



# **Toward an Efficient & Sustainable Microinsurance Market:**

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## **The Regulatory Perspective**

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# Outline

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# 1. Introduction

- Both microcredit and microinsurance products have essentially emerged in a regulatory vacuum, which did not hurt microcredit delivery as witnessed by the vigorous growth in the scale of operations and the diversity of products.
- However, microinsurance has been struggling to take root. The extreme scarcity of capital is well-known to the poor (witness the historical rates charged by the proverbial village moneylender), which made microcredit popular.
- But even when the implicit risk premium associated with informal or self insurance can be even more exorbitant (indeed, infinite), the awareness of the high cost of non-market insurance, and the associated concepts of pooling risks are poorly conceived by many unless they are provoked to do so.



# Introduction....

- Protecting the policy holder and fostering market innovations are the primary goals of a regulatory regime in the insurance context.
- From an economist's perspective, such a regulatory regime must ensure the industry remain competitive and financially solvent in the long run.
- In this paper, the term 'regulation' refers to a set of formal guidelines which are legally binding on the regulatee and for which there is a functioning supervisory authority.



# Introduction

- This paper interprets the role of regulation to be in enabling the industry to attain and maintain efficiency and sustainability.
- The term efficiency describes an outcome where the services provided are meaningful to the poor (both in terms of product diversity and quality) at the least possible cost.
- Products that are efficient by design are sustainable if the cost is affordable to the poor, and if continuous innovation occurs leading to improvements in the range and quality of microinsurance services.

## 2. Regulatory Benchmarks

### a) Formal vs. Self-regulation:

- Consumer protection becomes extremely important as low-income and poorer individuals may not fully understand modalities of pooling and shifting of risks.
- Regulation ought to enhance access by the poor to insurance.
- The standard arguments in favor of binding regulation are to:
  - I. Guard against opportunistic behavior
  - II. Make it easier for the insurer to deal with covariant risks, *and thus,*
  - III. Help attain long-run sustainability
- This paper argues in favor of a *formal scheme*.

# Benchmarks...

*b) Prudential vs. Non-Prudential Regulation:*

- The regulatory framework should not be unduly stringent, though it should allow adequate monitoring on behalf of policy holders who are themselves not equipped to carry it out.
- Insurance services may call for prudential regulation and supervision, but not necessarily the credit operations of an MFI.
- Cautious and gradual progress toward prudential regulation would appear to be the way to go (although it need not be at a level comparable to that applicable to deposit money banks or non-bank financial institutions).

# Benchmarks...

*c) The Primacy of Financial Transparency:*

- Financial transparency norms enhance the efficacy of insurance and other financial services.
- The lack of non-comparable data leads to many difficulties.

*i. Financial Reporting Standards:*

- Relative efficiency of service providers can only be judged if their financial statements are presented in a uniform way.
- This is important since sound competition in all dimensions of financial services is vital to improving the efficiency of the industry.

*ii. Product Design & Reform:*

- The lack of credible financial information in the market invariably leads to suboptimal product design.

# Benchmarks...

## *iii. Cost Effectiveness:*

- The lack of comparable information would prevent an assessment of how the cost structure of microinsurance and related services evolves over time.
- In the absence of a uniform code of accounting practices, the important goal of lowering the true operating cost of microinsurance services is compromised.
- Uniformity is necessary to examine how a service can be made more cost effective to compete globally in order to attract venture capital or reinsurance services from international entities.

## *iv. Regulatory Consensus*

- Once the transparency norms are standardized, the scope for consensus-building on many regulatory issues widens considerably (*Radcliffe and Tripathi, 2006*)

# Benchmarks...

## *d) Diversity of Delivery Channel:*

- In India, the IRDA stipulates microinsurance be sold only by registered commercial insurers through their appointed agents. This effectively encourages the partner-agent model (with MFIs/NGOs) as it would be too costly for an insurer to engage traditional agents in the diverse poor and rural communities.
- In order to widen the scope of microinsurance many experts call for agnosticism in the organizational structure of the microinsurance industry to allow experimentation so that markets can offer a variety of products and modalities to clients (*McCord, 2008*).
- Many authors insist on community participation in choosing the insurance contract (*Dror et al, 2007*).

# Benchmarks...

## e) Coverage, Risk-Pooling and Cost Efficiency:

- Across all insurance schemes, unless the coverage is wide, effective risk-pooling cannot be achieved.
- The Khalily et al (2008) survey found that very 'large' MFIs (more than 1 million members) witness huge operational profits with their insurance programs. The ratio of annual claims paid to annual premium collection was a mere 9.4% for this group, a drastic difference when compared to the same ratio for 'very small and small' MFIs (up to 25,000 members) at 33.4%, and 'medium to large' MFIs (25,000- 500,000) at 41.8%.
- It was further seen that the relative size of the insurance provider did not affect the premium rate structure, and thus it must be questioned whether the deviation stemmed from the ability of very large MFIs to pool risks more efficiently than the rest.

# Benchmarks...

## *f) Regulatory Coordination: How Many Regulators?*

- Regulation of the industry is made difficult by the fact that the orientation of commercial insurers (profit-driven) and that of NGO/MFIs, (socially-driven) differ markedly. *However*, efficiency and long-run sustainability are equally applicable to both.
- An Insurance Regulatory Authority (IRA) Act is in the process of being adopted by the parliament, and the Microcredit Regulatory Authority (MRA) has recently recognized microinsurance as a legitimate activity of MFIs. Both operate under the Ministry of Finance (MoF), and both appear incomplete insofar as microinsurance regulations are concerned.
- It would be opportune for the MoF to promulgate a set of common statutes relevant to the industry regardless of the type of insurer.

# Benchmarks...

- g) Sustainability and the Design of a Subsidy Regime:*
- Sustainability for credit, life, livestock, or credit-cum-life type risk coverage is primarily a function of being able to reach a wide pool of clients since these are essentially idiosyncratic risks.
  - A classic case of market failure for non-life products is when the product is made unaffordable to the majority of the poor, and thus, a subsidized micro health insurance (MHI) program may be a net welfare enhancing intervention.
  - In the event that MFIs are themselves insurers, the financial sustainability may involve the assumption of overhead expenses by the parent organization, or by a onetime capital transfer, or by another form of cross subsidization.
  - Rather than ad-hoc annual subventions made by public authorities, donor funds or private trusts, it may be superior for the promising MHI programs to secure an endowment fund.

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# 3. Microinsurance in Bangladesh

- Microinsurance (MI) providers in Bangladesh can be divided into two categories:
  - I. Mainstream insurance companies (Delta Life Insurance Company)
  - II. NGO/MFIs (Grameen Kalyan, Sajida Foundation)
- The partner-agent model has yet to take root in the country.
- MI includes many specific products that are adapted to the needs and demands of low income households to cover specific risks. Products can be divided into the following types:
  - Life insurance
  - Disability insurance
  - Livestock insurance
  - Crop insurance
  - Health insurance
  - Property insurance
  - Micro enterprise insurance

# Microinsurance...

- MFIs appear to offer insurance programs to minimize institutional risk, to partly mitigate the risk of borrowers and, since the premium income exceeds the claim settlement, they gain access to a revolving loan fund (Khalily et al, 2008).
- Accordingly, the main MI product offered by MFIs is credit life insurance.
- The formal MI providers in Bangladesh offer endowment type life insurance schemes which encompass elements of savings, protection and investment.
- One important distinguishing feature between commercially driven insurers and NGO/MFIs is that their source of fund is different, where the former have access to equity capital.
- A membership card is the most common vehicle of marketing the product, where the card subscription fee serves as the premium income, and where the typical claims are settled in kind by the provider.

## 4. Bangladesh Regulatory Framework

- Many stakeholders believe that a comprehensive legal regulatory framework is a prerequisite for the successful development of the industry.
- To date the regulation of the insurance industry in Bangladesh has largely been rudimentary.
- The new Insurance Regulatory Authority (IRA) Act currently being adopted, replacing the earlier Insurance Act of 1938, is nearly empty insofar as microinsurance is concerned. Given that commercial insurers are authorized to sell MI, one would presume that the directives, to the extent IRA is able to implement, these would apply with equal force to the MI business carried out by such entities.



# Regulatory Framework...

- Though the details are yet to be approved by the Parliament, the draft version of guidelines in the Microcredit Regulatory Authority (MRA) Act consider insurance services of MFIs as a discretionary component of their activities.
- Each licensed MFI has the authority to ‘offer different types of insurance services...for the loan recipients and members of their families’ (article 24).
- It would be fair to state that the MRA has yet to develop any formal regulatory statutes guiding the fledgling microinsurance industry.
- This paper calls for a new set of ‘microinsurance regulatory and supervisory directives’ (MRSD) issued by the Ministry of Finance.

## 5. Proposed Regulatory Directives

- The following directives highlight the key goals of cost efficiency, financial viability and inclusivity. They are also aimed at fostering innovations in product design and delivery.

a) Definition:

- It is critical to settle on a workable interpretation of the concept of microinsurance.
- In essence, *microinsurance services are those risk-shifting devices offered by insurers that are especially suited to the needs of low-income households and are affordable.*

- b) *Simplicity of microinsurance products:* The regulatory directives ought to require that each microinsurance product/scheme be written in plain language where all benefits and documentary requirements for the claim settlement process are clearly explained.

# Proposed Directives...

c) Quantification:

- A flexible structure is needed to allow for innovations.
- For credit/life type policies, the benchmark products may include all that offer indemnity in a range of 1.5 to 5 times the average size of the annual microcredit loan, which as of March 2009 stood at about BDT 11,000. A similar figure may be assigned to health coverage per family.
- Coverage below the threshold cited here can be presumed to offer little value to the average poor/low-income person since it would be inadequate to offer her a chance to overcome the vulnerability due to the loss.
- Other risks such as livestock and value of immovable structures may be covered up to the average replacement cost.

# Proposed Directives...

d) *Eligibility for Insurance:*

- Once the products are defined, it does not really matter who subscribes, except what may be required to overcome issues of adverse selection.
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e) *Duration of Coverage:*

- It is proposed that directives may be framed so as to require the insurer to offer a conversion of credit policies to equivalent life coverage once the borrower ceases to be one, and the insured will thus have a choice to continue the coverage or look for alternate plans.
- The industry should be encouraged to offer flat annual premium for terms of 5 and 10 years, especially for term life insurance.

# Proposed Directives...

*f) Life vs. Non-Life Products:*

- The new IRA guidelines require carriers of life and non-life risk to be distinct, which makes little sense in microinsurance, as it prevents risk pooling across product lines and the ability to cross-subsidize some services by others (e.g. health by life).

*g) Institutional Innovation:*

- Innovations whereby either a commercial carrier teams up with an MFI or a consortium thereof, MFIs themselves forming a new company, or by smaller MFIs partnering with national level MFIs to jointly operate a microinsurance program ought to be encouraged for efficient risk-pooling.
- It is also proposed that MFIs separate their microinsurance operations from all other activities, and accordingly receive a separate license from the MRA to run the former line of business.

# Proposed Directives...

## *h) Promoting Inclusivity:*

- Some countries have targeted inclusivity and sought to expand the reach of MI by requiring all insurers to serve the low income market.
  - For large, nationwide firms, this policy may be practical, but certainly not for the smaller entities.
  - For smaller insurers, such a law may force mergers, which by itself may be anti-competitive and thus against the interests of the policy holders.
- It is worth debating if compulsion is superior to alternative incentive strategies such as tax reliefs
- Marketing innovations have also been identified to play an important role in promoting inclusivity (i.e. cell phone communication).

# Proposed Directives...

*i) Capital Adequacy and Related Prudential Guidelines:*

- Internationally, risk-based capital is the norm, where the capital requirement is based on the risks the insurer is exposed to.

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- MRSD ought to consider that the scale necessary to successfully operate credit and insurance services need not be the same, and hence micro insurers may face a higher capital requirement, unless they are in partnership with other MFIs or commercial insurers.
  - The IRDA requires a minimum capital of \$22 million to form an insurance company.
  - In the Philippines, levels are set between 1 and 2 million dollars, depending on 'life' or 'general' companies. Accordingly, the Philippines allows mutual benefit associations to register with a paltry initial capital of under \$200.

# Proposed Directives...

*j) Capital Adequacy and Related Prudential Guidelines  
(continued):*

- MFIs in Bangladesh are required to put up BDT 4 million (about USD 58,000) as capital in order to obtain a license to offer microfinance (including insurance) services.
- The capital requirement may pave the way for self-selection of NGO/MFIs who essentially offer social services from those who actually offer 'insurance'. Social service providers would then be willing to re-label their products appropriately, and remain outside the purview of the MRSD regime, which may well be in the long-run interest of all.

# Proposed Directives...

## *k) Design, Accumulation and Investment of the Insurance Fund:*

- Guidelines would be necessary to deal with the disclosure of the rationale of the chosen premium rate structure, the investment of such funds and rules regarding the build-up of excess funds and disposal thereof.
- A recent analysis of MFI run 'insurance' revealed, for large insurers, only 10% of the annual premium was used up in the annual indemnity claims (*Khalily et al, 2008*). It was also revealed that 85% use it as a 'revolving loan fund', exposing the fund to the same risks that the insurance products attempt to guard against.
- It would seem that the high premium structure is there merely to build up a fund that can be accessed at zero interest for further on-lending, which is against the policyholder's interests.

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# Proposed Directives...

## *l) Audit and Supervision:*

- An external audit has been made mandatory for each MFI which is to be carried out by an eligible CA firm with experience in MF activities, and who must follow the Bangladesh Standard of Auditing (BSA). The draft MRA goes beyond and suggests that it intends to issue a manual detailing the modalities to be followed.

## *m) Educating the Regulator:*

- Many developing country regulators do not have skilled manpower in the public service who would fully understand how the low income insurance market should function.
- A road map would be necessary to impart and endow the regulatory authority with the required human resources and training on an on-going basis.

## 6. Conclusion

- In the design of a suitable regulatory framework, the issue of balancing the rigor of formal regulation and supervision (which is legally binding on the regulatee) with the idea that innovation is not inhibited must be considered.
- It must also be ensured that the insurance market be 'efficient' and 'sustainable' and that there is consistency among regulatory guidelines.
- The set of regulatory and supervisory directives in this paper illustrate that the conflicts cited above need not necessarily arise in the delivery of microinsurance services.