Article from:

International News

August 2010 – Issue No.51

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Microinsurance 101

By Denis Garand and John J. Wipf

Both authors have worked as consultants in the field of microinsurance for more than 15 years. Aside from microinsurance product development, experience reviews, pricing, and other types of actuarial work, the bulk of their effort is in other areas of microinsurance development such as assisting with market research, operations training, business planning, IT systems development, and others.

WHAT ARE THE DIFFERENCES BETWEEN COMMERCIAL INSURANCE PRODUCTS AND MICROINSURANCE IN DEVELOPING COUNTRIES?

Since microinsurance is a very broad term with many definitions we adopt the simplest of these, "insurance products designed for low-income households."

Most consumers in developed countries (and better-off consumers in developing countries) buy, or at least are familiar with, many kinds of insurance products which cover their lives, property, cars, and even the risk of their cancelled flights. These products exist largely because the market demands them.

Although microinsurance has been around for a long time under various names such as "industrial insurance," the number of products has increased tremendously in the past few years as donors and development organizations realized the importance of insurance in complementing poverty alleviation programmes. At first the main suppliers, i.e., insurance companies, simply took existing commercial products and scaled them down to a level where poor households could afford the premiums. This approach did not work very well since the needs of the poor are different from the commercial market, and because the commercial products were too complex. Today, more commonly, insurers and self-insured programmes are developing simpler products on the basis of expressed household needs with additional inputs from other stakeholders such as front-line distribution channels.

Generalizing, microinsurance products are usually much simpler, designed to cover the various needs of the poor, more inclusive, and often extend to all members in the household. Often, several microinsurance products are bundled as one composite product covering several risks. Premium is usually payable more frequently, even weekly, to suit the cash flows of poor households. At least one innovative programme in India collects premium through a network of agricultural cooperatives in the form of milk produced by its participating dairy farmer households.

HOW CAN THE POOR AFFORD THE COST OF INSURANCE?

The fact is the poor cannot afford to buy coverage for all of the insurable risks that they are exposed to. Typically, product development begins with a survey within the target market to determine the premium level that households can comfortably afford to pay, are willing to pay, as well as when and how they can pay. Another objective of such surveys is to build a priority profile of the risk events that households want to insure and the approximate coverage amounts expected.

The second step is to feed the summary information from the survey into an actuarial model from which the future financial performance of

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the microinsurance programme is studied. The premiums and benefits are adjusted until a suitable balance is achieved in the model. This process results in a sustainable product that is also affordable, and although coverage is based on the preferences of the majority it generally does not cover all of the household's risks.

One key to making products affordable is to minimize distribution costs. This is why microinsurance works best if it is offered through existing client/member servicing channels such as non-government organizations (NGOs), microfinance institutions (MFIs),[1] or credit unions. In the latter case, for example, the accounts of members can be accessed for frequent premium collection at marginal cost. Without taking advantage of such distribution synergies it is difficult to make microinsurance work.

Insurance can also be made more affordable by enforcing mandatory coverage for all members of a group. Although this policy is often criticized, it improves economy of scale, simplifies administration, and improves claims experience, hence making the products cheaper per unit of insurance.

By way of example, a product developed with the assistance of the authors for 25,000 clients of an MFI in south-east Asia costs USD$0.07 per week and includes limited assistance if the head of the household is hospitalized (USD$67, and it can be claimed only once every 5 years), as well as life insurance for the whole family (ranging from USD$65-$200). Participation is mandatory. In addition, the MFI requires each borrower to purchase credit life when taking out a new loan (single net premium of 0.40 percent of insured volume per annum). These products were carefully priced in combination using a survivorship/business planning model developed for this purpose, but required extensive inputs from the MFI to project realistic expenses, lapse rates, investment strategies, etc. and to set important parameters such as targeted rate of surplus build-up. Affordability in this case was determined through a market survey and focus group discussions of the MFI's clientele.

CAN MICROINSURANCE WORK WITH THE VERY POOR OR ONLY WITH THE ECONOMICALLY ACTIVE POOR?

The description above on how products are developed should make the answer to this question obvious- products are developed based on what the target market can afford. Occasionally governments and donors will subsidize programmes but this usually does not achieve good long-term results since the subsidies are only temporary. It is near impossible to cross-subsidize products between higher and lower risk groups although it is sometimes possible to a degree in communities where the spirit of self-help and solidarity is high.

The main solution for the very poor is to include them in government-sponsored social protection programmes. This is equivalent to saying that redistribution of wealth within the country is necessary. Unfortunately, in most developing countries the tax base is much too small in proportion to the scale of poverty for this to work well. Some countries do achieve at least a measure of success, such as in Philippines where the poorest of the poor do not have to pay for participating in the government-run national health insurance programme.

WHAT KIND OF RISKS DOES MICROINSURANCE USUALLY COVER?

A recent study[2] showed that the main

[1] Note that some MFIs are NGOs, some are not.

[2] See The Landscape of Microinsurance in the World's 100 Poorest Countries *http://www.microinsurancecentre.org/UploadDocuments/Landscape%20study%20paper.pdf*

> "Product innovation is driven by the market and by other factors such as technology."

microinsurance product is credit life; this pays off the outstanding loan of a borrower who dies. Generally this product is mandatory in order to take out a loan. Being driven by lending institutions is one reason why this is the most popular product and the fact that it is one of the easiest to manage is another.

Other popular products include term life, whole life, endowment, health, and some non-life products such as property protection. Savings products linked to such needs as education of children, cost of funeral services, or retirement are also in great demand but limited.

Most products are group products since individual underwriting and distribution is uneconomical for products with such low insured amounts.

Most market studies show that health insurance is in greatest demand. Unfortunately, it is also the most complex to manage for a wide variety of reasons. Today, a great number of health insurance programmes are self-insured because insurance companies do not want to assume the risk. The few successful programmes educate their market well, ensure that high quality and efficient care is delivered, and promote holistic health strategies to the market.

WHAT OTHER TYPES OF MICROINSURANCE PRODUCTS ARE BEING DEVELOPED?

Theoretically, products can be developed if there is demand and the risk event is insurable. Product innovation is driven by the market and by other factors such as technology.

Of late, index-based products are generating a lot of attention but most of these are still in pilot phase. One example is a product that is currently being piloted in the northern Kenyan district of Marsabit where satellite technology is used to measure the amount of forage in pilot areas. This measure is used as a proxy for livestock mortality. Index-products such as this have some great advantages over indemnity-based versions since they practically eliminate moral hazard and the high cost of individual claims adjustment, but their utility is reduced since compensation is usually not reflective of real individual losses.

For some markets, products need to be modified in order to make them Shariah compliant, i.e., to ensure that they conform to Islamic principles and values.[3]

WHAT TYPES OF INSURANCE COMPANIES ARE BEST SUITED FOR MICROINSURANCE?

Generally, mutual insurance programmes with sufficient technical assistance and reinsurance are positioned to develop more relevant products and can service these more efficiently than commercial insurers. Some insurers, however, are working very hard to improve their performance in this area and some are succeeding.

Some commercial insurers are very innovative, such as one general company in India which distributes insurance to farm households by attaching a small amount of accidental death and disability cover (US$90) to each bag of fertilizer sold by its agricultural distribution partner. The buyer of the fertilizer has coverage for a year whether or not he wants it since the premium is packaged with the cost of the fertilizer. Each farmer can only avail himself of a maximum amount of insurance (25 bags). The name on the fertilizer receipt is also the person covered. In 2005 the company sold over 25 million bags of fertilizer.

[3] This is called Takaful insurance.

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WHAT ARE THE MAIN IMPEDIMENTS TO AND REQUIREMENTS FOR SUCCESS IN MICROINSURANCE?

In the authors' experience, limited availability and poor data creates some difficulties in pricing but this is not the most significant challenge by far. There are numerous other challenges, many of them situation and culture specific, but perhaps the most significant universal problem is the low level of awareness and lack of financial literacy. It is a surprise to many that after launching a new product, uptake is not as they had expected. This is often due to a lack of trust and limited awareness which can only be overcome with persistent and effective market education. Providers must enter a particular market for the long term in order to realize financial success.

Developing a cost effective distribution system is a key to success. Using traditional individual distribution methods is costly and difficult. It is important to work with organizations that the low income market trusts; therefore existing institutions that have gained that trust are excellent partners. One MFI in India offers credit life insurance plus a lump sum funeral benefit if the borrower or spouse dies. Being very close to its clients enables the MFI to effectively process and pay claims within 24 hours after death. Their total annual cost of operations including distribution is less than $0.10 US per insured member. Without access to a trusted and effective distribution channel such as this there is little chance for viability.

For insurance companies, a principal challenge is to understand the operational changes that are required such as a) simplifying contracts to single pages; b) communicating simply yet effectively to clients; and c) changing claims adjustment policies by removing bureaucracy while maintaining control.

In the early 1990s a study conference was set up by the Indian regulator IRDA and a leading NGO in that country with an objective of creating a dialogue between insurers and NGOs on how to make microinsurance succeed. In that conference, insurers in unison presented their existing methodologies applied to smaller sums insured while the NGOs suggested alternative, simplified approaches to administration and developing products. Today, it is the insurers urging innovative and alternative changes to process and products. In fact, by engaging in microinsurance, a major learning for the insurance industry has been that by simplifying processes, profitability on their regular lines of insurance could be greatly improved.

CONCLUDING THOUGHTS

Actuaries interested in microinsurance are encouraged to study the many excellent publications that exist and are available on the website of the Microinsurance Network. To be effective, it is important to gain real experience and understanding on how to work with low income populations and in different cultural settings. Interventions should be regarded as a form of public service and one should not expect to earn regular fees when working with populations earning less than $2 a day.

For insurance companies, there are valuable lessons from microinsurance that will improve their efficiency and profitability on their regular lines of business. Success will only follow those that are open and willing to change.

Working with microinsurance helps remind us all realize the tremendous social value that insurance has on society.

Although microinsurance has been around for a long time under various names such as "industrial insurance," the number of products has increased tremendously in the past few years as donors and development organizations realized the importance of insurance in complementing poverty alleviation programmes.

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John and Denis have coauthored a handbook "Key Performance Indicators for Microinsurance," and will be releasing shortly a book on introduction to microinsurance. □