Actuary of the Future

November 2009 – Issue 27

Insuring the Low-Income Market: Challenges and Solutions for Commercial Insurers

By Craig Churchill

Craig Churchill is a microfinance expert at the International Labour Organization. He recently launched the Microinsurance Innovation Facility and can be reached at churchill@ilo.org

INTRODUCTION

While the term 'microinsurance' has only been around since the late 1990s, the concept is not really new. Some of today's large insurance companies began in the 1800s as mutual protection schemes among low-income workers. In the early 1900s, many insurers built their business by selling 'industrial insurance' at factory gates, and insurance was seen as a financial service for the poor, since wealthy people essentially self-insured. Over the years, however, this perception has reversed—many poor people today think insurance is only for the wealthy. Indeed, microinsurance can be described as a 'back to basics' campaign for the insurance industry, to protect vulnerable people through the solidarity of risk pooling.

In many developing countries, commercial insurers are becoming interested in serving the low-income market by providing microinsurance. To do so, they have to overcome both operational and regulatory obstacles. Although certain regulations actually give commercial insurers an advantage in serving the low-income market, by restricting competition from specialized microinsurance companies, this opportunity is unlikely to last indefinitely. Commercial insurers that are keen to reach out to new markets, such as the huge volume of low-income people in many countries, would be wise to move quickly to overcome key operational issues. In particular, insurers need to recognize that microinsurance is not just existing products with smaller insured sums, but that it requires a significantly different approach from conventional insurance.

This article defines microinsurance, describes its recent emergence and explains the main challenges faced by commercial insurers serving the low-income market. It discusses key strategies commercial insurers need to consider when serving this market. These include a) improving the insurer's familiarity with the preferences and behaviour of poor persons and b) educating the market about insurance to create low-income consumers.

1. WHAT IS MICROINSURANCE?

Microinsurance is the protection of low-income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risk involved. It is not a specific product or product line. It is also not limited to a specific provider type. Microinsurance is the provision of cover to a specific market segment: low-income persons.

How poor do people have to be for their insurance protection to be considered micro? The answer varies by country. Generally, microinsurance is for persons ignored by mainstream commercial and social insurance schemes. Since it is easier to offer insurance to persons in the formal economy with a predictable income than to cover informal economy workers with irregular cash flows, the latter represent the microinsurance frontier.

Microinsurance can cover a variety of different risks, including illnesses, accidental injuries, and death and property loss — any risk that is insurable as long as the product is affordable and accessible for low-income households. Microinsurance can be offered as a single risk product or several covers can be bundled together into a composite product, perhaps even underwritten by different risk carriers.

Microinsurance does not refer to the size of the risk carrier. Some providers are small and even informal. There are also some very large companies that offer microinsurance, such as AIG Uganda, Delta Life in Bangladesh and Zurich in Bolivia. In addition, all insurance companies in India are required to serve the 'rural and social sectors' by the regulatory authorities.

Insurance can be delivered to low-income households through a variety of channels. Microinsurance risk carriers include small, community-based schemes, mutuals and cooperatives, as well as joint stock companies and

large enough to pose a dilemma for regulators). Second, some development agencies have encouraged the financially excluded to create risk-pooling mechanisms that can benefit from government's redistribution of resources from the rich to the poor. Third, with encouragement from microfinance institutions, some insurers see the vast number of low-income persons in developing countries as a new market opportunity.

This 'new market' perspective has been best articulated by C.K. Prahalad (2005) in his book Fortune at the Bottom of the Pyramid. Prahalad identifies the more than four billion persons living on less than US$2 per day as a market opportunity if the providers of products and services innovate new business models and create low-income consumers.

In particular, when serving the bottom of the pyramid (BOP), even if the per-unit profit is minuscule, when it is multiplied across a huge number of sales, the return can become attractive. This attribute is a perfect fit for insurance and the Law of Large Numbers, whereby actual claims experience should run much closer to the projected claims when the risk pool is larger. When projections can be estimated with a high degree of confidence, then the product pricing does not have to include a large margin for error, making it more affordable to the poor. Prahalad also makes a strong case for: a) utilizing technology to enhance the efficiency of managing large volumes of small transactions; and b) making significant investments in educating the market in order to create a demand—both of which are essential for the successful uptake of insurance by the poor.

CONTINUED ON PAGE 30

government-owned insurers. To reach poor households, risk carriers often partner with delivery channels that already have financial transactions with the low-income market. The most common arrangement is with microfinance institutions that provide credit and perhaps savings services, and therefore microinsurance essentially becomes bancassurance. However, delivery channels can also include cooperatives, community organizations, small business associations, trade unions and even retail companies that cater to the low-income market.

2. THE EMERGENCE OF MICROINSURANCE

Microinsurance is primarily a phenomenon in developing countries largely because insurance penetration is low and government social protection schemes cover only a small minority. Consequently, microinsurance has emerged to fill the gap from three parallel entry points. First, to cope with risks, many low-income persons form their own mutual benefit associations, creating unregulated insurance schemes (of which some have grown

As Prahalad's thinking filters through the insurance industry, many commercial companies are beginning to look at the low-income market a bit differently, especially when the results from vanguard insurers show that it is possible to provide microinsurance profitably. Yet to serve this market, insurers have to think differently about customers' needs, product design, delivery systems and business models.

3. MAIN CHALLENGES FACED BY COMMERCIAL INSURERS IN SERVING THE POOR?

Although the insurance industry is beginning to take notice of the vast under-served market of low-income households, insurers must overcome numerous obstacles if they are to offer quality insurance products to low-income people.

PRODUCTS GENERALLY AVAILABLE FROM INSURERS ARE NOT DESIGNED TO MEET THE SPECIFIC CHARACTERISTICS OF THE LOW-INCOME MARKET, PARTICULARLY THE IRREGULAR CASH FLOWS OF HOUSEHOLDS WITH BREADWINNERS IN THE INFORMAL ECONOMY.

One of the primary stumbling blocks is the transaction cost associated with managing large volumes of small policies. In serving the poor, insurers incur significant expenses marketing to a clientele that may be unfamiliar with insurance, collecting premiums from persons who may not have bank accounts, and assessing and paying out small claims. A related problem is the distribution of insurance to the low-income market. The system of brokers, agents and direct sales used by commercial insurers is generally appropriate for corporate customers and high-value individual customers, but does not reach the poor.

Products generally available from insurers are not designed to meet the specific characteristics of the low-income market, particularly the irregular cash flows of households with breadwinners in the informal economy. Other key product design challenges include inappropriate insured amounts, complex exclusions and indecipherable legal policy language, all of which conspire against effectively serving the poor.

It is generally assumed that low-income men and women are more vulnerable to risks than the not-so-poor. However, most insurers do not have data to accurately interpret the vulnerabilities of the poor. To address such a problem, insurers may build in a hefty margin for error and then make adjustments once the claims experience starts rolling in. However, this practice often renders the premiums unaffordable for the low-income market.

Insurers do not have the right mechanisms to control certain insurance risks, such as adverse selection and fraud, among the low-income market. For example, the claims documentation requirements and the verification techniques used to ensure that someone with a US$100,000 life policy is not defrauding the insurer are inappropriate for a US$500 policy.

Lastly, another major challenge in extending insurance to the poor is educating the market and overcoming its bias against insurance. Many poor persons are sceptical about paying premiums for an intangible product with future benefits that may never be claimed —and they are often not very trusting of insurance companies. Creating awareness about the value of insurance is time-consuming and costly. This bias goes in both directions. The people who work for insurance companies are usually unfamiliar with the needs and concerns of the poor. They assume that the poor cannot afford insurance. In addition, the culture and incentives in insurance companies reward and encourage focus on larger policies, more profitable clients and discourage staff from the idea of selling insurance to the poor.

Table 1. Illustrative distinctions between commercial and micro insurance

Commercial Insurance	Microinsurance
Premium collected mostly from deductions in bank account	Premium often collected in cash or associated with another financial transaction; should be designed to accommodate customers' irregular cash flows, which may mean frequent payments
Agents and brokers are primarily responsible for sales	Agents may manage the entire customer relationship, perhaps including premium collection
Targeted at wealthy or middle class clients	Targeted at low-income persons
Market is largely familiar with insurance	Market is largely unfamiliar with insurance
Screening requirements may include a medical examination	If there are any screening requirements, they would be limited to a declaration of good health
Sold by licensed intermediaries	Often sold by unlicensed intermediaries
Large sums insured	Small sums insured
Priced based on age/specific risk	Community or group pricing
Limited eligibility with standard exclusions	Broadly inclusive, with few if any exclusions
Complex policy document	Simple, easy to understand policy document

Adapted from McCord and Churchill (2005).

4. HOW CAN COMMERCIAL INSURERS SERVE THE POOR?

Knowing what the challenges are, commercial insurers can identify strategies to overcome them and actually provide valuable insurance coverage to the poor. The first step is to understand the market and identify a particular customer need to be fulfilled. However, this is not so easy given the significant social and economic differences between persons working for insurance companies and those working in the informal economy. Commercial insurers must recognize that they probably do not know very much about the target market, and have an open mind about how to solve the needs of these customers.

Insurance professionals who have spent time interacting with poor persons, through surveys and focus groups, invariably come away with two pertinent observations: 1) these people definitely need insurance as a tool to help them manage risks; and 2) a different approach to product design and delivery is required to serve this market.

Key differences between microinsurance and commercial insurance are not just in the products themselves, but also in how they are made accessible to poor persons. As summarized in Table 1, microinsurance products are not just scaled down versions of existing products. They should be as simple as possible, with a minimum of exclusions or restrictions. The product and its related processes must be simple enough so that illiterate people can understand them.

After insurers educate themselves, they need to think about educating the prospective market. Unconventional but effective communication methods, such as street theatre and soap opera-style videos can go a long way to help poor persons understand how insurance works, what it can and cannot accomplish, and how it complements other financial services. Efforts to sell insurance to the poor will be more effective if the target market can make informed choices as to the best tools to employ to manage the risks they face. Communication and education efforts have to move beyond sales to create an insurance culture. In many developed countries, it took generations before people commonly turned to insurance to address

CONTINUED ON **PAGE 32**

their risk-management needs. Microinsurance providers can help build the culture of insurance if they serve their clients' needs in a fair and equitable way.

Microinsurance products that respond appropriately to potential policyholder needs and demands will help to generate an insurance culture. The key strategy to achieve this goal is to involve policyholders (or prospective clients) in the process of making hard choices between benefits and price. The poor cannot afford comprehensive coverage, so which benefits are they most willing to pay for, and how much are they willing to pay? Tools that can enable clients to see the trade-offs and voice their preferences will go a long way toward appropriate product design.

Paying a claim — delivering on a promise — is arguably the most important opportunity to reinforce the value of insurance. Because insurers have a reputation of being quick to take the policyholder's money and slow to pay it out, microinsurance has to prove otherwise. The best marketing opportunity for an insurer, the best way to change the opinion of a lukewarm and sceptical market, the best way to demonstrate its trustworthiness, is to pay claims. At least, insurers should take great pains to avoid rejecting claims, for example, by keeping the product simple, making sure policyholders are crystal clear about what is and is not covered, and requiring only the most basic claims documentation, which is easy to access.

There is no room for fat in a microinsurance budget. By keeping the product simple, it may be possible to hire less expensive staff members, ideally people from the local communities. Where possible, insurers should rely on existing groupings to conduct bulk transactions. One way to earn the trust of the market and maximize efficiencies is to collaborate with community organizations. Well-respected organizations and community leaders can enhance the credibility of insurance (or of insurers). If the local organization already engages in some sort of financial transaction with the target market, then efficiencies could be generated by 'piggybacking' premium collection onto a loan, savings or money transfer service.

Great expectations are placed on the potential of technology to enhance efficiency. Technology can improve the microinsurance business because of the information-processing nature of the sector. Even before the birth of the computer, large insurance companies drove the development of sorting, tabulating and calculating machines to improve efficiency. Today, these capabilities are available to small insurers as well. Microinsurers big and small must take advantage of ways of improving efficiency, through the use of smartcards, mobile phones, the Internet and wireless communications, among others.

To succeed in an insurance company, microinsurance needs dedicated human resources, as well as some space to experiment and innovate, to do things differently than the insurer has done them in the past. Different sets of incentives and targets should be considered for microinsurance staff members. To provide good value to customers, insurers must take a long-term perspective and assume that real returns will only come several years down the line. Efforts to generate quick returns may backfire by reinforcing the market's negative perception of insurers. Instead, the focus should be on maximizing customer loyalty under the expectation that today's low-income household may be in tomorrow's middle class, demanding larger sums assured and additional covers.

6. CONCLUSION

To take advantage of this opportunity, commercial insurers will have to overcome some key obstacles. Internally, insurers need to make a commitment to serve the poor, which involves getting to know the market, and having the resources and latitude to innovate. In many companies, this 'willingness' issue is not an easy one to overcome, at least not until senior executives are convinced that the low-income market is worth the trouble. Externally, insurers have to work hard at securing acceptance by the low-income market, about insurance as a relevant risk-management tool, and about the insurer itself.

Backed by a grant from the Bill & Melinda Gates Foundation, the ILO's Microinsurance Innovation Facility was established in 2008 to support the extension of insurance to millions of low-income people in the developing world, with the overall aim of reducing their vulnerability to risk.

The Microinsurance Innovation Facility engages in four sets of activities:

- *giving grants to institutions to devise and test innovative approaches to providing better insurance products to low-income women and men in developing countries*
- *supporting the development of technical assistance providers and encouraging the demand for technical assistance*
- *supporting research on core issues related to insurance cover for low-income*
- *households disseminating information and lessons learned to key stakeholders*

To find out more, contact us at:
International Labour Office
Social Finance Programme – Employment Sector
4, route des Morillons
CH-1211 Geneva 22
Switzerland
Tel.: +41 22 799 67 86
Fax: +41 22 799 68 96
Website: www.ilo.org/microinsurance

About the author

Craig Churchill joined the ILO's Social Finance Programme in 2001. Craig has 15 years of microfinance experience in both developed and developing countries. Prior to joining the ILO, he worked with Get Ahead Foundation in South Africa, ACCION International, the MicroFinance Network, and Calmeadow. In his current position, he focuses primarily on the role of financial services that the poor can use to manage risks and reduce their vulnerability, including microinsurance and emergency loans. He serves of the Chair of the Microinsurance Network and on the Editorial Board of the MicroBanking Bulletin. A graduate of Williams College and Clark University, both in Massachusetts, Craig has authored and edited over 40 articles, papers, monographs and training manuals on various microfinance topics including microinsurance, customer loyalty, organizational development, governance, lending methodologies, and regulation and supervision.