
Personal accident	10 000 (US\$226)	50 000	1

This regulation is seen as an important step towards expanding microinsurance in India. However, critics argue that this regulation is very narrow because it focuses on just one approach, the partner-agent model. They also argue that product details should not be centrally regulated. Since the high-minimum capital requirement for an insurance company (US\$22 million) has not been lowered, there is perhaps insufficient competition among risk carriers. In response to this last point, the supervisor has recommended to the

¹⁵ US\$1 = Rs. 44.25 (Indian Rupee)

government that the capital requirements for health insurance be reduced by half to increase the number of health microinsurance operators.

The new microinsurance regulations show one path to enhancing distribution efficiency, by a partial relaxation of training and remuneration norms and by the bundling of products, without compromising the risk-taking ability of a commercial insurer.

3.2 South Africa (SA)

Microinsurance in SA has been undertaken for many years, just not under that name. The most common form of microinsurance is funeral insurance (often offered under an Assistance Business Licence in SA), which is “a life policy in respect of which the aggregate value of the policy benefits, other than an annuity, to be provided....does not exceed R10,000 (US\$1,500)¹⁶ or another maximum amount prescribed by the Minister”. The Assistance Business Licence then allows uncapped commissions. The Friendly Society Act allows for cover up to R5,000 (US\$750). All other funeral insurance providers have to register under the Long-Term Insurance Act, which requires minimum capital of ZAR 10 million (US\$1.5 million). They can offer funeral insurance for any sum assured, but their commissions are capped (Genesis Analytics, 2005).

Most microinsurance in South Africa is generated by the funeral industry, which has been in the low-income market for some time, but the market is still under-served. The question is how to expand funeral services in a sustainable manner. In this regard, the SA Financial Services Board (FSB), the non-bank regulator and supervisor, faces a significant dilemma. A large proportion of funeral insurance is effectively unregulated since the main providers – burial societies and funeral parlours – are registered under the Friendly Societies Act. The supervisor is concerned about the continued viability and sustainability of this model, and the ability of existing providers to manage their risks in the future.¹⁷ In the event of failure, the insurance supervisor, as well as the insurance industry, would face a reputation risk and market confidence could be devastated. Instead of being reactive, the supervisor, the government and the existing industry are considering proactive steps.

South African supervisors have not intervened as directly as their India counterparts to legalize and promote microinsurance. Rather, they rely on

¹⁶ US\$1 = R6.65 (South African Rand)

¹⁷ Besides revealing the significant scale of burial societies in South Africa (see Box 90), the FinScope Africa surveys of financial services (www.finscopeafrica.com) indicate that informal mechanisms are not ideal: 9 per cent run out of money to pay claims and 4 per cent suffer from fraud. Default rates at these levels among formal insurers may be seen by regulators as a systemic problem, particularly because of the large numbers of people affected (Genesis Analytics, 2005).

the Financial Sector Charter,¹⁸ whereby all financial service providers have agreed to voluntarily serve the low-income market. Consequently, the SA insurance industry has experienced a huge wave of innovation as insurers experiment with new delivery channels to reach the poor, including joint ventures and partnerships with retailers (*see Chapter 4.6*). It is too early to assess whether the new wave of innovation will succeed. At present, less than 1 per cent of SA's poorest 60 per cent have short-term insurance (i.e. non-life), which has to be raised to 6 per cent if the Charter's targets are to be met. To assist companies in meeting the targets, the FSB is responsible for promoting consumer education. Therefore, the FSB has a massive role to play in terms of facilitating, funding, monitoring and coordinating better consumer education.

At present, there is an initiative to create a more level playing field and to remove burial societies and funeral parlours from the Friendly Societies Act to a parallel Cooperatives Act which is more suitable in the SA context. The development of this new tier will comprise a dedicated funeral insurance licence available to all players in the market, with reduced entry and compliance requirements. The new tier should be accessible to both member-based and commercial insurers. Small, member-based burial societies should come under the new Cooperative Bill.

3.3 Philippines

In the Philippines, the insurance supervisor has created a two-tier system, similar to the tiered regulatory environments that have emerged for microfinance. To create a life insurance company under the first tier, it takes Php 50 million (about US\$1 million) and for non-life Php 100 million (US\$2 million).¹⁹ The Insurance Commission (IC) of the Philippines plans to increase the minimum capital requirement for all new insurance players.

The second tier comprises mutual benefit associations (MBA), an institutional form created by the IC under the ambit of the insurance law. Although most MBAs are small and unregistered, once they become significant enough to be "noticed" in terms of volumes and membership numbers, they need to be registered, i.e. licensed by the Commissioner.

¹⁸ The Financial Sector Charter (2003) in South Africa was originally conceived as a transformational blueprint for the financial services industry, i.e. de-racializing the financial sector in terms of its – hitherto predominantly white – ownership, employment and procurement practices; however, it also includes very specific targets for an improvement in financial access. Signatories of the Charter include government, industry bodies and representatives of labour and civil society. In specific terms, banks and insurers have committed to provide certain products and services to lower-income people by 2008.

¹⁹ US\$1 = 52.87 Php (Philippine Peso)

According to the Mutual Benefit Associations Act,²⁰ such associations are subject to supervision and need to have access to an actuary. An MBA must deposit US\$182 as initial capital and continue to contribute to a guarantee fund at least 10 per cent of its assets, up to the minimum capital required for a fully fledged insurance company. MBA licensing and supervision provides some protection for members since the supervision reduces the scheme's vulnerability to fraud and mismanagement. The IC has established a special MBA unit to supervise them.²¹ Nonetheless, in practice, it does not aggressively challenge non-registered MBAs due to its limited supervisory capacity, which raises doubts as to the degree of consumer protection under the current arrangements. Agents of MBAs do not require licences.

One problem with this arrangement is the high income-tax differences between commercial insurance companies and these second-tier institutions, which can be a deterrent to conversion into a first-tier entity. For example, CARD MBA, which provided life insurance to more than 600,000 poor Filipinos in 2004, originally planned to become a fully fledged insurance company. This plan has not progressed, however, due to the high tax burden on insurance companies, even though CARD MBA would have a number of interesting business opportunities as a first-tier insurer.

Although this tax issue is not directly in the realm of insurance supervisors, they are in a position to provide relevant input and convey it to the policymakers. In the present situation, when governments in many countries are looking to promote alternative market-based mechanisms to provide protection for the lives, health and assets of their population, policymakers may find merit in such proposals.

Some MBAs are registered as such to take advantage of more favourable tax conditions (regulatory arbitrage) and some MBAs are not in the best of financial health, possibly due to mismanagement, among other reasons. In recognition of these problems, the IC plans to adjust the MBA regulation in the near future.

4 Conclusions

The starting point for creating inclusive insurance markets is for supervisors to have a mandate to do so. If insurance supervisors are to comply with this mandate and take their market development responsibilities seriously, they need instructions from policymakers to the effect that this is indeed a priority. Such instructions make sense, given the role of insurance in achieving the

²⁰ Chapter VII of the Insurance Act (Sections 390–409).

²¹ In 2001, 18 out of the 32 licensed MBAs (56 per cent) were inspected on-site.

Millennium Development Goals (*see Chapter 1.1*) and the limited resources available for publicly-sponsored social protection benefits (*see Chapter 1.3*).

The major challenge for supervisors is to create an enabling environment for outreach and sustainability of the growing microinsurance market. From the policyholder's perspective, supervisors need to guarantee that the increasing number of semi- or informal microinsurance schemes fulfil their obligations to their members. The protection of poor people's scarce funds is a critical concern.

It is quite difficult to provide this consumer protection while at the same time encouraging innovative solutions to respond to the insurance needs of low-income households. Adjustments to regulatory frameworks are often perceived as being in conflict with prudential principles and risk creating distortions in the market place. Therefore, supervisors have to find a balance that promotes inclusion – which means extending insurance to the huge low-income market while protecting their investments and confidence – without putting an undue burden on supervisors. This is not an easy task.

Since high capital requirements are inappropriate for small microinsurance policies, one solution which needs to be further explored is the risk-based capital (RBC) approach. RBC represents an amount of capital that a company should hold to protect customers against adverse developments based on an assessment of risks. It is typically calculated by applying factors to accounting aggregates that represent various risks to which a company is exposed. Risk-based supervision has become recognized as an international standard, endorsed by the IAIS and the developed market supervisors.

Each jurisdiction has its specific features and there is no one solution that fits all. This is illustrated in the examples from India, South Africa and the Philippines, where each country has adopted a different approach. India compels insurers to serve the poor and has made some critical regulatory adjustments by reforming its broker/agent regulation, which may be the easiest way to stimulate the increased provision of microinsurance. South Africa, on its way to a new framework for microinsurance, is cautiously approaching its enormous informal insurance industry. The supervisor wants to extend consumer protection to those who have informal insurance, but does not want to regulate the schemes out of existence. The solution found in the Philippines is to build on the strength of mutual schemes. The model of the guarantee fund, tied to volumes and not requiring much initial capital, is an appropriate mechanism for providing consumer protection for these second-tier providers.

The revision of agent and broker licensing requirements could be the fastest and easiest way of stimulating increased provision of insurance services, while the creation of a new tier of institutions might be a major step for-

ward, but could require some time and effort. In addition, the emergence of third-party administrators could be important, since microinsurance is a high-volume, low-margin business that requires considerable administrative expertise. It is also useful to consider alternative distribution channels; retailers and cell phone companies – any organization that engages in financial transactions with the low-income market – could distribute microinsurance.

There should be a coherent, principles-based regulatory framework to take into account the different institutional requirements for microinsurance. Such a framework does not necessarily mean a separate law for microinsurance, as in the case of India. It could also comprise amendments to the insurance act, as in the Philippines. Rather than shoehorning all insurers into one common set of regulations, this framework approach requires differentiated rules and regulations for different provider models. In other words, special institutional options for microinsurance are likely to be more effective in enhancing the inclusiveness of the insurance industry than the standard regulation with a single tier.

Microinsurance promotion implies that policymakers and supervisors take concrete steps, while understanding that incorporating microinsurance schemes into the regulated sphere imposes costs on supervisors as well as on the microinsurers, which may have to be passed on to the policyholders. In addition, one has to look critically at the threat that the formalization of informal schemes may result in a loss of social orientation.²²

Good supervision requires insurance-specific technical competence. It is certainly not appropriate to delegate responsibility to other government authorities. In the same line, the capacity of insurance supervisors is a serious consideration. It is unrealistic to promote adjustments to the regulatory environment that will result in an increase in regulated insurers, some of which will need different supervisory approaches, without building up the capacity and resources of insurance supervisors.

A critical question is how to react to small schemes that are not (yet) able to adopt the commercial orientation required for a formalized institution. It is important to define a threshold where formalization is required and where regulation needs to be imposed (Genesis Analytics, 2005). Microinsurance operations up to this threshold would then be exempted from supervision. However, once the threshold is crossed, such entities need to be formally licensed.

²² In microfinance, the data show that the correlation between formalization and mission drift is much weaker than suspected, and was never considered to be a serious problem. This might be partly related to the fact that finding “real commercial” owners was, in most cases, not an urgent necessity for the transforming MFIs due to the many development-oriented investors available.

An intermediate step for smaller microinsurance providers that are too large to operate outside the regulatory radar, but still too weak to apply for a licence for fully fledged insurers, could be self-regulation (market-conduct standards) organized by an apex body. Self-regulation may help the industry to some extent, but can never free insurance supervisors from their responsibilities. This approach would only be feasible in countries with a significant number of providers (Genesis Analytics, 2005).

Microinsurance straddles the boundary between government-provided social protection and market interventions. Consequently, intensive stakeholder dialogue is required to ensure compatibility and cohesiveness of both private and public policies. For example, an insight into the pricing mechanism of insurance schemes subsidized by governments could provide a benchmark showing how such schemes would have worked in the absence of subsidy. In addition, it also provides evidence on the merits of public-private partnerships for ensuring better servicing, lowering costs and subsidies and directing subsidies to the most vulnerable segment of the population. Clear rules need to be defined in terms of accounting and solvency norms to segregate government-subsidized products in an insurer's portfolio.

Finally, for regulatory adaptations to work, there needs to be a significant investment in education at many levels. Policymakers and supervisors have to understand the risks and potential of microinsurance, and therefore know-how transfer and dialogue are primary concerns. Donors and other promoters are also learning and have to be prepared to finance and technically assist supervisors as well as microinsurance providers. Finally, the customers who demand microinsurance services are not well-educated; governments and donors have to assume a role in this area. These challenges have to be dealt with alongside the regulatory and supervision aspects.