



Topics Nr. 18

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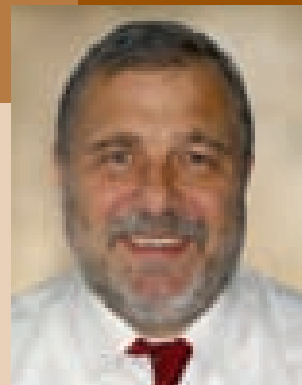
Microinsurance – and Why It Cannot Work

Rainer Schürmann

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“I think there is a world market for maybe five computers.”

Thomas J. Watson, 1943

“640K of memory should be enough for anyone.” *Bill Gates, 1981*

We all know the fate of these two predictions – although Bill Gates claims that he never made such a statement.

In 1976, when Muhammed Yunus started lending small amounts of money to women in a village in Bangladesh, most observers were convinced that his concept had no chance of success. Conventional wisdom held that the rural poor would never be able to pay back the loans. A loan without collateral or other securities? Impossible! Yunus was neither the first nor the only one trying to fight poverty with loans to poor people; however, his model became a huge success. His creation, Grameen Bank, now covers 81,362

villages in Bangladesh, has 8.28 million customers (97% of whom are women) and has issued loans totalling USD 9.4 billion over time, with a recovery rate of more than 97%.¹ Yunus was awarded the Nobel Peace Prize in 2006, and the bank he founded has become a global organization.

Microinsurance is different from microcredit. It really cannot work; there are too many good reasons:

- People who live on a dollar or two a day cannot afford paying for anything more than their daily needs.
- In most cases, they don't know the concept of insurance; paying hard earned cash for a mere promise would not seem enticing.
- Many of these potential clients are illiterate. How could they read, understand and sign a policy? How could there ever be a proper documentation, a basis for settling disputes?

- As much as potential microinsurance buyers wouldn't trust people who take money for promises, insurance companies would be suspicious of an inherent moral risk with people who struggle for their survival every day.
- Products and a credible pricing for the risks at the bottom end don't exist.
- Even if credible pricing were possible, the values at risk or sums insured would be so small that the acquisition and administration expenses would be a multiple of the premium.
- For exactly that reason, the cost of selling insurance to people who not only have no money but also need education beforehand would be unreasonable.
- Individual risk underwriting would not be economically viable.
- Similarly, claims control on an individual loss level simply would not be possible.



- Communicating with many of the potential clients would be difficult. They may live in far-out places with no established roads and talk in local dialects that the insurance agent would not understand.
- Last but not least, there is the issue of premium collection and claims settlement: The poor don't have bank accounts.

The weight of these highly valid arguments has been so overwhelming that microinsurance has yet to become a mainstream insurance business.

Microinsurance – but it actually does work!

This doesn't mean that microinsurance doesn't exist. Putting aside the arguments against microinsurance for a while, we have noticed over the past 15 years an increase in products or arrangements that might be or were labeled "microinsurance".

One of the main drivers of this increase was the growth of the microloan business. In order to protect the lender and relatives or the peer group of the borrower, loans were bundled with a life insurance (or an accident cover with a death benefit only), which was compulsory in most cases. Among the first to go down this route was AIG in Uganda in 1996, a case that has attracted a lot of academic interest over the years.²

Health insurance was an early focus as well. A compendium issued in 2000 by the ILO (International Labour Organisation) lists 130 health insurance schemes that could be categorized as microinsurance,³ and Dr. David Dror, now head of the Microinsurance Academy,⁴ edited a book about the role reinsurance can play in health insurance for the poor.⁵ In health insurance, there is a tendency to combine insurance with state subsidies or donor funding, such as the RSBY scheme in India.⁶

A very different kind of microinsurance is the mutual and cooperative approach that has been a proven way of sharing risks for centuries. While this is not microinsurance per se, many existing microinsurance schemes are built on formal or informal risk-sharing groups that are effectively mutuals. The insurance scheme set up by the Self Employed Women Association (SEWA)⁷ in India is an example of cooperation between an organization of informal workers and commercial insurance. Another example is the accident cover, which is sold automatically with each bag of fertilizer from IFFCO in India.⁸

India is generally a hothouse for microinsurance innovations because licensed insurance companies have a

legal obligation to offer insurance to the "social and rural sectors". Introduced in 2002, this obligation applied not only to the four state-owned insurance companies but also to the infant private insurance companies that were allowed to be active. The companies have to write a certain percentage of their premium or a defined number of life insurance policies from the target customer base.⁹ Not all insurers see this as an opportunity, but some, such as Allianz,¹⁰ have invested considerable effort within the framework of their global microinsurance strategy.

The prospect of 200 to 300 million clients in India alone and, depending upon the criteria used, between 1.5 and 3 billion worldwide has attracted commercial interest beyond the established insurance companies. Leapfrog Investments,¹¹ which calls itself "the world's first microinsurance fund", has just collected USD 112 million to be invested in microinsurance ventures – and to make money from it. There are dozens of websites dedicated to microinsurance, often in conjunction with microfinance,¹² and a snapshot of the microinsurance landscape shows hundreds of products and suppliers, albeit most of them rather small.¹³

So microinsurance is around, and while it is still small and has no obvious development path ahead, the observations collected by



Churchill¹⁴ and the short overview from Lloyd's¹⁵ help us to further understand where we stand.

Doing business at the bottom of the pyramid

Microinsurance is often referred to as insuring the “bottom of the pyramid”. This refers to a wealth pyramid, shaped similarly to the age pyramid where the youngest, or the least wealthy, are the largest group and thus the foundation on which the older, or wealthier, stand. When numbers are presented, target group is between 1.5 and 3 billion people living on less than one or two dollars a day. Let us try to be a little more precise, and look not only at the potential clients, but also at the products and the potential suppliers.

Who, exactly, is the target group?

According to the definition used by the IAIS (International Association of Insurance Supervisors),¹⁶



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“10) ... Microinsurance is insurance that is accessed by low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practices (which should include the Insurance Core Principles). Importantly this means that the risk insured under a microinsurance policy is managed based on insurance principles and funded by premiums ... Microinsurance therefore does not include government social welfare as this is not funded by premiums relating to the risk, and benefits are

not paid out of a pool of funds that is managed based on insurance and risk principles.”

It is important to note that the layer at the very bottom of the pyramid, people with no income to spend at all, is not considered a potential microinsurance client base. Of course, there is no clear dividing line; the IAIS takes great care to include hybrid products, where state subsidies or other donor funds pay a part of the premium, but the overall premium calculation and claims settlement still follow the ICP

(Insurance Core Principles). Subsidies of any kind may also be used to do the necessary research for a microinsurance product or provide initial funding for a microinsurer.

There is also no well-defined cut-off point between microinsurance and “ordinary” insurance. It is probably reasonable to say that individuals who buy standard insurance covers, even if the sum insured is small and the clients have only a little money, are not “microinsureds”. In India, the “rural sector” is clearly defined:

“Rural sector” shall mean any place as per the latest census which has

- a population of not more than 5,000;
- a density of population of not more than 400 per square kilometer; and
- at least 75 % of the male working population is engaged in agriculture.

Any insurance policy sold in such a place helps to fill the rural sector quota. For the purposes of this article, however, only policies specially designed for the low-income population are regarded as “microinsurance”.

Designing products for the poor

Once again, we use the words of the IAIS:

“17) One key difference between microinsurance and other insurance is how it is made accessible to the low income market. The core issue for microinsurance is simplicity. How does one develop a product and its related processes simply enough that people can understand them? Given the huge volumes of small policies, can the administration of premiums and claims be done as efficiently and inexpensively as possible?”

The concept of simplicity, in this context, includes but is not limited to:

- Group policy rather than individual coverage
- Small premium, small sum insured
- Clearly defined benefit, no disputes, no moral risk

- No risk specific exclusions, no individual risk assessment, no underwriting
- Simple, clear wording in local language
- Sold by people who understand the local concerns
- Designed to fulfill local or group specific needs

Furthermore, the insurance provider needs to collect regionally specific data in advance, and must be ready to embark on a “learning by doing” journey, where determinations about

Enabling technology

The two major problems for servicing the rural and informal communities are premium collection and claims settlement. While there have been ways around these problems with microcredit – for example, cooperating with Micro-Finance Institutions or making special agreements with banks – the future for both microcredit and microinsurance will probably lie in the use of mobile phone technology. “Banking for the unbanked” has experienced an extremely rapid

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such factors as risk premium or cost of doing business may be quite different from the original assumptions. Another major obstacle is the wariness of the potential clients, who may take some time to appreciate the value of the promise they get from their insurer.

development. Beginning with enabling remittances from migrant workers to their families far away, it is quickly becoming the method of choice for the population in many countries of Africa as well as in Asia to safely – and at much reduced cost – send money from one place to another.¹⁷ Companies, such as Estel Telecom,¹⁸ are beginning to serve this growing and innovating market at a breathtaking speed.

Microinsurance has yet to benefit from these new opportunities, but with increasing efforts on the supply side, tapping the potential of mobile phone remittances for premium and loss payments has the potential to give a boost to microinsurance innovation as well.

A new view of “risk carrying entity”

So far, we have not covered the biggest questions in microinsurance: how to sell, and what can be successful sales





channels. Bundling life insurance with microloans, and later on, other coverage, or even using the coupon-style insurance IFFCO is selling with its fertilizer bags, is certainly workable, but does this offer the growth potential needed to access the more than 95% of the prospective market that hasn't even thought about insurance? Group policies that are tailor-made for local or group specific needs, similar to what Allianz is offering in India, are an innovative approach, but do they remove all of the obstacles listed above?

A new way of introducing insurance to people who thought they could not get any protection is an adapted concept of mutual insurance. Uplift in India provides not only a good example but presents also a concept of activity.¹⁹ Dr. Dror and other academics²⁰ promote the concept of risk sharing and solidarity within clearly defined local and social groups.

The basic risk is mutualized among members, while the risk of individual severe losses, or catastrophic losses, is transferred to reinsurers. Reinsurers or other organizations provide the know-how to set up an insurance product and its pricing, both evolving over time with experience. And, as Uplift clearly states: "A mutual organization has the capacity to receive donations and subsidies to perform its activities." Here is the possibility to blend commercial insurance with public funds, be it for permanent risk rate reduction or for initial research and establishment of the venture.

Regulating these entities, which are not insurance companies, will be a challenge. By their very nature, they cannot comply with capital and solvency requirements, reporting obligations and so forth. In the aforementioned paper, the IAIS clearly addresses these issues in a

way that encourages its members to be innovative and support the development of such new approaches:

"135) Supervisory authorities should assess how they can contribute to developing and overseeing microinsurance activities while simultaneously continuing to promote safe and sound financial systems"

"147) The identification and management of risks in the microinsurance environment are just as important as in the traditional insurance environment. It might be costly to expect a specialized microinsurer to have comprehensive risk assessment and management policies/systems in place. Therefore, guidance could be useful in facilitating supervisors to play an enabling role by way of setting the minimum requirements and prescribing procedures and processes for prudential risk



assessment and management processes for insurers who offer microinsurance products which can be easily complied and monitored.”

Among other nations, the Philippines, South Africa, Kenya and Ghana have already enacted provisions that enable and promote microinsurance schemes established by mutual associations.²¹ In most other places, such as India, these risk carriers have so far been unregulated, but regulators are determined to rise to this formidable challenge.

A whole new insurance landscape?

We know insurance as a business where the “law of large numbers” counts – many instances of the same cover, sold by rather large insurance companies through agents or brokers, to affluent and more or less sophisticated clients. As reinsurers, we are used to deviations at the top end; where there are fewer risks and higher exposures, and where very large and sophisticated buyers form captive brokers, captive insurers or reinsurance companies



that simply retain large parts of the risk or form risk retention groups.

In the future, we will also have to get accustomed to distortions at the bottom end. In addition to simplified or adapted standard insurance products, we will see a lot of diversification. Small mutuals and cooperatives will be formed and carry most of the risk themselves. Reinsurers will be asked to provide capacity for severe and catastrophic losses, but also share their know-how and provide input for the products and services to be offered. Other organizations, such as MFIs, CARE International, the Microinsurance Academy and similar groups, will be active to help such ventures to set up shop. NGOs or national social welfare will

offer to inject money to support the start or the ongoing operation. Once such mutuals are established, they will form umbrella organizations that can and will leverage their buying power with reinsurers. Insurance and reinsurance brokers, who don't see the money in this field yet, will set up departments specializing in the bottom sector. All this will come along with improved and extended benefits for those who don't have access to insurance today.

It is probably not a question of if, but rather when this will happen. As established suppliers of insurance and reinsurance capacity, we will need to prepare for the challenges about which we only have a vague idea today.





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The people behind the promise.

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