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Certified Expert in Microinsurance

Unit 1: Introduction to Insurance and Microinsurance

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Abbreviations

AFI	Alliance for Financial Inclusion
BC	Before Christ
CGAP	Consultative Group to Assist the Poor
CSR	Corporate social responsibility
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
EU	European Union
FASECOLDA	Federación de Asegurados Colombianos
FENACOR	Federação Nacional dos Corretores de Seguros Privados e de Resseguros
FMO	Entrepreneurial Development Bank
FUNENSEG	Escola Nacional de Seguros
GDP	Gross Domestic Product
GDV	Gesamtverband der Deutschen Versicherungswirtschaft e.V.
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IETS	Instituto de Estudo do Trabalho e da Sociedade
IFC	International Finance Corporation
ILO	International Labour Organization
IRDA	Insurance Regulatory Development Authority
KfW	Kreditanstalt für Wiederaufbau
KPI	Key Performance Indicators
KYC	Know Your Customer
MFI	Microfinance Institution
MNO	Mobile Network Operators
NAFTA	North American Free Trade Agreement
NGO	Non-governmental organization
OECD	Organisation for Economic Cooperation and Development
PACE	Product, Access, Cost, Experience
PPP	Public Private Partnerships
RSBY	Rashtriya Swastya Bima Yojana
WTO	World Trade Organization

Learning Outcome

Understanding the concept of insurance and its economic and social role in development is a prerequisite to the study of microinsurance in particular. This unit will introduce the key features and main players.

Introduction and Overview

In this first model we will give an introduction to the concept of insurance, how it works, how it evolved and its economic and social role. This first chapter of Unit 1 shall provide you with a sound foundation for your study of the special topic of microinsurance throughout the rest of this course. The second chapter will introduce you to the subfield microinsurance and is based on the assumption that microinsurance is not separate from insurance in general, but rather an integral part of it. The historical evolution of microinsurance as part of microfinance programmes in developing countries is described and recent statistics illustrate growth trends.

Furthermore, the typical growth path of a developing insurance market and the important role of microinsurance are introduced. The discussion of real cases serves to illustrate the presented material. Additionally, special attention is given to long run profitability for the provider in a market that is characterised by small premiums and low levels of funding. Large scale and cost effectiveness are paramount elements. The unit concludes with the topic of consumer protection and elaborates on three key elements: a strong regulatory framework, responsible industry conduct, and empowerment of the consumer.

1. Insurance

1.1 Introduction

Risk and the insurance mechanism

Whether we are aware of it or not, risk pervades our lives. We are threatened every day by events that can have severe social, human or financial consequences: property damage, natural disaster, sickness, disability, accidents in their countless forms, and of course death. As a result humans instinctively seek security, often right after the most basic needs like food, clothing, and shelter. Risk arises from the possibility of losing economic security and usually stems from the likelihood of unexpected and adverse outcomes. The best we can hope for is to diminish the consequences and thus ease our fear of such events occurring. Insurance addresses these two fundamental and the interconnected human emotions of fear and hope.

The following saying illustrates well the inextricable relationship between risk and insurance: "*If risk is like a smouldering coal that may spark a fire at any moment*, *then insurance is our fire extinguisher*". Insurance in this context can be understood as any attempt to control and diminish risk, i.e. from the informal reciprocity obligation of a tight community that helps each other out in hard times, to the highly formalised and commercial insurance sector. In its most obvious expression, insurance eases the financial burden of sudden adversity and loss for individuals and businesses in the form of monetary compensation or services. For people and businesses this can sometimes mean the difference between financial security and destitution or bankruptcy. Think of the following examples: providing for a family after the breadwinner dies, seeking medical help without fearing the expense, assisting a homeowner in rebuilding his property after a fire or flood, protecting both consumers and manufacturers against a defective product.

Some definitions for insurance:

A promise of compensation for a specific potential future loss like damage, illness, or death in exchange for a periodic payment.

Insurance protects individuals from risk of uncertain outcomes. It is a two-party contract that transfers the risk of financial loss from an individual or business to an insurer.

Insurance is a social device for spreading the chance of financial loss among a large number of people.

How insurance works

At its most basic and fundamental level, the insurance mechanism involves individuals or entities that form a group of policyholders. They pay a fixed amount at regular intervals (premium) into a common pool, from which money is drawn (claim payment) to compensate one or more policyholders, who are victims of a predefined event under specific circumstances. Normally, only a small percentage of policyholders suffer losses and thus, the entire pool compensates the unfortunate few. Essentially, insurance preserves the original social goal of risk sharing and also the human dimension, trust and individual responsibility of mutual assistance, while reflecting the development and growing complexity of society. Insurance companies also defer risk through reinsurance, through which a company insures the risk of insurance companies, thus allowing the insurance companies to offer higher levels of protection to the policyholder, since they do not have to worry about covering the full losses.

The fundamental concepts of insurance for it to work are:

- **risk pooling** to distribute the risk of adversity to hit over as many policy holders as possible;
- **mathematical probability calculation** to assess the likelihood of an adverse outcome to occur; and
- **large and reliable data** is paramount for accurate calculations.

Here are some basic key concepts you might already be familiar with. Please review them and use them as a glossary throughout the course:

Figure 1: Basic key concepts of insurance

Key Concept	Definition	Example
Adverse selection	An imbalance in an exposure group created when persons who perceive a high probability of loss for themselves seek to buy insurance to a much greater degree than those who perceive a low probability of loss.	The tendency of those in dangerous jobs or high risk lifestyles to get life insurance.
Insurance density	Total premium/total population	Insurance density is calculated as the ratio of total insurance to total population.
Insurance penetration	Total premium/ GDP	Penetration rate indicates the level of development of the insurance sector in a country. Penetration rate is measured as the ratio of total premium underwritten in a particular year to the GDP.
Law of large numbers	This law states that when a large number of people face a low-probability event, the proportion experiencing the event will be close to the expected proportion. For instance, with a pool of 100,000 people who each face a 1 percent risk, the law of large numbers says that 1,100 people or more will have losses only one time in one thousand.	Car insurance, which aggregates widely varying risk exposures in terms of gender, age, type of car, driving habits and experience, etc., has relatively reliable statistics with regards to frequency and severity of accidents.
Moral hazard[1]	The risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles.	Insurance companies worry that by offering payouts to protect against losses from accidents, they may actually encourage risk-taking, which results in them paying more in claims. Insurers fear that a "don't worry, it's insured" attitude leads to policyholders with collision insurance driving recklessly or fire insured homeowners smoking in bed.
Probability theory	Probability theory is a branch of mathematics to predict random events by analysing large quantities of previous similar events. The	Probability theory allows for an insurer to calculate the premium to insure a potential risk based on the probability ratio that it occurs.

[1] investopedia.com

	probability ratio expresses the likelihood that the event will occur.	
Reinsurance	Reinsurance is insurance purchased by insurers from re-insurers to limit the total loss the insurer would experience in case of a disaster.	In cases like natural catastrophes or a plane crash it is evident that a risk can cause a loss amount which no single insurer could bear and which therefore renders risk reinsurance absolutely indispensable.
Risk	Risk is a form of uncertainty about outcomes that are expected to have a potentially adverse effect on an individual or an entity.	The risk to die from the Ebola virus is very high compared to the risk of dying from a plain cold. The undesired outcome here is death. It can be quantified in terms its financial repercussions to survivors for example.
Risk pooling	To distribute the risk of adversity to hit over as many policy holders as possible and thereby diminishing the singular impact on one individual or entity.	If many household nationwide insure against the damage of a hurricane occurring, the individual financial impact if it would occur is marginal because very few will actually be affected. The premium in this case is the cost of pooling one's own risk with that of others via an insurance company and includes the insured's share of expected claims costs, administrative expenses, sales and marketing expenses, and a profit for the insurer.
Risk transfer	A risk management technique whereby one party pays another, usually an insurer, to assume a risk that the insurer is better equipped to deal with than the actually affected party.	When someone purchases home insurance, he is essentially paying an insurance company to take the risk involved with owning a home. In the event that something does happen, such as property damage from a fire or natural disaster, the insurance company will be responsible for dealing with any resulting consequences.
Underwriting	Underwriting is the practice of calculating risks and determining a premium based on client data and probabilities.	Typically insurance companies are in the business of underwriting.

1.2 The Historical Evolution of Insurance

The insurance mechanism is an intrinsic part of society and social behaviour. It has been around for a long time, and it is fascinating to see how it developed over millennials and in many different societies. Obviously, the need to protect ones livelihood and mitigate the impact of uncontrollable risks has always been a prime concern of mankind. Below is a brief history of insurance with some important milestones of the last 5,000 years.

China

3000 BC

The earliest recorded descriptions of insurance date back to the third millennia B.C. Chinese merchants divided their goods evenly among several ships, so that each boat carried a mix of cargo, and not just that of one merchant. In case of a shipwreck a slight loss for all occurred instead of a crippling loss for one — the principle of pooling risk.

"Hammurabi Code"

1790 BC

Around 1790 B.C., the Babylonians enacted the "Hammurabi Code" which was one of the first forms of written insurance laws. The law allowed merchants to finance their shipping through loans from lenders. These loans were paid back, with interest, only after the safe arrival of the goods. But, if the merchandise was lost in transit, they did not. Thus, it offered basic insurance in that a debtor did not have to pay back his loans if some personal catastrophe made it impossible (disability, death, flooding, etc.). Similarly, also first signs of liability laws were found in the so called "Codex Hammurabi": “If a builder builds a house for a man and does not make its construction firm, and the house which he has built collapses and destroys property, he shall restore whatever it destroyed, and he shall rebuild the house which collapsed from his own property.”

From Ancient Rome to Guild Coverage

Classics to the Middle Ages

In ancient Rome we see people joining together in burial societies "collegia funeratica" that paid funeral costs out of monthly dues. Although these associations began as purely religious groups, they gradually became broader in scope as the benefits of the sharing principle became steadily more apparent. Health and burial insurance evolved extensively under a mutual plan without profit considerations in the Anglo-Saxon and German guilds of the middle ages. As successors to their Greek and Roman counterparts, the guilds combined the characteristics of trader associations, unions and fraternal societies. Members had to pay dues to the guild and the wealthier ones had reserves that acted as a type of insurance fund. If a master's practice burned down, for example, the guild would rebuild it using money from its coffers. Similarly if a master were robbed, the guild would cover his obligations until money started to flow in again. In case of sudden disabled or death, the guild would support him or his widow and family.

This safety net encouraged more and more people to leave farming and take up trades. The insurance used by guilds is still existent today in the form of "group coverage”.

Rennaissance

Shipping insurance in Italy

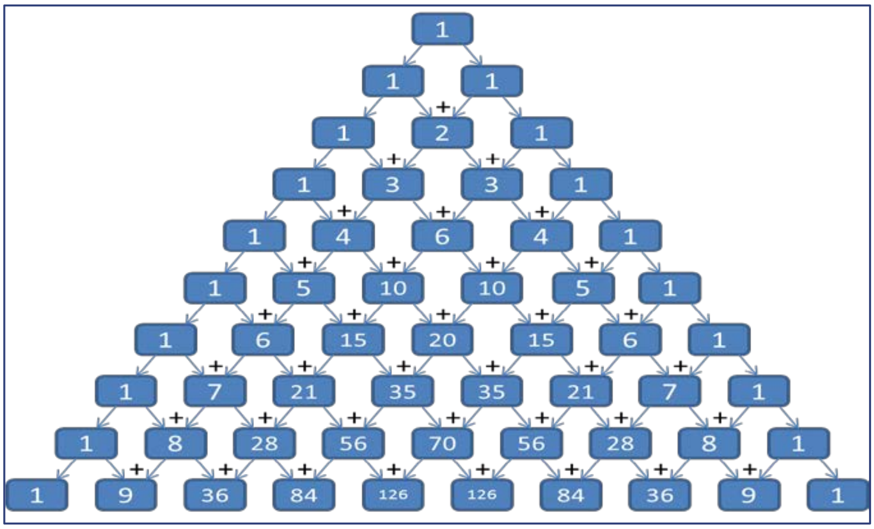
The very first insurance contract was signed in Genoa, Italy, in 1347. Its principles were similar to ancient Babylonian ones. With a written agreement merchants could take out loans guaranteeing safe arrival of shipments. For the first time these were stand-alone and separate from investment. In the next century maritime insurance developed widely and premiums were intuitively adjusted with risks.

17th century

Colonial trading in England: Lloyds Coffeehouse

In the late 1600s, shipping was just beginning between the New and the Old World as colonies were being established and exotic goods were ferried back. A coffeehouse, Lloyd's of London, was the primary meeting place for merchants, ship owners and others seeking insurance. It is there, that the practice of underwriting emerged, i.e. in London coffeehouses operated as the unofficial stock exchange for the British Empire. Once a voyage was secured, the merchants and ship owners would go to Lloyd's and hand over a copy of the ship's cargo to be read to the investors and underwriters, who gathered there. The people interested in taking on the risk for a set premium would sign at the bottom of the manifest beneath the figure indicating what share of the cargo they were taking responsibility for (hence, underwriting). In this way, a single voyage would have multiple underwriters, who would try to spread their risk as well by taking shares in several different voyages. As Britain established itself as a leading economic power through the exploitation of the slave trade, the shipping industry was at the heart of this economic boom. As slave trading was a high risk trade (1,053 slave vessels are recorded as having been lost between 1689 and 1807) the insurers of Lloyd’s also were in high demand. Lloyd’s continued to grow and insurance moved from being desirable to essential in just a few centuries. If you were in shipping you needed marine insurance.

Figure 2: Probability calculation



In 1654, Blaise Pascal, a Frenchman discovered a way to express probabilities and, thus, calculate levels of risk. Pascal's triangle led to the first actuary tables that were used when calculating insurance rates. These calculations formalised the practice of underwriting and made it possible for insurance companies to anticipate the likelihood of claims, and this made the business of insurance reliable and profitable.

London's Great Fire: the introduction of fire insurance

17th- 19th century

In 1666, the great fire of London destroyed around 14,000 buildings. Over 70,000 of London's 80,000 inhabitants lost their homes in this tragic blaze. It was from the shock and devastation caused by this fire that underwriters, who had dealt exclusively in marine insurance, started to offer fire insurance, a first form of property insurance. Similarly, as a result of large fires in German cities, mandatory fire societies were founded to protect against losses as for example in 1676 in Hamburg. Also in the U.S. great fires in New York (1835), and Chicago (1871) called attention to the need for adequate reserves to meet unexpectedly large losses through fires in dense urban areas. Mandatory reserves and reinsurance, whereby losses are distributed among many companies, developed as a result, in order to respond to a potential claim of this magnitude. Interestingly the insurance industry has often responded to disasters with innovative products, such as flood protection, climate change, renewable energy, and terrorism to name a few.

Birth of modern insurance

By 1693, the first mortality table was created and life insurance was introduced. In the U. S., however, insurance had a slow arrival due to religious prejudices and the particular dangers of colonial live that no insurance company would cover. Only in 1735, the first insurance company in the American colonies was founded at Charleston, S.C.. It took more than 100 years for insurance to establish itself. When it finally did, it brought the maturity in both practice and policies that developed during that same period in Europe.

Two phenomenon of the late 17th and 18th century in Europe mark the birth of modern insurance as an independent economic sector:

- the development of distinct insurance types
- the founding of actual insurance companies

From mutual assistance to insurance

As described earlier in the chapter, people have often pursued risk protection by grouping themselves in communities (e.g. families, villages, trade organisations) and paying into a common fund from which any member suffering a misfortune could draw. These systems of mutual assistance are still common in some developing countries, where there is no formal insurance mechanism and people rely on traditional values of kin solidarity, family support, craft or trade organisations.

Mutual assistance schemes, however, have a decisive shortcoming: the members of the communities present a similar exposure to similar risks and are usually limited in numbers. Family members often fall sick together or within a very short time frame; or, fire in a factory will put all workers out of work and under financial strain at the same time. Weather patterns exist across regions and a flooding will devastate most people who live there. In these cases, the common fund is not enough to cover all individual losses. The pool of participants is too small and the risk is not transferred but only shared among a small and homogenous group that experiences the same exposures. It therefore does not protect reliably enough against the effect of the very hazard that the community was attempting to control. This is where the importance of insurance companies comes in. Insurance companies can much more effectively calculate and spread risk over a large and diverse pool. Today insurance companies have therefore largely replaced mutual assistance programmes.

Insurance in modern times – the rise of social protection schemes

By the late 19th century, however, governments began to initiate national insurance programmes against sickness and old age. Germany built on a tradition of welfare programmes in Prussia and Saxony that began as early as in the 1840s. In the 1880s, Chancellor Otto von Bismarck introduced nationwide old age pensions, accident insurance and medical care that formed the basis for Germany's welfare state and was eventually implemented in some form all over Europe. The key structural principles of the system are solidarity, benefits-in-kind, equal financing by employees and employers, self-administration and plurality. Insurance companies thrived in Europe, especially after the industrial revolution. Statutory health insurance for example, is one of the five branches of German social insurance and originally stems from Bismarcks 1883 social laws.

In the box below you can find a summary of the most important features that characterize social insurance schemes:

Principal elements of social insurance:

- social insurance is financed by **contributions which are normally shared between employers and workers**, often with **state participation** in the form of a subsidy;
- participation is **compulsory**, with few exceptions;
- a **person's right to benefit is secured** by his contribution record without any test of need or means.

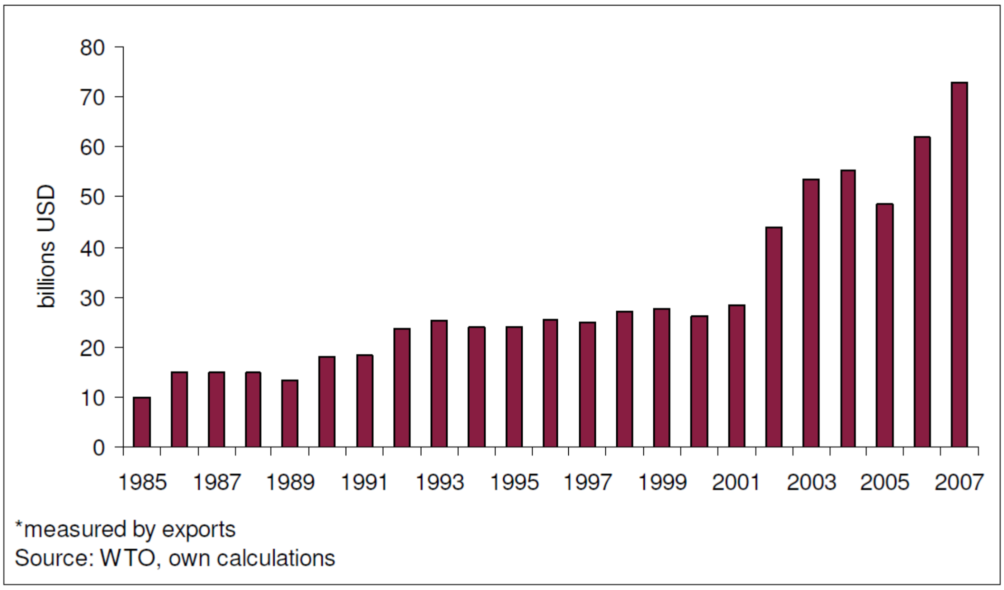
Source: ILO: Social Protection

Insurance and globalisation

Insurance and the insurance industry has grown, diversified and developed significantly ever since. Insurance companies were, in large part, prohibited from writing more than one line of insurance until laws began to permit multi-line charters in the 1950s. From an industry dominated by small, local, single-line mutual companies and member societies, the business of insurance has grown increasingly towards multi-line, multi-state and even multi-national insurance conglomerates and holding companies. The chart below illustrates the increasing global scope of insurance services.

Figure 3: Global scope of insurance services

Worldwide trade in insurance services*



Source: *GDV/WTO: Globalization of insurance markets: Present situation and trends in the German market, 2011*

The insurance sector is deeply tied to trends in globalisation. The outcomes of trade agreements, environmental problems, global health pandemics, volatility in financial market, terrorists attacks and security problems, and basically any worldwide trend, will impact individuals, companies, and governments, all of whom own insurance policies. The reduction of legal barriers to cross-border activities of financial services companies, the opening-up of new markets to foreign providers (e.g. Eastern Europe, China, India) and a deregulation of many national markets have played a key role. The internationalisation of the insurance market has also been favoured and propelled by multilateral agreements, such as the WTO, EU and NAFTA. Last but not least technological developments like the internet have of course changed how insurance is sold and administered.

Summary
According to Figure 1, since the 1990's, we have predominantly seen the following major developments which continue to be important trends also for the future:

- **Concentration and centralisation among financial service providers to form transnational financial groups:** e.g. mergers between small and medium insurance companies or banks.
- **New insurance products,** e.g. increasing insurer participation in

pension insurance and reduced participation of governments; new insurance products against political, military, climatic, and informational risks.

- **Technological innovation,** e.g. internet sales of insurance products and mobile phone applications.

Increasing liberalisation of insurance markets worldwide has facilitated international sales volume.

1.3 The Socio-Economic Role of Insurance

1.3.1 Protecting Citizens

As we will explain further below, insurance is of value to society in several ways, but foremost its goal is to protect the citizens and in consequence lend stability to society.

Enhancing personal financial security and peace of mind

Enabling families and businesses to remain financially stable in the face of adversity has many positive spill overs and facilitating effects:

- It can help maintain a decent standard of living and quality of life after retirement in the case of certain life insurance products and long-term care insurance.
- It can prevent business interruptions that could otherwise lead to bankruptcies, which cause job loss and economic hardship for employees and their families.
- Financial security offered by insurance removes the risk of destitution if someone falls ill for any length of time or their house burns down.
- Also commercial entities that are exposed to claims for damages benefit from insurance when they face liability claims for defective products. If a business were unable to transfer this risk to an insurer by taking out insurance, the company would need to reserve capital for potential liability claims resulting from a defective product. The company would, therefore, have less capital available to invest in new technologies and product innovation. In this way, insurance supports economic growth by taking on risks, which normally the commercial entity would need to bear.
- Insurance may actually lower the total risk the economy faces since insurers have incentives to measure, price and manage the risks to which they are exposed, as well as promote risk mitigation activities. Insurers develop expertise in measuring

risks because it determines the calculation of the premium as well as the necessary reserves. By charging a premium that reflects the underlying risks it acts like an "invisible hand" and provides signals in the form of incentives and disincentives. A concrete example is the "bonus-malus" system in motor insurance. It has a concrete impact on drivers' behaviour because prudent behaviour is incentivised and risky behaviour and losses are at a higher cost to the insured.

- Insurers also give risk management advice and services to individuals and companies in order to promote risk averse behaviour and hence lower the risk they face themselves (e.g., health insurances engage in health education and preventive measures to have a healthier pool of clients, that cost less in health expenditures).

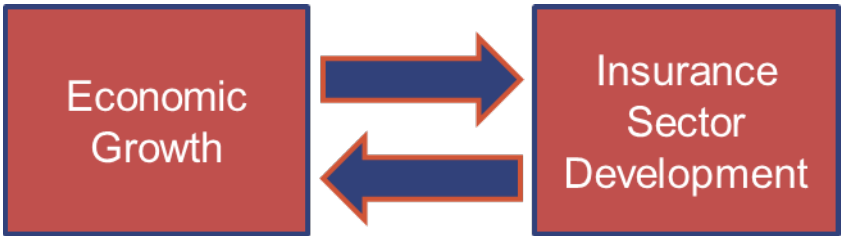
1.3.2 Promotion of Economic Stability and Growth

The insurance sector plays a critical role in financial, economic and social development. It contributes to economic growth by facilitating investment and promoting more efficient economic activities through the provision of risk-mitigating tools. Insurance can protect against uncertainty and severe losses among the population and therefore gives peace of mind in a critical area. Furthermore, higher risk economic activities with a low frequency of occurrence but that offer higher returns can be mitigated through insurance and, hence, become engines of growth. Agricultural insurance, for example, allows farmers to invest more in production and better seeds because insurance helps them to mitigate the potentially devastating consequences of adverse weather during crop seasons. Similarly, insurance facilitates lending and commercial transactions by protecting the lender against loss of money and the borrower against bankruptcy (such as life insurance connected to business loans or mortgages).

Insurance and economic growth: the empirical link

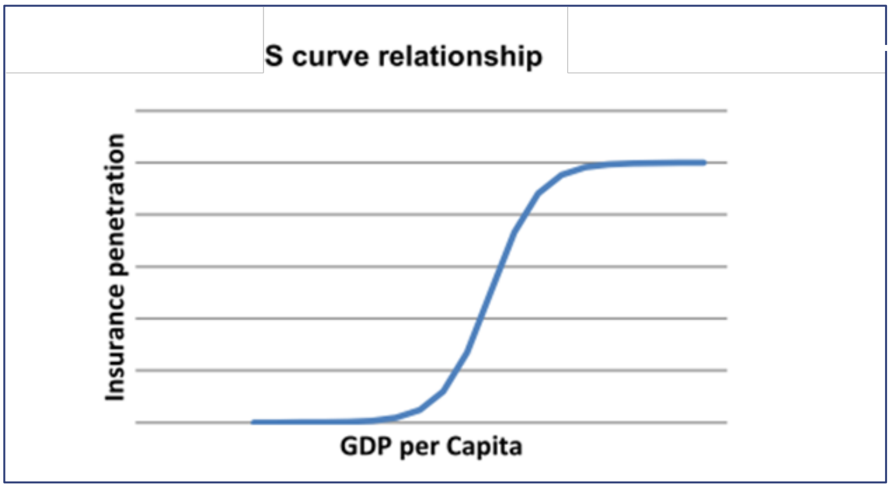
It has been proven that there is a reciprocal relationship between insurance market size and economic growth. There is a circular relationship between insurance sector growth and economic development, i.e. the growth of one facilitates growth of the other.

Figure 4: Interrelation of Economic growth and insurance sector development



Not only that a growth of the insurance sector in developing countries is to be expected as their economies expand (as individuals and business seek to manage their new risk exposures) but also that an increase in the presence and availability of insurance should be actively encouraged in order to stimulate economic growth. Empirical studies have highlighted this positive correlation between insurance development and economic growth. As countries become wealthier the demand for non-life insurance increases. This means that a country with a higher level of income would be expected to have a higher level of non-life insurance coverage. It is well documented amongst insurance related literature that insurance penetration follows an S-curve relationship against GDP per capita.

Figure 5: S curve relationship



Also Marco Arena (2006) of the World Bank drew on data from 56 countries for the 1976-2004 period to find equally strong evidence of a causal relationship between insurance market activity and economic growth. And similarly a study by the National University of Singapore[2]

[2] Harichandra, K, Thangavelu, S.M: Institutional Investos, Financial Sector Development and Economic Growth in OECD Countries, National University of Singapore, 2004

proves the significant impact of institutional investors on stock market development and economic growth in OECD countries.

Supporting trade and enhancing entrepreneurial activity

As we have learned earlier, insurance for the shipping industry dates back thousands of years and for a good reason. Economic activities that pose higher risk, however with a low frequency of occurrence, but offer higher returns can only flourish if the risk of failure is shared i.e. mitigated through insurance for example. The case from the shipping industry below illustrates how insurance facilitates trade and other entrepreneurial activities that carry a high risk of loss.

Example: Insurance for the shipping industry

Company A has a shipment worth USD 1 million of crude oil by boat to transport to Europe. If the chance of loss (through pirates, war or storms for example) on each trip is 3 percent, the loss will be USD 30,000 (3 percent of USD 1 million), on average. Let us assume that company A can also transport the oil by pipeline which is safer, but also more costly. Pipeline transportation would cut the risk by one percentage point, thus saving USD 10,000, on average. If the additional cost is less than USD 10,000, it is a worthwhile expenditure. But if cutting risk by a further percentage point will cost USD 15,000, it sacrifices resources.

To deal with the remaining 2 percent risk of losing USD 1 million, company A should consider taking out insurance. To cover administrative costs, the insurer might charge USD 25,000 for a risk that will incur average losses of no more than USD 20,000. For company A, however, the insurance may be worthwhile because it is a comparatively inexpensive way to deal with the potential loss of USD 1 million.

The important economic role of insurance here is: without insurance, the company might not be willing to risk shipping the oil at all.

The insurance industry facilitates banking activities

By protecting the lender against loss of money and the borrower against bankruptcy (e.g. life insurance connected to business loans or mortgages) insurance facilitates lending and commercial transactions. If someone wants to take out a loan to buy a house, he usually is required to also buy life insurance, as a guarantee for the bank in case he dies and cannot pay back the outstanding money. Most of the life insurance products sold in emerging economies are credit life policies, typically mandatory and covering the outstanding balance of a loan in case of the death of a borrower.

Insurance stabilises financial systems

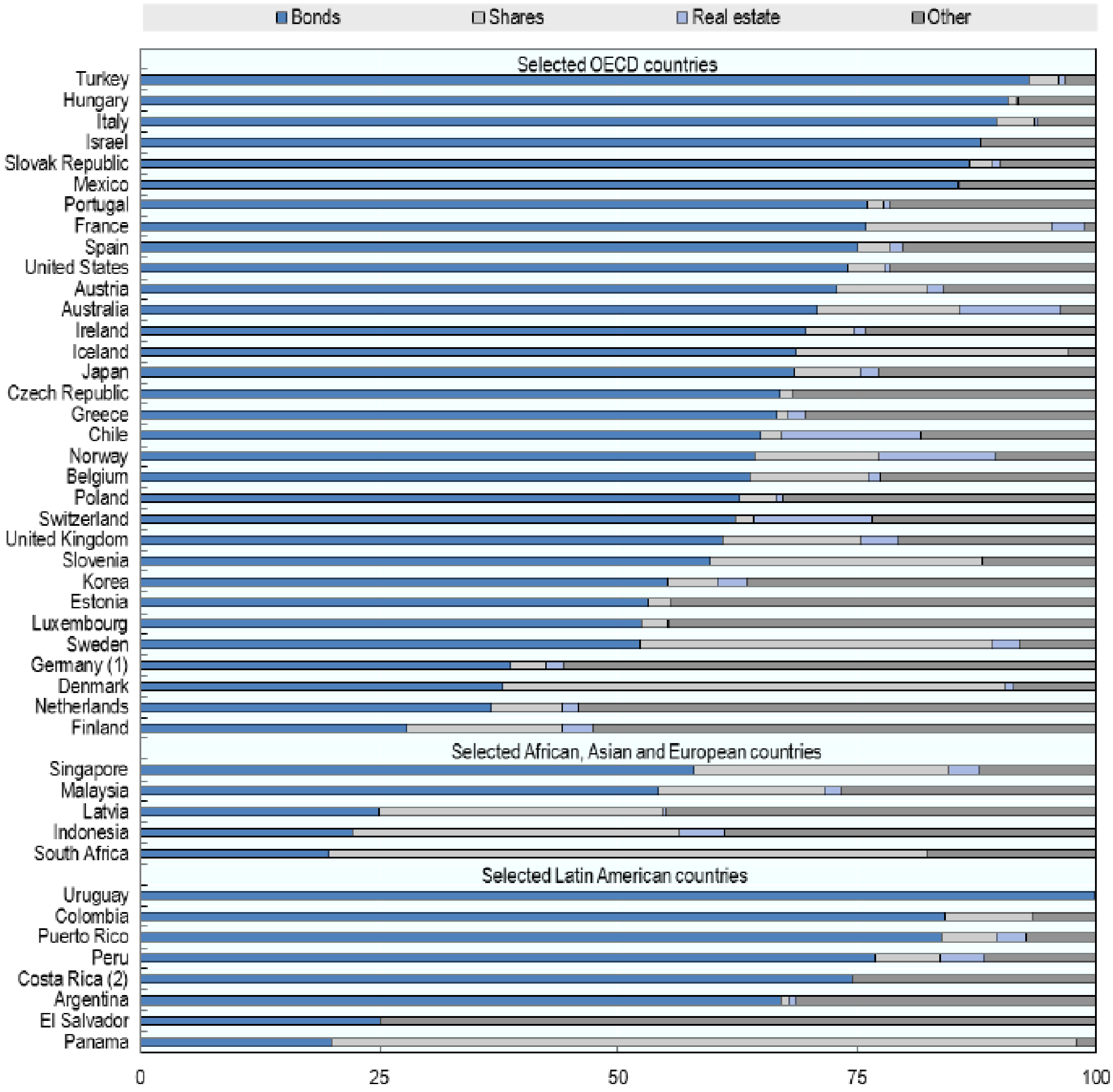
Insurance companies also play a considerable role in stabilising financial systems. They collect upfront premiums which give them strong liquid cash-flow without requiring wholesale funding. In particular, long-term insurance policies enable insurers to act as stabilisers to the financial system because they typically need to invest collected premiums as reserves for future claims payments. By accumulating large pools of capital invested in real and financial assets, insurers foster capital formation and can play an important role in infrastructure financing. Over time the role of insurers as investors and financial intermediaries has grown and continues to do so. In fact the insurance sector is now one of the largest institutional investors in the world with invested financial assets of an estimated USD 24 trillion, representing 12% of global financial assets at the end of 2011. Life insurers hold almost five times the financial assets of nonlife insurers and roughly three quarters of insurance investments are held in Europe and the United States.

Where do insurers invest their funds?

The graphic below shows that in most countries insurers invest heavily in fixed-income securities, namely government and private bonds. In the life sector, the share of bonds is higher than in the nonlife and composite sectors because long-term bonds allow for a better matching of assets and maturities with the long-term liabilities of life insurers.

Investment Portfolio Allocation: Life Insurers (2013, % of total)

Figure 6: Investment portfolio allocation: Life insurers (2013) (as a % of total investments)



Source: [OECD: Global Insurance Market Trends, 2014]

1.3.3 Insurance in Support of Social Security Systems

Securing the future of aging populations

In many countries social security systems exist that are administered by the government and cover the whole or large parts of the population. One of the first such systems as we saw was installed under Chancellor Bismarck in Germany. Many countries have national retirement or health insurance plans. The pressure on financing these social security systems, however, has been increasing considerably due to an aging population and a reduction in birth rates.

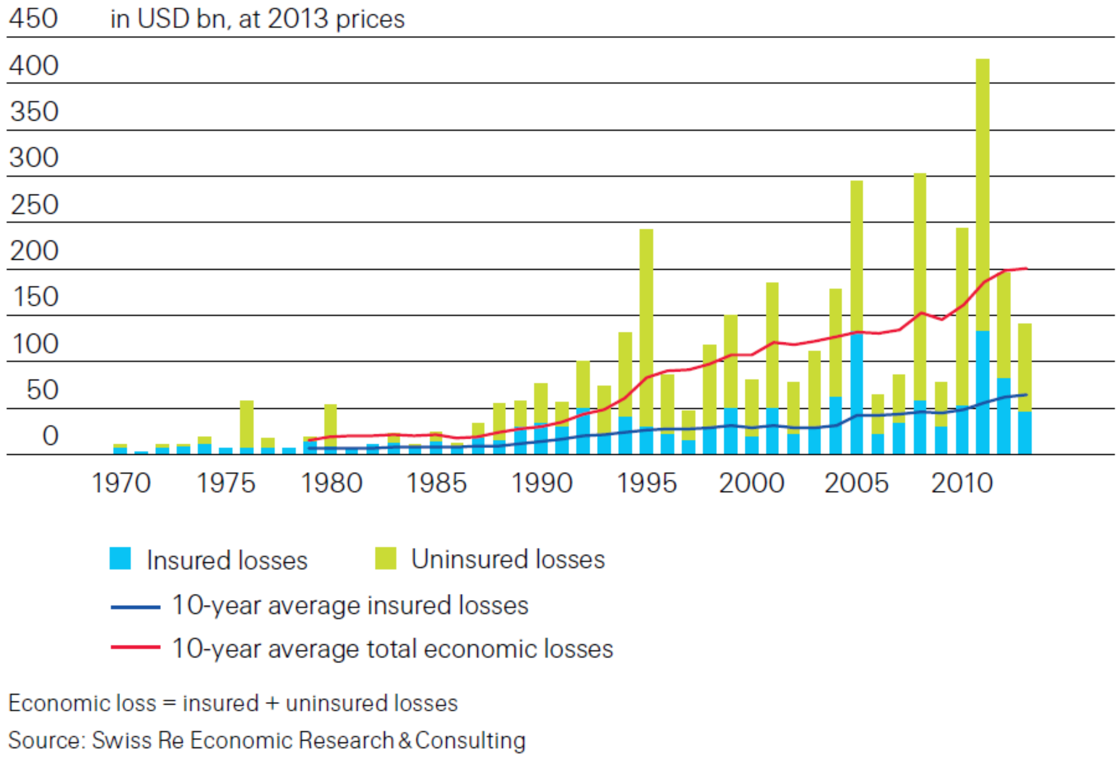
However, the insurance sector can play a critical role in supplementing social protection, as fiscal pressures mount due to a changed population structure. For example, life insurance, private pension schemes and retirement annuities can all supplement national insurance coverage. Such schemes can be mandatory and in this case serve to reduce the government's pay-as-you-go social security systems and provide an alternative route for individuals to prepare for their retirements. The role of insurance, therefore, goes far beyond its role as financial investor and supporter of economic growth. Already now, but increasingly so in the future, the effectiveness of the intergenerational contract will need to rely on insurance as one of the providers of "savings products", complemented by a mitigation of longevity risk, for the retirement age. At the moment, market penetration of these products is still low so that the insurer is not only the provider but also takes a role in creating awareness of the solutions available.

1.3.4 Some Challenges of the Future

Throughout its history the insurance market has been shaped by the risks people encountered. The demands of the early shipping industry facilitated the first transportation insurance policies and property insurance grew out of the experience of the devastating fires in London and the rest of Europe. The insurance industry continues to adapt to the changing and evolving risks we face in the world we live in.

Catastrophes and climate change

Figure 7: Natural catastrophes and man-made disasters: Insured vs. uninsured losses 1970-2013



Source: Sigma: Natural catastrophes and man-made disasters, Swiss Re, 2013

As you can see in the above chart, natural catastrophes and man-made disasters have been increasing over recent decades and correspondingly, also the costs to insurers have been rising. The reason is not only global warming and its consequences, but also a mix of complex socio-economic and demographic trends: e.g. migration of populations to flood-prone areas like coastal cities, increasing reliance on vulnerable electric power grids, and rising material wealth are among the many drivers.

These factors are accompanied by changes in the incidence and impacts of extreme weather events and sea-level rise, both attributed to global climate changes. As a consequence, natural catastrophes result in ever more significant damages. When a natural disaster strikes, the dense population and asset concentration leads to losses, which can severely impact a country's economy and population. Not only private and commercial property is damaged, but also infrastructure such as roads, harbours, and telecommunication, energy networks, which has an immediate effect on the economy. Insurance cover allows for quick reconstruction and reestablishment and, therefore, stabilises the economy as a whole. Similarly to climate related disasters, insurers also experience rising losses under political risk policies in these regions, as civil unrest and conflicts over food, water resources, and refugees manifest in the wake of natural disasters.

Insurance operations in developing and transition economies are the most markedly affected by climate change and most forms of insurance are vulnerable to its harmful effects, including property, liability, health, and life. Understanding the nature and impact of climate risks in advance is extremely effective in minimising the impact of disasters. The insurance industry is increasingly working on improving loss prevention and technology development in the areas of natural disaster risks, drawing on its massive expertise acquired over the past. The spectrum ranges from developing digital hazard maps, hazard-resilient property to supporting public hazard mitigation programmes. As we will see in the later chapters, microinsurance can contribute significantly to disaster risk management in developing countries. It has been designed to be affordable for the underprivileged and aims to support poverty-stricken households.

Even though the southern hemisphere is hit the hardest by the impact of disasters, it is important to understand that by extension, insurers from industrialised countries share these disaster related losses through their growing expansion into these emerging markets.

Cyber risks

With the ubiquitous development of the internet over the past 15 years the new, vital threat of digital risk has emerged. Internet and networked technologies have changed many aspects of how business operates. While the benefits of using Internet-based and other technologies are numerous, so are the inherent risks, creating exposures that were unheard of two decades ago. These include:

With Internet-based technologies, "i-exposures" are largely intangible, the result of human error, or deliberate malicious attacks and crimes. There are many far-reaching potential liabilities for businesses, including: operational risks, financial risks, intellectual property risks, legal and regulatory risks, and reputational risks. Recently there are a growing number of cyber risk products and solutions becoming available.

Terrorism

The terrorist attacks on September 11, 2001, against the United States raised a fundamental question about the responsibilities of the public and private sectors in reducing the risks of terrorist attacks and in providing adequate financial protection to victims of catastrophes. Also recent years have seen major terrorism events in London, Madrid, Mumbai, Moscow and elsewhere. In addition to increases in instances of terrorism, there has been a substantial rise in political instability which has forced risk managers to reassess their approach to threats of terrorism and politically-motivated civil unrest. Normal insurance policies had not covered the often devastating damages caused through terrorism and they were also often beyond the scope of the insurers financial capability. However, to provide commercial entities with the cover they require, a small standalone terrorism insurance market developed which since has evolved in both size and capability.

Chapter 1 – Exercise 1

Which of the following statements are true?

1. Insurance is a fairly recent concept of the 20th century.
2. Insurance can be defined as a promise of compensation for a specific potential future loss like damage, illness, or death in exchange for a periodic payment.
3. Insurance penetration is closely connected to economic output and generally follows what is referred to as an S-Curve. Insurance penetration is slower at lower levels of development, accelerates as the insurance market and the economy develops, and then slows again as the market matures.
4. Climate change affects only the insurance sector of developing countries because the majority of natural disasters are happening in the southern hemisphere.
5. Insurance activity lends stability to financial systems because of the large sums of up-front premiums it collects and then invests in assets and infrastructure.

Solutions: Please refer to chapter 5.

Chapter 1 – Exercise 2

How does insurance facilitate entrepreneurial activity? Review the list of possible answer and think of two or three additional examples. If you find it helpful, feel free to make up a story of a fictitious low-income client

Solutions: Please refer to chapter 5.

2. Distinction between Traditional Insurance and Microinsurance

Initial Scenario

Ama,

Age 38, female, with family
Experienced with microcredit and relies heavily on traditional savings habits
Egypt

Ama lives in a small village on the countryside near Cairo with her husband Hemu and her three children Edfu, Nassor and Layla (6, 8 and 14 years old). Hemu works from time to time on construction sites in Cairo. She takes care of the children and the processing of their piece of land, and she takes care of their animals. They do not need the milk, and she sells it to her neighbours. Sometimes Hemu also takes some to Cairo to sell there. Thank God they have enough to eat and a little money each month.

Since some months, Ama saves USD 10 per month in a product of a local insurance company. They put the money aside for emergencies. If they need more money in a month, they are able to make a withdrawal. In better times, they are able to pay it back into their contract. They can also pay extra money into the contract if they have more money.

With the contract, they also enjoy insurance coverage. If for example Hemu is not able to go to work because of health reasons, then Allianz pays for their further contributions, until Hemu is healthy again. If anything should happen to Hemu or Ama, they get paid by Allianz an insurance sum. With this amount they can pay the funeral and spend a little on their home budget. If they should have more luck and they pay three years into their savings contract without any claims, then they can obtain an education insurance policy for their children and continue to save money for the future.

2.1 Microinsurance

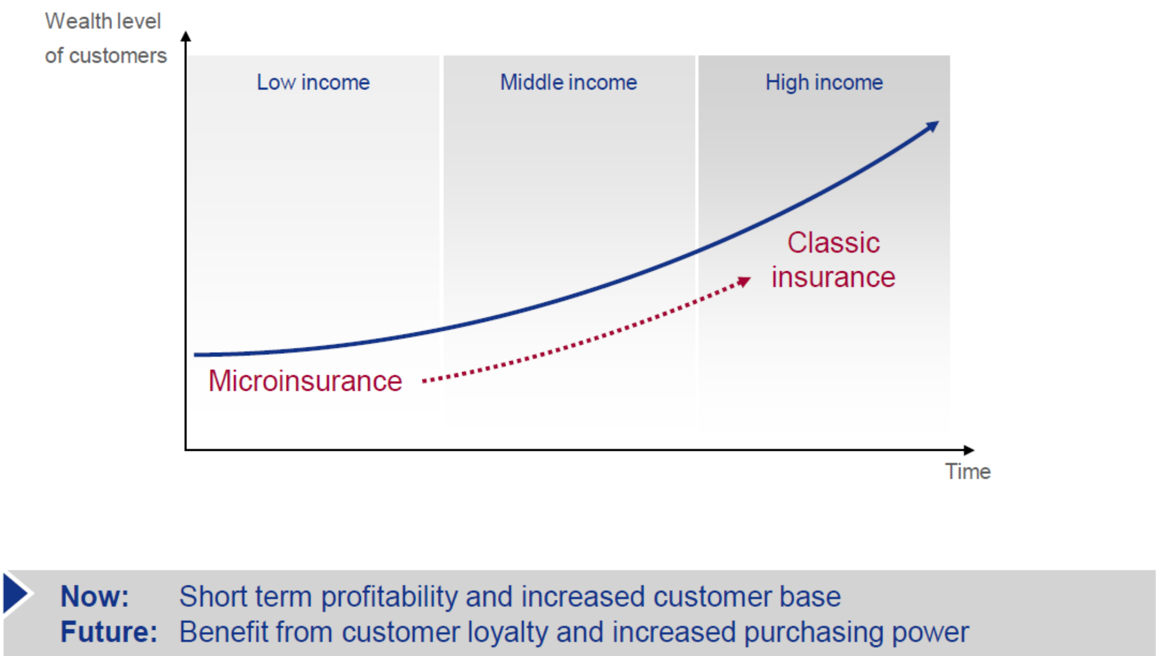
In the last section, we reviewed the history and development of insurance, which reaches back nearly 5,000 years ago. We have seen how insurance evolved from simple risk pooling mechanisms for merchants into schemes that cover a wide range of risks from property to health to accident and disability. We learned how insurance has protected individuals, their businesses, or their property and discussed the greater socio-economic impact of insurance. We saw how insurance has a stabilising impact on nations and promotes economic growth and commercial development. In short, insurance has played a vital role in the development of many advanced economies.

All of the positive attributes of insurance also hold true for microinsurance. Indeed, microinsurance has a great deal of potential to serve low-income clients and provide them with a risk reduction environment in which they can begin to prosper and advance. Microinsurance can complement the efforts of banks, MFIs, and cooperatives, who are working to increase financial inclusion.

But, what is microinsurance and what makes it different from “normal” or conventional insurance? What do we mean when we speak about risk reduction for low-income populations?

Microinsurance is merely an outgrowth of the insurance sector. Its key distinction is that it focuses on low-income clients. This distinction though is important because it is the basis for designing insurance solutions (now, we are back to the term insurance) that are customised for the needs and requirements of lower income classes. As the graph below shows, there is no break or separation between insurance and microinsurance. They are related - a part of the same continuum.

Figure 8: Relation between insurance and microinsurance



Source: Microinsurance at Allianz Group: 2012 Full Year Report, 2012

Yet, in our course and in practice the term microinsurance exists as a standalone business model. It has developed as such in order that new, innovative ways to approach insurance could be created to meet low-income client requirements. In the following sections, we begin to explore how and in which ways microinsurance distinguishes itself from conventional insurance. We will review broadly the following questions in order to understand better the distinctions between microinsurance and conventional insurance.

1. What is the historical context and definition of microinsurance? Did microinsurance start at a particular time? When did the term first appear?
2. How does microinsurance distinguish itself from traditional insurance? What are the unique product qualities? Is there a particular sales or distribution strategy?
3. Why is microinsurance relevant? How does microinsurance impact low-income clients?
4. What is the recent history and evolution of microinsurance? Who were the major contributors to microinsurance?

In sum, we will learn that microinsurance has its own client specific requirements, features and characteristics. We will see that these elements are critical to achieving a sustainable business model and to access effectively low-income clients. We will be able to appreciate how microinsurance differentiates itself from traditional or conventional insurance propositions; yet remains a part of the overall insurance sector's value proposition.

Value proposition

A value proposition is a clear message or statement that explains what benefits or advantages a consumer will receive by acquiring a product or service.

In financial services, the intangibility of the product makes a well-articulated value proposition extremely valuable. As insurance products often have the reputation of begin complex and intangible, sales forces (e.g., insurance agents, loan officers) need to understand what the key product benefits are and should be trained to articulate these in a simple manner. End-clients on the other hand require support and education on insurance and must be aided to capture how the product will improve their lives and that that of their families and businesses. Value propositions are relevant to product positioning by preventing mis-selling of the product and minimising client dissatisfaction.

In the later units on client analysis and product development, we learn exactly how value propositions can impact microinsurance in particular.

2.2 Microinsurance – A Historical Context and Definition

Historical context

Let us begin by taking a short historical tour.

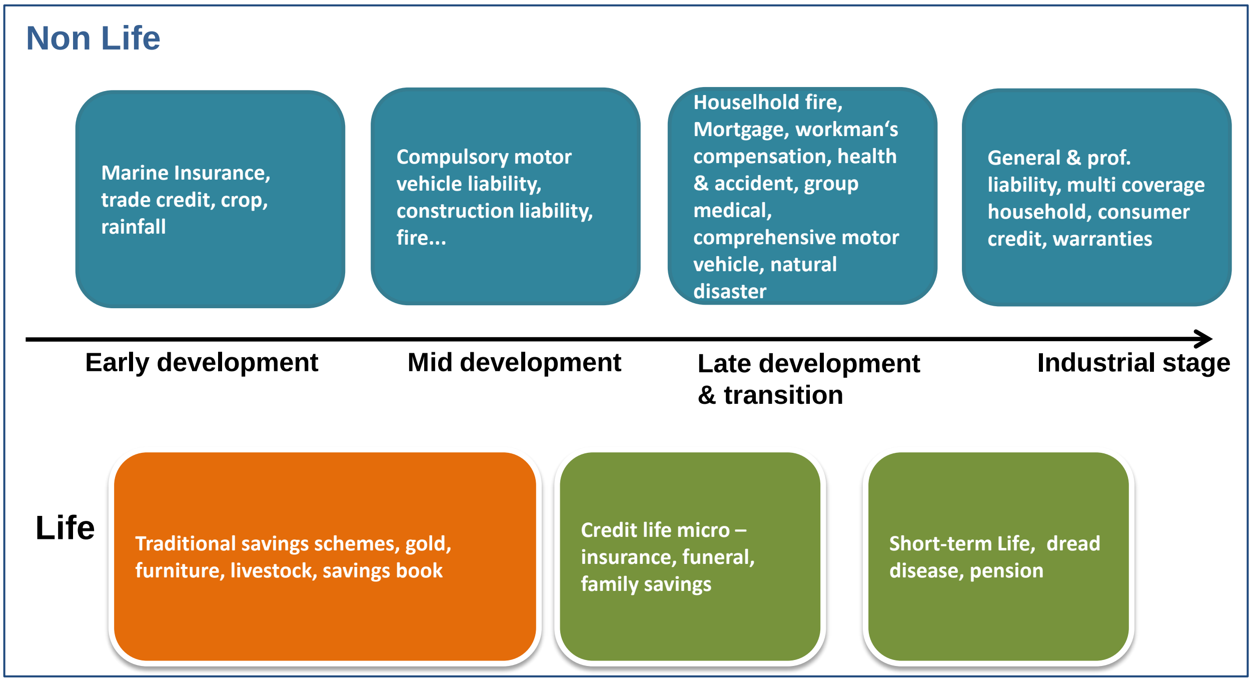
Small insurance policies have existed as early as the 19th century, when industrial life and mutual protection schemes were offered. At this time, no particular attention was paid towards defining a separate type of business approach for these small policies. These policies were simply integrated into existing schemes.

Mutual insurance companies grew out of a history of pooling risk for agrarian communities. With time, cooperatives and credit unions established insurance companies and offered policies to their small business owners as well. Micro-oriented business models have existed for quite some time; however, they were not given any particular or specific attention from the core business.

In individual markets, non-life and life insurance schemes continued to develop through an evolutionary process, passing first through an early phase, followed by a mid- and late-development transition until an industrial stage was reached. Large projects were first covered then until ultimately individuals in the wider population received risk reduction solutions. The term "microinsurance" however was not used. Small policies were rather integrated into the existing product offers and not distinguished. This view continued through most of the 20th century with no particular attention paid to the need for a more customised and differentiated product design, marketing or distribution strategies for low-income clients.

The graphic below shows microinsurance as an integrated part of the insurance developmental process and that is first appeared after markets passes through an early and mid-developmental phase. At this juncture, the insurance sector reaches sufficient institutional capacity to sustain a low-premium, low-margin product offer and expand its offer to low income clients and microenterprises. However, the industry often avoids steps to create a unique microinsurance business line and rather as the historical context indicates they continue to integrate small policies into the existing product offers.

Figure 9: Insurance development process



Source: Rodney Lester: The Insurance Sector in the Middle East and North Africa, November 2010

Microinsurance defined

For many years, the term microinsurance was not used. Microinsurance did not make its debut, until the late 1990s, following the success of the microfinance sector. Within increasing success, MFIs sought mechanisms to reduce their loan portfolio risk and looked for instruments to achieve this goal. MFIs first began to offer credit life insurance policies that insured the loan in the event that the borrower died and provided the family too with a level of protection in this event. In many cases, such policies were made a mandatory loan requirement and drove awareness of how insurance could be directed to low-income populations. As insurance awareness grew among low-income populations, MFIs started the process of linking savings and insurance, which has resulted in the development of life savings solutions, particularly among MFIs not legally allowed to mobilise savings. With time, low-income clients have started to demand a wider range of products to cover livestock, health and property-related risks.

The first official use of the term "microinsurance" appeared in 1999 in David Dror's publication "Micro-insurance: Extending Health Insurance to the Excluded". In his publication, Mr. Dror describes "micro" as "the level of society where the interaction is located, i.e., smaller than national schemes and "insurance" refers to the economic instrument.[3]

[3] *Ingram, M, et. Al: Defining "Microinsurance": Thoughts for a Journey towards a Common Understanding, Molly Ingram and Michael J. McCord*

This introduction launched a new phase in the development of insurance for low-income clients. It threw a spotlight on the question of whether a small policy is a "micro" policy or whether any differences existed. Donors and NGOs became very involved at this stage and helped to sensitise and educate both the industry and the public on the need for a distinction between conventional and microinsurance. Microinsurance was seen as a way to supplement existing social protection schemes in developing countries or to make up for a lack of such services. Initial projects concentrated in Latin America, Africa and Asia.

Microinsurance – Is it universal?

Quite often discussions among experts are limited to the applicability of microinsurance in Africa, Asia and Latin America, where the risk coverage gap among low income clients is deep. However, we would like to challenge this concept. Our opinion is that microinsurance is universal and exists wherever small, affordable policies are needed. Microinsurance knows no national or continental boundaries and can be useful in developed as well as emerging economies. For example, in the United States where social protection schemes, particularly for retirement or health, have been limited, the application of microinsurance in and the lessons learned from developing countries could be quite helpful in developing low-cost insurance schemes for American living close to the poverty line.

In the last decade, countless microinsurance definitions have emerged. Consensus on one definition has not been reached and a variety of opinions are circulating. The difficulty with arriving at one view on microinsurance is that conditions from country to country vary, and microinsurance becomes relative to the unique challenges faced by local populations, the distribution infrastructure, the level of urban versus rural populations, etc. Therefore, we would like to make you aware of this challenge and expose you to a range of views and note in the paragraph below some of the more widely accepted definitions of microinsurance. We follow this summary with a brief assessment of each definition.

Microinsurance – Selected Definitions

1. The protection of low-income people against specific perils in return for regular premium payments proportionate to the likelihood and cost of the risk involved (Preliminary Donor Guidelines, 2003).
2. A risk transfer device characterised by low premiums and low coverage limits, and designed for low-income people not served by typical social insurance schemes (Micro Insurance Academy, India, 2007).
3. Insurance that is accessed by the low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practices. Importantly this means that the risk insured under a microinsurance policy is managed based on insurance principles and funded by premiums (International Association of Insurance Supervisors, 2007).
4. A mechanism to protect poor people against risk (accident, illness, death in the family, natural disasters, etc.) in exchange for insurance premium payments tailored to their needs, income and level of risk (ILO's Microinsurance Innovation Facility, 2008).

Source: *Microinsurance Network: Brief history*

Definitions – An Assessment:

- The **Preliminary Donor Guidelines** definition of microinsurance captures correctly the need of low-income individuals to protect themselves from specific perils or risks; however, the definition indicates that low-income individuals would do so in return for regular premium payments. It is rare that low-income clients would prefer regular premium payments due to the irregular income of low-income households.
- The **Micro Insurance Academy** captures the low-income client's requirement for risk transfer in exchange for low premiums and low coverage limits. However, the definition limits coverage to those not covered by social insurance schemes. As we learn in the coming units, microinsurance schemes are also offered in countries with existing social insurance schemes and are used to provide additional protection to vulnerable populations.
- The definition provided by the **International Association of Insurance Supervisors** focuses on the need that microinsurance policies are based on insurance principles yet the definition does not provide clarity on what risks or what types of product design would be appropriate and thus limits the scope of this definition to regulatory requirements.
- The **ILO Microinsurance Innovation Facility's** definition encompasses many aspect of what will be covered in this course and points to a number of different risks that can be

> covered and that the product itself should be tailored to the client's needs, income and level of risk. This definition is quite holistic in its view of the client and the product interaction and as such provides a very good base for understanding microinsurance.

The variety of definitions and the current lack of consensus among practitioners on microinsurance again highlight how new this sector is as a standalone business. We would therefore now like to turn your attention to where we believe the greatest difficulty has been. A recent discussion paper of the Microinsurance Centre indicates that much of the discussion amongst experts has been on the difference between taking a purely qualitative description of microinsurance versus a purely quantitative definition.[4] Let us review these distinctions together.

Qualitative definitions of microinsurance describe the product in relation to the clients. Donors in particular favour this approach as a means to focus on the objective of poverty reduction. They would like to concentrate on the consumer definition in order to ensure that certain segments of the population remain in focus. In these definitions, consumer terms are used to describe the product as for example in the definition provided in the Preliminary Donor Guidelines for Supporting Microinsurance (see above). The clear emphasis is to describe the client in terms of being low-income, with a need for low premiums, flexible payments schemes, paperless enrolment and innovative distribution. The definition is broad and can be transported from one developing economy to the next. While reference points are all accurate and absolutely distinguish microinsurance from conventional insurance; it is however very difficult for a government regulator to implement such a programme without some level of specificity as to who is being targeted and what type of parameters a microinsurance product should have.[5]

As a result, quantitative factors are being introduced to describe what a microinsurance policy is. These descriptions assist regulators to promote regulatory policies targeted at the introduction, implementation or oversight of microinsurance. Quantitative definitions can be found in many emerging markets, e.g., Brazil, India, Mexico, the Philippines, Peru and Taiwan. In Brazil, the regulator has chosen to distinguish "popular or mass insurance" from microinsurance by more precisely defining it as:

"…insurance protection provided by licensed entities within the country against specific risks, which aims fundamentally to preserve the socioeconomic, personal and family situation of the low-income

[4] *Ingram, M, et. Al: Defining "Microinsurance": Thoughts for a journey towards a common understanding, pg. 3, 2011*

[5] *idem*

population by means of premium payments which are proportional to the probability and cost of risks involved, in accordance with the legislation and globally accepted insurance principles."

Source: SUSEP, Superintendencia de Seguros Privados

Further, Brazil defined the low-income population for microinsurance using references to monthly per capita income based on the national minimum wage. In Peru, the legislation on microinsurance (2007) is even more detailed and sets specific monthly premiums, not greater than USD 3.30 with coverage not exceeding USD 3,300. Additional requirements include no deductibles, co-payments, or exemptions, claims payments should be transacted within 10 days of filing and complaints for non-payment of claims should be settled within 15 days.[6]

The challenge for our purposes with using purely quantitative definitions is that these are not easily transportable across nations. Premium size depends on national GDP and per capita income, minimum wages may not exist, claim processing and handling of customer complaints depends on infrastructure. We therefore take the view of the Microinsurance Centre and the ILO (Churchill 2006, Microinsurance Compendium) that a definition for microinsurance should combine both quantitative and qualitative elements.

We see microinsurance as predominantly aimed at the world´s low-income population, especially those in the informal economy, who is underserved by mainstream financial services. Microinsurance provides policyholders resources to adjust following a critical event. Microinsurance covers a range of risks at affordable premiums, with flexible payment mechanisms and distribution channels. Microinsurance helps families avoid devastating risk coping measures, including having children work, selling productive assets or eating less.

In sum, the distinction with conventional insurance can often be blurred and difficult to make; therefore, it is useful to see how different countries have coped with defining microinsurance with both quantitative and qualitative aspects in mind.

Ingram, M, et. Al: Defining "Microinsurance": Thoughts for a journey towards a common understanding, 2011

Lester, R.: The Insurance Sector in the Middle East and North Africa", 2011

[6] *Iravantchi, S., et. Al,: Microinsurance in Brazil, Colombia, Mexico, and Peru, IDB, 2012*

2.3 Microinsurance – Key Differences between Microinsurance and Traditional Insurance

Microinsurance distinguishes itself from conventional or traditional insurance in that its focus is to provide low-income clients with a reasonable amount of risk coverage in return for reduced premiums. However, as we saw with the definitions of microinsurance, grey zones make it difficult to distinguish between what is regarded as conventional insurance and what we view as microinsurance. Further, the rise of mass retail insurance products that distinguish little between client groups has perhaps driven marketing costs down but has made it more difficult to take a customised approach towards low-income clients. In the following section, we review key differences between microinsurance and conventional insurance and provide you a more tangible base with which to distinguish the two. Later we will see how these differences play a central role in marketing and distribution strategies.

Similar to conventional insurance, microinsurance covers a range of risks including death, illness, accident, property, unemployment, crop failure or loss of livestock. Most risks covered by conventional insurance are mirrored in the products of microinsurance. Over time, risk providers have been expanding the range of microinsurance product offered on the market. We will take a closer look at the variety of microinsurance products in the unit on product development. But for now, we would like to highlight key differences.

Microinsurance differentiates itself from conventional insurance only in the amount and type of coverage, simpler administration procedures, and the types of distribution mechanisms that are employed. Some key differences between conventional insurance and microinsurance are captured in the table below for quick reference.

Figure 10: Key differences between conventional insurance and microinsurance

Conventional insurance	Microinsurance
Limited eligibility with standard exclusions	Broadly inclusive, with few if any exclusions
Regular premium payments requiring banking transaction	Premiums accommodate customers irregular cash flows. Cash payments or alternative possible
Usually minimum of 12 months	Period of coverage can be as short as 4 months
Screening requirements may include medical exam	Limited declaration of good health
Priced according age / risk	Community / group pricing
Agents / brokers are primarily responsible for sales	Distribution channel may manage the entire customer relationship including premium collection and claims payment
Market is largely familiar with insurance	Market is largely unfamiliar with insurance

Source: Adapted from [Tomchinsky, G.: Introduction to Microinsurance: Historical Perspective, ILO, 2008]

As we see above, there are differences in the conventional insurance and microinsurance approach. Microinsurance products tend to have less restrictive eligibility requirements, are designed for irregular income streams, have broader pricing criteria, and are available for purchase at places where the client spends time. Typical microinsurance features include a simple product design, low and flexible premium payments schemes, premium holidays, transparent claim processing, ease of enrolment, clear documentation, efficient processes and trust. Let's go through these together below.

Key Microinsurance Features

Simple product design: Microinsurance products minimise complexity to the client. Insurance products are often considered to be non-transparent and difficult to comprehend. Microinsurance attempts to provide the client with a product that clearly states the risk to be covered and does not overly complicate the product design by including coverage for multiple risks. Unlike more developed economies, where products reached their height of complexity (e.g., variable annuity life schemes) right before the 2008 financial crisis, microinsurance has tended to remain simple.

Flexible payment schemes, short duration and liquidity: Due to irregular or seasonal income streams, low-income clients require insurance products, which can be paid in either instalments or which allow for premium holidays. Additionally, as liquidity is of high importance due to unforeseen emergencies (e.g., illness, death, or resettlement), clients appreciate products that allow for loans on premiums paid. Most products have durations of under one year (e.g., disability for mine workers in South Africa) but no more than 3-5 years, particularly for life savings products (e.g., wedding or educational savings). This flexibility increases the attractiveness of the insurance product and makes it more accessible for all types of low-wage earners.

Transparent claims processing: Low-income client segments often struggle to understand what risks are covered for a particular product. Sometimes products are mis-sold due to an untrained sales force. These issues mostly surface when clients process a claim for a perceived risk event. At this time, clients may file claims that are not valid. They do so because they did not understand the original coverage. This of course leads to disappointment and reputational damage as clients share their experience. Further, risk providers or their distributors have failed to provide adequate explanations for why filed claims fail to meet product requirements. In other cases, missing documentation slows down claim processing times. A transparent and simple claims process is very important to retaining client trust and ensuring that client satisfaction remains high. As we will see in later units, some organisations have overcome these challenges by better educating their sales forces, reducing or simplifying claims documentation requirements and/or communicating more rapidly with clients in a more client-oriented manner.

Trust: By far, one of the most important features that distinguish microinsurance from conventional insurance is the significance of trust and its effective transmission to the end-client. One commonality among various markets whether in Asia, Africa or Latin America is the demand for hands-on and face-to-face communication between the provider or intermediary and the client. This type of communication can be quite costly as it requires a larger sales and marketing presence; however, it has often proven indispensable to acquire and retain low-income clients. We will see in the unit on alternative distribution methods how some organisations attempt to combine new technologies that are more cost effective with financial literacy measures that build trust. Our opinion is that the human factor and presence will remain a critical success factor to those engaged in microinsurance.

As we see, microinsurance products differ in a number of categories. They adapt their design, their distribution and marketing and client servicing to the profiles of low-income clients. At this stage, it is important to remember how microinsurance products distinguish themselves. In further units, we detail further the above features and show how different organisations have delivered customised solutions to low-income clients.

2.4 Relevance of Microinsurance

Microinsurance, similar to conventional insurance, plays a stabilizing role in society. Microinsurance reduces everyday risks facing a significant portion of the population in emerging and developing markets. Human resource and economic capacities are thus freed-up and can be applied to improving the socio-, economic and / or political situation of low-income populations.

Rather than relying on the generosity of neighbours, charity or borrowing money at high interest rates, families with insurance can receive claims payments for an insured event. They can bridge an accident or injury, rebuild a business destroyed by fire, or continue to plan for important traditional life events. As chapter one revealed, through insurance risk reduction, lives are not disrupted, and destitution is avoided. Economic output is better assured, and the spillover effects of financial insecurity, hunger or criminal activity (e.g., theft) are reduced.

Life Savings Plans – Stabilising impact on families

A family breadwinner, for example, can insure against certain risks in the event of his or her death and ensure that savings capital is employed as intended. In many countries, savings for children's education or for a future wedding ceremony are important life events. But, what happens if the breadwinner passes away or has an accident and can no longer work? Does this mean that the child will no longer have future educational opportunities or that a traditional marriage ceremony cannot take place? Of course, it could mean this in the instance of an uninsured event. The family would no longer have the resources and savings capacity would be diverted for other family needs. Microinsurance, however, provides the family in the case of a life savings plan with the possibility of saving and should there be a death or injury certain guarantees and pay out dependent on the product design. In this case, the family will not have to forfeit important educational or life opportunities for their children. The family is able to progress.

Example: Positive microinsurance factors

Gabrielle Tomchinsky lists four factors, which functional microinsurance schemes can impact positively:

1. financial inclusion;
2. social protection;
3. commercial development; and
4. macroeconomic stabilisation.

Source: *Tomchinsky, G.: Introduction to Microinsurance: Historical Perspective, ILO, 2008*

Let us review these factors in more detail and see how microinsurance can be relevant to societal development. At the end of this section, we will also add a comment on traditional savings and risk reduction methods as we recognise that many families in developing economies rely on such methods. We will show how microinsurance can complement these age-old traditions and do not replace or diminish them.

Financial inclusion

In the last decades, microfinance has transformed access to finance for low-income clients and increased financial inclusion across the globe. Millions of non-bankable clients have been able to take out loans more easily, supply their businesses with liquidity, and manage their cash flow more adequately. MFIs and other organisations that have promoted financial inclusion have facilitated the entry of microinsurance.

As the MFI business model matures, it begins to replicate global banking trends, i.e., tying loans to the development of savings and extending their product portfolios to include insurance solutions together with partners. This “all-finance banking model” bundles savings, credits and insurance products and provides clients with a further financial diversification. Client awareness on how financial services work together has grown through the MFIs’ involvement in non-loan product areas; however, not in every country can MFIs mobilise savings or are permitted to be sales agents for insurance products. Limitations still exist; yet, in many countries, microinsurance has become an attractive cross-selling product for loan officers.

Until recently, MFIs have included microinsurance in their product offer as a credit life solution. Microinsurance providers however are now developing savings solutions that allow families to plan for the future education of their children, weddings and funerals. Microinsurance providers have also developed more innovative solutions for micro-entrepreneurs to assist them in reducing certain risks associated with business loans, equipment or job-related hazards. Microinsurance awareness has also increased low-income clients more active involvement in planning for risk. Many of these products are now being introduced or will be introduced by MFIs who are natural partners for risk providers. We will see though in later units that MFIs are just one of the existing distribution partners for risk providers.

Credit Life

Credit life schemes have protected families in the case of death of the breadwinner from destitution and default on loans. Many such families would not receive assistance from the government in covering expenses related to repayment of loans and would largely be unable to close the income gap. Microinsurance has stepped in to close such risks and allows families to protect themselves above and beyond what local social protection schemes can offer.

For example, the Allianz Group entered the Indonesian life insurance market in 1996 and has been offering in the last 6 years a credit-life insurance product "Payung Keluarga" (literally Family Umbrella). This particular product provides coverage for the death of the debtor, in which case the family receives two times the original amount of the loan. Loan sizes covered are between USD 55-1,100. Distribution is carried through insurance agents and local MFIs. 95% of loans are below USD 300.

Social protection

As covered in the introduction to insurance, we saw how conventional insurance can supplement or in some cases substitute for inexistent social protection services, particularly by providing schemes in the areas of life, pension and health insurance. Similarly, microinsurance contributes to the social protection of low income clients and provides them with alternatives means to protect themselves and their families from risks. Due to their limited financial reserves, low-income individuals are extremely susceptible to external shocks such as poor health, death of a breadwinner, natural calamities or agricultural shock. Microinsurance can protect households against losses not covered or supported by the safety protection net due to cost, remoteness or other economic or social barriers. Microinsurance can supplement public schemes that are under pressure due to fiscal pressures.

In several developing countries, the governments have introduced microinsurance into social welfare legislation and facilitated these through public private partnerships (PPPs). PPPs have been an important vehicle through which government welfare programmes can deliver valuable social services to the poor. One well-known PPP is India's Rashtriya Swastya Bima Yojana (RSBY), which is a national inpatient insurance programme for low-income households. This PPP, which is based on a smart-card system, covers over 30 million poor households and provides cashless hospitalisation across 10,000 hospitals. So far, RSBY has covered 25 states and currently, 14 insurance companies are participating. Client only pays for registration, and premiums are shared with the government. In Pakistan, Waseela-e-Sehat, which is an outgrowth of the Benazir Income Support Programme, improves access to health insurance services to low-income populations and lowers financial or income loss from catastrophic health events.[7] It works in partnership with health insurance companies and has been launched in 15 districts of Pakistan. The system works with a biometric card, which permits patients to receive health services at participating private and public hospitals. Currently, one family is covered under one premium.

In other instances, the national government has pushed risk providers to become more engaged in low-income insurance schemes. In India, the government mandates insurers to provide a certain percentage of microinsurance to the low-income population, while in Colombia, the government provides commercial insurers with subsidies for microinsurance premiums to incentivise the development of the low-income market and create an insurance culture among the low-income population.[8]

Microinsurance has contributed to stabilisation by supplementing social protection schemes. The same holds true for the variety of microinsurance products that protect against disability, provide emergency medical and health treatment, and assist families to save for immediate as well as mid-tern needs.

Commercial development

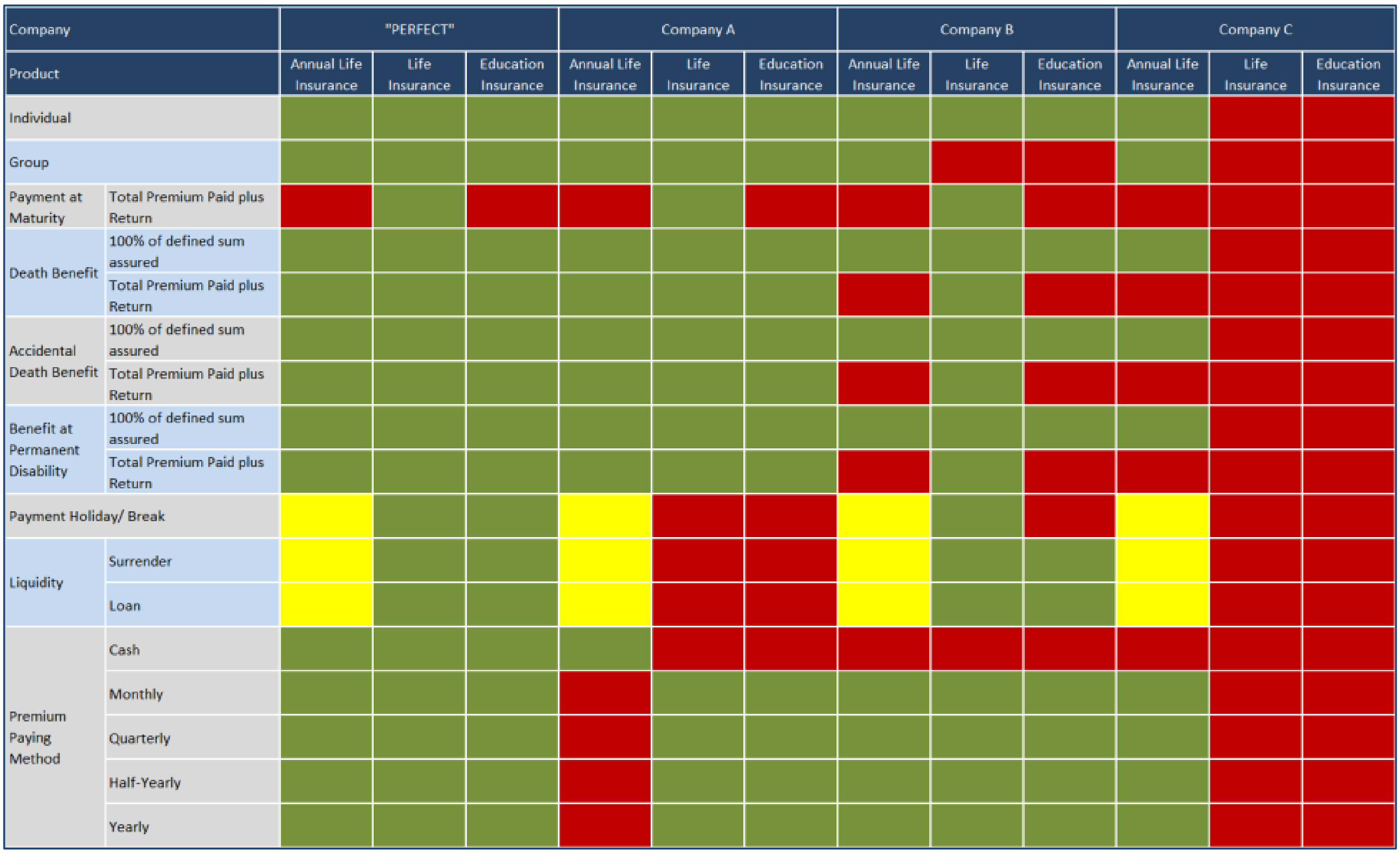
Microinsurance has provided local and regional insurance players with a new client segment and with the opportunity for commercial development and to expand their business models. In many emerging and developing markets, insurance companies have focused largely on industrial clients or targeted the wealthy and upper middle classes or expatriate communities. For a time, this strategy has worked and competition for market share was limited. However, as economies have opened their markets to foreign investors, pressure has grown on insurance companies to look for new markets. One response of insurance companies has been to expand beyond their traditional client base and reach out to lower income classes, where insurance penetration is either low or inexistent. These client segments sometimes represent between 50-80% of the entire country's population. Insurance companies have therefore welcomed some of the new developments in microinsurance product design and distribution methodologies, which will allow them to launch services for low-income clients at an affordable cost and to generate new business growth.

[7] *Health Marketi Innovations: Waseela-e-Sehat (Benazir Health Insurance)*
[8] *Ramm, G: Public-Private Partnerships in Microinsurance. Luxembourg, Microinsurance Network, 2011*

Example: Turkey

In Turkey a large portion of the low-income client base continues to be uninsured. Insurance companies have invested little effort in developing products for these clients, who desire simple products that allow for liquidity, premium holidays and maturities of less than 5 years. The table below provides an overview of three Turkish life insurers – a dominant Turkish player (Company A), a mid-sized provider (Company B) and a foreign subsidiary of a global giant (Company C). We then display a "perfect solution" scenario from a company outside of Turkey, where a well-designed microinsurance offer exists. We compared its features with the offers of the selected Turkish insurers.

Figure 11: Comparison of three Turkish live insurers with a perfect solution



= fulfills criteria

= does not fulfill criteria

= not applicable

Not surprisingly, few of the product features that low-income clients demand are present in the existing solutions. Aside from the fact that product descriptions are complex, the following observations stand out:

- companies A, B and C provide low premiums payable on a monthly, quarterly or annual schedule;
- all selected companies offer at least one product with maturities of between one to ten years;
- only company B (mid-size player) offers access to loans relative to paid-in premiums and allows for cash payments;
- none of the sample companies provide premium holidays in the case of unemployment or seasonal income flows; and
- none concentrate on life event planning with a focus on family needs, for example, short- and medium-term savings for wedding, education or household acquisitions.

While regional and local players have been key players in microinsurance, large global players have been incredibly active too. Their activity has been based on the fact that many of the markets in which they currently operate are saturated with high penetration rates, particularly in contrast to emerging and developing markets. In Europe, for example, we see how global players are faced with saturated markets, where insurance products are highly developed. Further, Europe struggles with slow growth in GDP as well as in population.

Figure 12: European insurance market

Country	Population (mn)	Change in Real GDP %	Insurance Penetration (%)
Germany	80	0.53	6.7
United Kingdom	64	1.74	11.5
France	63	0.29	9.0
Italy	59	-1.85	7.6
Spain	46	-1.22	5.3

Source: 2013 Figures. International Monetary Fund, World Economic Outlook Database, October 2014; Swiss Re, sigma No 3/2014

On the other hand in emerging markets, we see quite a contrasting picture. Populations, with the exception of Russia and Poland, are quite young and growing. These countries all share a very low level of insurance penetration. For example, penetration in India is 3.9% and in Russia merely 1.3%, while in more established insurance markets like Germany or the UK you have 6.7% and 11.5% penetration respectively. We can begin to understand, based on these figures why global players are turning towards Latin America, Africa and Asia for new growth business opportunities. These markets provide insurance companies investment options that have good medium- to long-term perspectives.

Figure 13: Emerging insurance markets

Country	Population (mn)	Change in Real GDP (%)	Insurance Penetration (%)
China	1,361	7.70	3.0
India	1,243	5.02	3.9
Brazil	201	2.49	3.6
Russia	144	1.30	1.3
Mexico	118	1.07	2.2
Turkey	77	4.05	1.5
Poland	39	1.55	3.4

Source: 2013 Figures. International Monetary Fund, World Economic Outlook Database, October 2014; Swiss Re, sigma No 3/2014

Macroeconomic stabilisation

Earlier, we discussed how insurance is a vital factor for macroeconomic stability and growth by supporting economic activities through risk-mitigating instruments, protecting against loss and uncertainty and giving people a certain peace of mind, and supporting entrepreneurialism. The same holds true for microinsurance with its impact felt with lower income segments of the economy.

Microinsurance can help productive segments of the economy (e.g., microenterprises, small businesses, farmers) to protect themselves from unforeseen events. Products available in the agriculture sector include weather index and livestock insurance, and policies exist to protect small enterprises from the outcome of fire or floods. These offers help families to recover and to regain their productive position in the economy.

Agricultural-based microinsurance has been quite helpful in improving the livelihood and productivity of subsistence farmers. Such farmers have faced many uncertainties due to severe weather or natural disasters. The threat of such occurrences has hindered investment in agriculture and impeded economic development. Microinsurance has assisted farmer by reducing uncertainty and allowing farmers to invest more in production, better fertiliser and higher quality seeds. For example, weather index products measure rainfall in drought prone areas. If rain levels go below a certain level, then farmers can make a claim for the land, which has been insured. These claims partially offset losses and mitigate the consequences of adverse weather patterns. The damage of total or partial crop during a growth season can be reduced.

Microinsurance can protect small farmers and business owners and their families from destitution. It assures that short-term income streams do not immediately dry up in the event of a death, disability or property damage. Individuals, who might otherwise close their businesses due to an unfortunate event, can remain active. Families, who might otherwise slip out of the economic mainstream, remain integrated and productive. Microinsurance, just as conventional insurance does, provides clients with time and resources to reorient themselves, thereby stabilising the macroeconomic environment.

Traditional savings

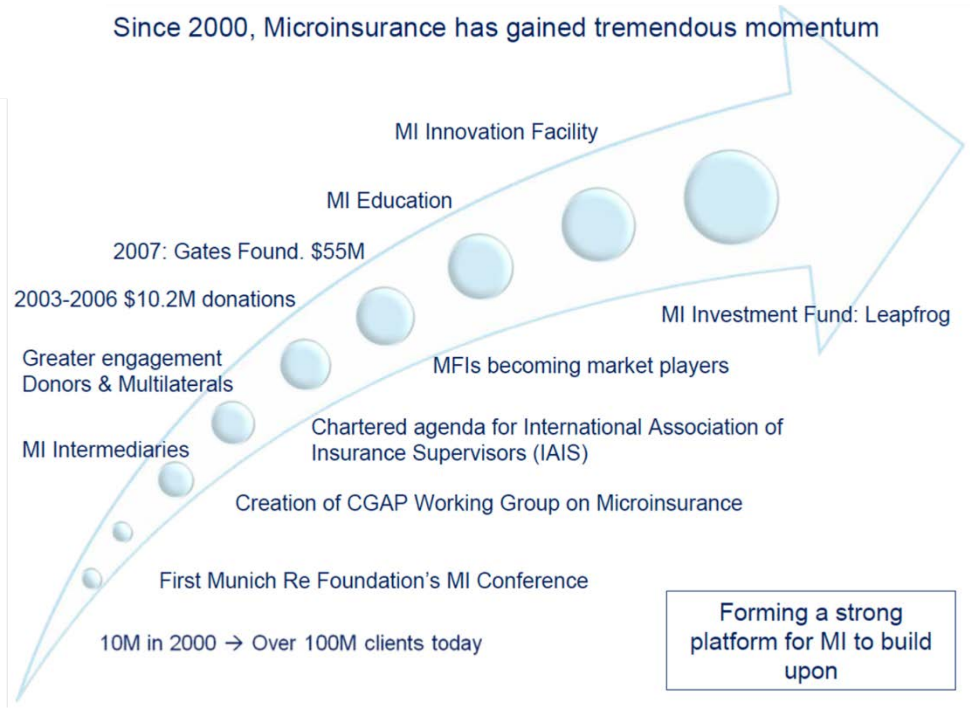
Traditional savings plays an important role in many rural and agrarian societies. Savings in gold, livestock and furniture have protected families in times of crisis and have allowed them to accumulate resources for important events. In addition, informal savings pools have existed such as Ekub in Ethiopia, Tontines in Cameroon and Niger, Esusu in Nigeria, Susu in Ghana, Gameya in Egypt, and Sanduk in Tunisia. Such schemes collect resources on an informal basis and are dispersed at the time a particular event happens to a member or a family. The challenge with these methods is that when a family or individual does not diversify and invest perhaps in more formal financial schemes, they may unwittingly be increasing their risk. For example, the price of gold fluctuates dependent on a range of world economic and political factors out of reach to most individuals. Livestock can perish due to disease, furniture could be destroyed through fire or informal schemes may be mismanaged by an unscrupulous individual. Financial services, such as microinsurance, can help families to diversify traditional savings. The combination of formal risk reduction together with informal savings schemes can be the beginning of a simple diversification of family assets. Microinsurance can play a positive role in this process.

Tomchinsky, G.: Introduction to Microinsurance: Historical Perspective, ILO, 2008

2.5 Recent History and Evolution

Since 2000, microinsurance has gained tremendous momentum growing from an estimated 10 million clients to between 100-500 million in 2011. During this time span, the sector has crossed a number of milestones and various groups (e.g., donors, risk providers, investment fund companies, and brokers) have contributed to the fast development as depicted in the graphic below. These groups have all pushed to develop a risk reduction scheme that is appropriate for low-income individuals and matches the distinct features we have reviewed.

Figure 14: Milestones of microinsurance and contribution of involved groups



Source: [Tomchinsky, G.: Introduction to Microinsurance: Historical Perspective, ILO, 2008]

The reality is that without the concerted effort of these groups microinsurance would not have emerged as a trend in developing markets. These groups have not only advocated on behalf of insurance for low-income individuals, they have financed research, piloted projects and designed and launched products. Let us go through several types of organisations that have played a critical role in the growth of microinsurance. While many of these groups are development financial institutions or NGOs, quite a few commercial or profit-based firms are recognising the business opportunity and taking an interest in microinsurance.

Donors & NGOs

International and national donor agencies have been strong proponents of microinsurance. Their initial efforts focused on start-up analysis on market demand and supply for microinsurance. Donors have been making the case to NGOs about the potential for social protection that can be extended to low-income individuals as well as revealing the business opportunity for commercial enterprises. For example, the Consultative Group to Assist the Poor (CGAP), which is located at the World Bank and a global partnership of 34 organisations that focus on financial inclusion, has aimed to develop solutions through research. Originally focused on microfinance, CGAP's established a Working Group on Microinsurance, which has provided an important forum for discussion on microinsurance. CGAP was also instrumental in establishing the Microinsurance Network, a Luxembourg-based NGO (see below). Another group, the ILO's Microinsurance Innovation Facility, which is now known as the Impact Insurance Facility, has in addition to sponsoring a number of studies on microinsurance, supported local risk providers and NGOs with grants to improve operational processes, extend distribution to lower income individuals and general worked to improve access to insurance.

Donors as we will see later in this unit have also been quite active supporting the development of consumer oriented regulatory framework for microinsurance. They have supported measures in the areas of consumer protection and financial literacy. Other donors such as the KfW and the IFC have been providing fund groups as described below with investment capital to finance risk providers that support the development of microinsurance programmes.

Microinsurance Network

The Microinsurance Network is a non-profit **global multi-stakeholder platform** based in Luxembourg, which concentrates on insurance services for low-income populations in emerging markets. The Network's membership consist mostly of experts, who represent a range of backgrounds and sectors, including insurers (mutual and commercial) and re-insurers, governments (social protection providers and regulators), academics and researchers, as well as third-party providers, funders (donors and investors) and promoters (industry associations and conference organisers). As of 2013, the Network had over 60 institutional members and slightly over 20 individual members.

The Network ensures the development of effective microinsurance sector. It supports research, working groups and dialogue on issues impacting microinsurance. The Network's website provides numerous useful publication on the topic of microinsurance: www.microinsurancenetwork.org.

Source: Microinsurance Network December 2014

Investment funds

Similar to the role that investment funds (e.g., Triple Jump, Blue Orchard, Tridos, etc.) have played in the provision of capital to MFIs, fund groups have provided growth capital to insurance companies. This capital has allowed risk providers to invest further in products, distribution channels and services and to extend their reach to low-income clients. Unfortunately, the number of investment funds is still few but the anticipation is to see microinsurance equity investments increase and experience a similar development as in the microfinance sector.

One investment manager, LeapFrog Investment, takes a direct equity stake in insurance companies that support microinsurance. LeapFrog invests in insurance companies across Africa and Asia and provides these companies with growth capital. LeapFrog's portfolio companies serve over 22 million people, and include AllLife, Apollo, ARMLife, Bima, and Shriram amongst others. Through LeapFrog's efforts large institutional investors, including J.P. Morgan, Prudential, Swiss Re, and TIAA-CREF have been introduced to microinsurance.

Brokers

Brokers have played an important role as intermediaries between clients (e.g., delivery channels) and risk providers. The general role of brokers is to work for the client to develop appropriate products for that client, and then work with all insurers to find a risk carrier for the product. Brokers have closed the huge gap in communication between insurers and delivery channels, particularly in microinsurance. There are two multinational microinsurance brokers at this time: MicroEnsure and PlaNetGuarantee.

MicroEnsure, a subsidiary of Opportunity International, is operational in the Philippines, India, Indonesia, Uganda, Kenya, Tanzania, and Ghana. They have developed innovative products from life insurance to health to agricultural index insurance with a broad array of insurers and delivery channels. One of the key channels with which MicroEnsure has been working is Mobile Network Operators or MNOs. In several of its key African markets (e.g., Kenya, Zambia, and Ghana), MicroEnsure has successfully launched an agent-free self-enrolment business model. Enrolment in a short-term disability insurance policy occurs at the time when an individual signs up for a mobile telephone plan. Premiums are embedded into the airtime. This innovative strategy has extended insurance coverage to millions of people, 80% of whom were not previously enrolled in an insurance policy.

PlaNetGuarantee, a unit of PlaNetFinance, is operational in several countries offering credit life insurance. PlaNetGuarantee develops partnerships with sector players, including insurers, reinsurers, banks, microfinance institutions and development agencies. It also can rely on the expertise of the PlaNet Finance, which includes know-how in microfinance and connections to funding sources for microfinance solutions.

Risk providers

Of course risk providers or regulated insurers have played a significant role in promoting microinsurance. Insurers in emerging markets have seen the need to move beyond traditional insurance markets (e.g., industry or higher income clients) and to address the lower income client market. South Africa, Kenya, the Philippines, and India are just a few of the countries where risk providers have entered the microinsurance market successfully.

Old Mutual Group – South Africa

Old Mutual, South African insurer, is one example of a risk provider that has invested time to improve the conditions and of insurance products to the low-income client and has thereby made microinsurance a more viable business proposition. Old Mutual Global operates in more than 70 countries with over 173,000 staff. It serves more than 12 million customers worldwide. In its South African portfolio of products, it has designed a low-income funeral insurance product “pay as you can”, which is distributed innovatively via over-the-counter markets at Shoprite. The product can be paid through mobile top-ups and distribution costs are kept low through a customer care hotline instead of a sales agent force. The product has provided value to low-income clients, who wish to protect their families from the high costs of ceremonial funerals that are very common in South Africa.

After reviewing these four groups, we can see that a tremendous amount of engagement in the microinsurance sector has been taking place. A number of groups are cooperating and working in parallel to assure that risk reduction products and services are available to low-income clients.

The rapid expansion of microinsurance over the last two decades is a further indication that demand for low-income, risk products is growing. It still has to be noted though that much work remains. While international donor advocacy has driven microinsurance to the top of the development agenda, these efforts must now develop into a national, regional and grassroots effort. National governments will be key in shaping and defining whether microinsurance will be successful across individual countries. National governments will play a significant role in developing a conducive regulatory environment for microinsurance. They can, as we will later see in the case of India's Insurance Regulatory and Development Authority, have a powerful impact on how active commercial insurers engage in developing microinsurance solutions and how fast the market demand grows.

By reviewing the history, definitions, relevance and recent evolution of microinsurance, you are now equipped to make certain distinctions between traditional insurance as we reviewed in chapter 1 and low-income policies. We have seen that small policies have existed throughout the history of insurance but that only recently has microinsurance been defined as a term and unique sector within the insurance industry. We have reviewed the complexity surrounding the definitions of microinsurance and demonstrated that consensus has not yet been reached about the actual term; however, we have learned too that microinsurance – as contentious a subject as it may be – has a significant role to play in the development of emerging economies. The rapid and recent evolution of microinsurance is a testament to how much demand is available and to how low penetration among low-income populations has been to date.

Chapter 2 – Exercise 1

Which of the following statements are true?

1. A key distinguishing factor of microinsurance is that it focuses on low-income populations.
2. A value proposition is a statement that is concerned with profitability.
3. The first use of the term microinsurance was in 1999.
4. Microinsurance is limited to emerging and developed economies.
5. Qualitative definitions of microinsurance focus on the product in relation to the consumer.
6. Some key microinsurance features include a complex product design and long durations.
7. Four factors which functional microinsurance schemes impact are financial inclusion, social protection, commercial development and macroeconomic stabilisation.
8. Developing markets have high insurance penetration rates.
9. Microinsurance can complement traditional savings and protection models.
10. Donors have been inactive in promoting microinsurance.

Solutions: Please refer to chapter 5.

Chapter 2 – Exercise 2

As we saw in this chapter, the definition of microinsurance is still in development. Consensus among experts, governments or enterprises does not exist and this has led to numerous definitions. The disagreement appears to circle around qualitative vs. quantitative dimensions. Some prefer to define microinsurance qualitatively (e.g., consumer focused), while others prefer the quantitative approach, which sets clear parameters around size of premiums, coverage and durations, as the examples in Brazil or Peru demonstrated. Definitions may also vary from setting to setting due to differences in cultural and business norms.

For this exercise, please define microinsurance for your organisation. Reflect on your national environment and decide on whether you take a quantitative or qualitative approach or a mix of the two. Rely on already existing definitions to guide you. Your definition should be no more than 50 words.

Solutions: Please refer to chapter 5.