Innovations in Microfinance

This series showcases innovative microfinance programs from the February 2000 "Advancing Microfinance in Rural West Africa" conference held in Bamako, Mali. The programs emphasize reaching new frontiers in rural areas, particularly in West Africa. These notes are an investigation of innovative practices working in specific environments, not a general endorsement of financial products. We recommend institutions utilize these technical notes as introductory information.

Insurance as a Microfinance Product

There is an attractive development logic for the provision of insurance to low-income households. One can easily create a compelling story of how a microinsurance product will protect the poor against devastating losses or smooth the volatile cash flow of low-income households, while generating increased profits for the microfinance institution (MFI). Today's microfinance industry abounds with such stories, and dozens of MFIs are rolling out microinsurance products in a rush to meet both client and institutional needs.

Defining Microinsurance

Insurance is a financial product that pools risk by collecting relatively small premiums from a large population and funding relatively large payouts to the small portion of that population that suffers losses from a specified risky event. Microinsurance refers to the subset of insurance products designed to serve and be affordable to low-income individuals and groups.

While there is no doubt that low income households are highly vulnerable to risks—nor that MFIs are in need of increased profits—microinsurance is only a partial response. It is also a response that most MFIs will find difficult to implement, because they have not yet had cause to create the specialized skills and institutional structures that commercial insurers have developed over decades, in order to underwrite risks prudently.

This brief describes the parameters of microinsurance in the range of risk management products and tools typically used by microfinance clients. Additionally, it describes the main types of insurance being offered by MFIs today, and highlights the resources MFIs require to manage insurance premiums and products profitably. It concludes with a suggested approach to microinsurance that is built on partnerships between MFIs and licensed insurers.

I. RISK MANAGEMENT IN LOW-INCOME HOUSEHOLDS

TYPES AND CHARACTERISTICS OF RISKS

Low-income households identify some of the most common causes of declines in their well being as death, injury, or illness of an income earner; natural disasters; and theft. Exposure to these risks affects households in two ways. First, households affected by a risky event incur a potentially substantial monetary loss, such as the cost of rebuilding a market stall destroyed in a fire. Second, households exposed to a risk suffer on-going uncertainty about whether and when a loss might occur. For example, if fires occur frequently in her market, a vendor may be unwilling to expand her stall for fear of losing the stall to fire before benefiting from the modifications.

Prior to developing appropriate risk management responses, it is useful to characterize the six most common risks according to (1) their degree of uncertainty (i.e., if, when, and how often the risky event might occur), and (2) the size of the loss the risky event may cause. Figure 1 presents these characterizations graphically for lifecycle, death, property, health, disability, and mass/covariant risks, each of which is briefly defined below.

1. **Life Cycle Risks** include the potential needs to supply a dowry, pay for education, and save for retirement. While these risks are not faced by all families, they occur with frequency. Further, while burdensome, their costs are generally manageable relative to a family's lifetime ability to generate income. The uncertainty associated with life cycle risks concerns primarily whether a given family's flow of income and accumulation of savings coincides with the timing of required expenditures.

2. **Death Risks** are unavoidable but have a greater uncertainty of *timing* than life cycle events. The associated costs may be simultaneously one time and small (funeral costs) and ongoing and large (replacement of income).

3. **Property Risks** include events of theft, damage, or loss of family or business assets. Property risks are far more uncertain than life cycle or death risks, because both timing and whether the event will occur at all are unknown. Property risk costs vary with the value of the asset at risk.

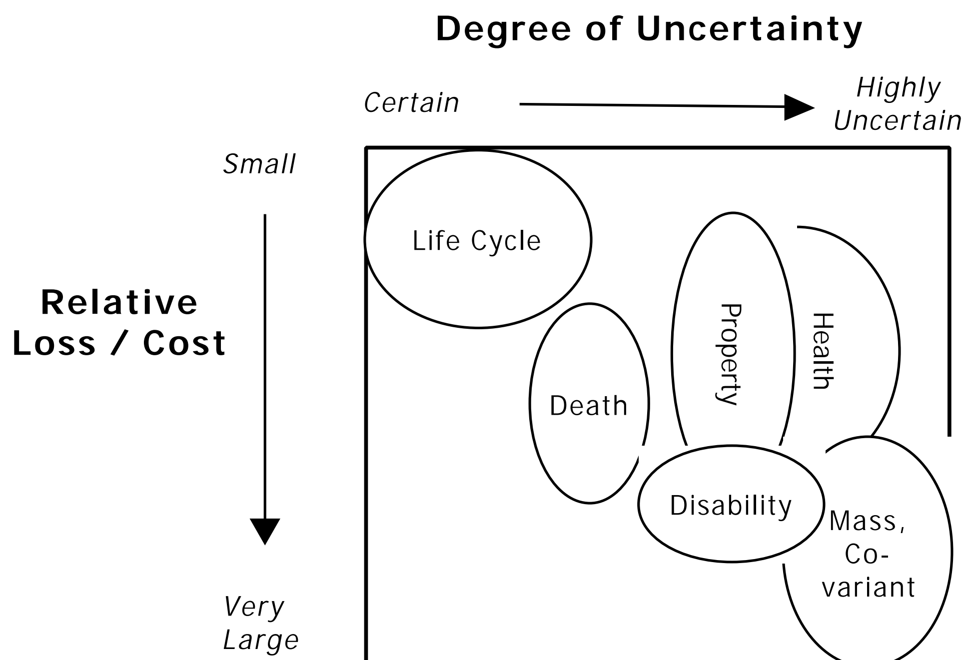
4. **Health Risks** from accidents, illnesses, and injury of household members vary in cost, depending on the nature of the event. These risks may be frequent, but their timing is difficult to predict. They are regarded by low-income households as generating a greater degree of uncertainty than most other risks.

5. **Disability Risks**, in contrast to the one-time or sporadic occurrence of health risks, are a continuing problem. Costs from disability risks are ongoing and may include treatment expenses as well as lost income. While higher in cost than health risks, their likelihood is more uncertain.

6. **Mass/Covariant Risks** include natural disasters, epidemics, and other major events that cause substantial and simultaneous losses for a large part of the population. While their

effects on individual families can be placed in the five categories just defined, mass covariant risks are considered separately because they are highly unpredictable, affect many people at one time, and often cause multiple losses within the same household. Mass/covariant risks occur infrequently and are generally impossible to predict with precision.

Figure 1: Characterizing Common Risks



RISK REDUCTION AND RISK COPING

Poor households already deal with the risks described above by employing a combination of **risk-reduction** and **risk-coping** strategies

Risk Reduction strategies are developed prior to risk events to reduce the family's exposure to the potential occurrence of the risk. Examples include diversifying income sources (e.g., farming and trading) and having several household members work in different types of employment or self-employment.

Risk Coping strategies reduce the impact of a loss after the risk event occurs:

- *Informal individual risk-coping strategies* include the accumulation of salable assets (livestock, gold), reciprocal lending or gifting, and the creation of a reserve credit capacity with merchants or other sources. The use of individual coping strategies such as these is widespread, but is less effective among poorer people who have smaller social networks and fewer assets.

- Low income households also seek to reduce vulnerability to loss through *informal group-based risk-coping strategies* such as savings clubs which accumulate savings and redistribute them to members either sequentially, at a defined time, or for specific events such as marriage or

death. Such savings clubs can be a particularly effective risk-coping strategy for lifecycle risks, which impose relatively small and predictable costs. There has also been some experience of borrowing on demand from the clubs, which has expanded their potential as a coping strategy for risks that impose somewhat higher one-time losses, such as medical emergencies and some property risks.

- Savings and credit products offered by institutions rather than organized by the participants themselves are examples of *formal group-based risk-coping strategies*. While these financial products have the primary purpose of serving investment needs, rather than mitigating vulnerability, some financial products are designed (and many more are used) as risk management tools. Savings and credit products are limited, however, to providing coverage equal to the amount that a household has saved or can repay.

INSURANCE: A SUPERIOR ALTERNATIVE…FOR SOME TYPES OF RISK

In contrast, insurance can provide low-income households with a greater degree of protection against property, death, health, and disability risk, because the risk of these events occurring is pooled over a large number of people, at a much lower cost or premium per person. The cost of insuring against an uncertain event is considerably lower than self-insuring through savings, and is small relative to a household budget.

As a risk event becomes more certain, and the expected amount of loss is more manageable, credit and savings products become more cost effective than insurance. For example, lifecycle events are mostly predictable, occur widely, and have a cost that most households can bear. If insured, the incidence of payout would be high and could be financed only through a premium that was high relative to a household's annual income. For this reason, lifecycle risks are typically mitigated with savings and credit.

Conversely, disability, and some death, health, and property losses are higher than the levels at which most households can reasonably self insure. However, these events are much more uncertain and may never occur at all within a certain time span. As a result, they are candidates for mitigation through broad-based risk pooling, accomplished through insurance with relatively low premiums per person.

Mass/covariant risks are generally not insurable (without access to reinsurance or a geographically diverse group of policyholders). The potential that an entire insured population would be exposed to a loss simultaneously largely eliminates the benefits of risk pooling. Financial sustainability of the insurance plan would require total premiums equal to the sum of individual self-insurance requirements.

Referring to Diagram 1, insurance emerges as an appropriate risk-management strategy only if the degree of uncertainty and the relative cost associated with the risk do not reach extremes on either end of the spectrum. Neither high-certainty/low-cost lifecycle risks, nor low-certainty/high-cost mass/covariant risks are readily mitigated through insurance. Table 1 compares the characteristics and applicability of insurance, credit, and savings products as risk-management strategies.

Table 1: Characteristics of Formal Risk-management Strategies

Financial Product:	**Insurance**	**Credit**	**Savings**
Cost	Low; cost covered by pay-in from a large pool of people	= Payout (loan principal repayment) + interest on loan	= Payout (amount saved) – interest earned on account
Leverage	High (Cost is a small fraction of payout)	1:1, excluding interest	1:1, excluding interest
Risk Sharing	Widespread	None: self-insuring	None: self-insuring
Recovery of Investment in Product (if no event of risk occurs)	None	Full: loan not taken or credit can be put to other use	Full: savings and interest are available for other uses
Best Use	Protection against larger, uncertain risks	Protection for smaller, more certain risks	Protection for smaller, more certain risks
Limiting Factors	More certain events and mass/covariant risks are uninsurable	Risk coverage limited to the amount of loan allowed	Risk coverage limited to the amount that can be saved

II. TYPES OF INSURANCE

MFIs have begun offering a wide range of insurance products. The most prevalent are summarized here.

LIFE INSURANCE

- **Term Life Insurance** provides coverage against the death of the insured for a specified term; the amount paid out (face value) is pre-determined. O*utstanding balance life insurance*, also called *credit life insurance*, is a type of term life insurance that will pay off a loan balance in the event of the death of the borrower.

- **Permanent Life Insurance** provides similar coverage, but has no specific term and also has a cash value that can be drawn down or borrowed against like a savings account. The cash value equals the premiums paid, less the cost of providing the insurance, plus interest earned on the premiums.

- **Endowment Life Insurance** carries a cash value but provides protection for a fixed term. At the end of that term (assuming no payout for death during the term) the policyholder receives a fixed payout equal to the policy's cash value and interest earnings.

- **Live Savings Insurance** is most commonly offered by credit unions. Generally, the credit union purchases a group policy for its members that provides a member's beneficiaries with a multiple of the member's deposit balance in the event of the member's death.

Term life insurance is the product that is most frequently offered by microinsurers, particularly outstanding balance life insurance. This product has the most limited coverage, but is also the least expensive. In effectively canceling the related debt it relieves surviving family members of part of the financial burden associated with death. From the perspective of most MFIs, the product's more important benefit is institutional, as it lowers loan default rates and collection costs.

More elaborate versions of outstanding balance life insurance include debt cancellation with additional benefit, either a fixed payment to the family, or a fixed overall payment equal to the original amount of the loan such that the family will receive a larger benefit if the loan is almost paid off. There are some instances of permanent and endowment life insurance, including policy loan features, offered in low-income markets in Bangladesh and Uruguay, but the complexity of these products has made them difficult to offer and manage.

Some microinsurers have been developing another type of term insurance, *loan default insurance*, which repays a loan once it has gone into default. Two major issues that have arisen with this type of insurance are that it is highly exposed to moral hazard and may obscure a weak credit methodology.

Other lessons learned by the MFIs concerning life insurance include:

- Insurance cannot be offered universally – elderly individuals and people with pre-existing terminal illnesses must be excluded to maintain the financial stability of the provider.

- Using mandatory, group policies reduces the insurer's costs and potential for abuses of policies, but insurers then have a reciprocal obligation to make sure that clients are satisfied with the product.

- Both staff training for marketing and client education about the nature of insurance and the mechanics of making payments and submitting claims is critical.

PROPERTY INSURANCE

Property insurance covers the cost of damage to or loss of any type of asset, including buildings, business stands, homes, livestock, inventory, equipment, vehicles, tools, and personal valuables. Like term life insurance, coverage is extended for a limited period of time. Three aspects of property insurance make it riskier and administratively more complex than life insurance:

- Greater complexity in asset valuation and determination of payout.

- Higher incidence of claims;

- Higher likelihood of fraudulent claims – significant administrative resources are required to verify claims and the cause of loss or damage.

Property insurance is usually offered by microinsurers to insure the property that is collateral for an MFI loan or a lease. For instance, Grameen Bank requires insurance coverage on all loans used to purchase livestock, and the NLC of Pakistan has mandatory insurance on leased assets. To reduce the risk and complexity of the product, the insurer may limit claims payments to the outstanding balance of related credit rather than cover the replacement value of assets.

Additional lessons learned include:

- Preventing property losses can help reduce claims. Conversely, policy holders should be rewarded for taking preventive measures. While low-income households have been unlikely to file false claims, access to insurance may cause them to neglect insured assets. Controls or incentives should be designed to discourage or prevent neglectful behavior.

- Property insurance lends itself to distribution with other products or services, through existing channels (such as loan officers or branches), even when it is offered as a standalone product.

HEALTH INSURANCE

Health insurance may cover all or part of the costs hospital and surgical expenses, medications, and doctors' fees, incurred as the result of specified accidents or illnesses. Payments may be made to either the household or directly to the care provider.

Health insurance is riskier and more complex than life or property insurance because health claims are frequent, complicated, and varied. The insurer is also dealing with the potential for unexpected claims due to adverse selection (tendency of persons with higher than average risk to seek insurance at standard rates), moral hazard, or other abuses by both the insured and the health care provider.

The microinsurers who are experimenting in this field are largely health care providers themselves. An exception to this is FINCA Uganda, which has established an agency agreement with a local hospital. None of the programs studied so far has consistently covered the full cost of providing both health insurance and health care services for a predominantly poor population. There are some lessons learned, however, that can be relayed:

- Premiums must be affordable, which will limit the range of services that can be provided. Clients should participate in the selection process so that the products are more likely to be accepted and client expectations are more likely to be sustainable. Coverage of preventive care improves members' health, and may reduce claims over the long run.

- Health insurance is a complex product that requires strong administration and controls.

- Families, rather than individuals, should be insured to reduce transaction costs and adverse selection.

- Co-payments, identification cards, generic drugs, and maximum coverage amounts are all used to control costs.

DISABILITY INSURANCE

Disability insurance is related to health insurance in that it protects against the reduction or loss of income due to illness or accident. Temporary disability insurance typically provides a portion of wages or income until recovery from the related illness or accident; permanent disability insurance provides income replacement if a person is not able to work again for life. Disability products are specialized, because of the difficulty in both estimating the probability of occurrence and assessing the amount to be paid as income replacement. This is a particularly significant problem for low income households, because of their erratic income flows.

The Dismal History of Crop Insurance in Developing Countries

To improve the ability of rural farmers to repay loans from agricultural development banks, many governments developed crop insurance programs in the 1970s and 1980s. These programs typically provided loan repayment and occasionally income supplements to farmers suffering crop yields below an established minimum. Similar programs were developed in countries as diverse as Brazil, India, the Philippines, and the United States. In each country, the results were disastrous, with expenses (administrative and claims) totaling 2 to 5 times revenues in any given year. The failure of these programs was, in large measure, the result of trying to provide insurance in uninsurable conditions:

- **Unspecific Coverage.** By guaranteeing a minimum crop yield, these programs were essentially insuring against all possible causes of poor crop yield, a virtually endless list of risks.
- **Covariant Losses.** Many of the programs were bankrupted when a drought or other natural calamity hit the region in which the program operated, affecting most of the insured members at the same time.
- **Moral Hazard.** Farmers were less likely to follow sound husbandry practices because all severe yield losses were protected, leading to an increase in claims.

Balance of Risks. Coverage was often focused in specific geographic regions and provided only for poor farmers, essentially covering only the highest risks.

WHAT CAN AND CANNOT BE INSURED?

Even where the general category of risk appears appropriate for mitigation through insurance, and the MFI and its clients both have an interest in the type of coverage being considered, other factors may make coverage impossible. To create a sustainable product, the MFI must ensure that its proposed coverage meets the following basic insurance principles:

- **Large Numbers.** Insurance works by pooling the risk of a large population. If the pool of policyholders is too small, volatility in the number of claims can lead to an unexpected increase in claims, thereby bankrupting the plan. Although no precise minimum number of policyholders can be established, fewer than 1,000-2,000 is likely to create undue risk for the provider.

- **Specified Risks Only.** Insurance can be designed to protect only against specific risks for which the chance of loss can be calculated.

- **Not Covariant.** Risks covered by insurance can affect only a relatively small portion of the total insured population at any given time. If a risk, such as a flood or HIV/AIDS for example, is likely to cause similar damage to a large portion of an MFI's clients at the same time, a single occurrence of the risk would bankrupt the plan.

- **Controls on Moral Hazard and Adverse Selection.** The ability of policyholders to influence whether the risk occurs must be limited or controlled. If a policyholder can control the timing or likelihood of loss, claims can quickly increase beyond expectations, leading to bankruptcy. Similarly, if policyholders can select into or out of coverage as the likelihood of their incurring the risky event increases and decreases, the plan will suffer

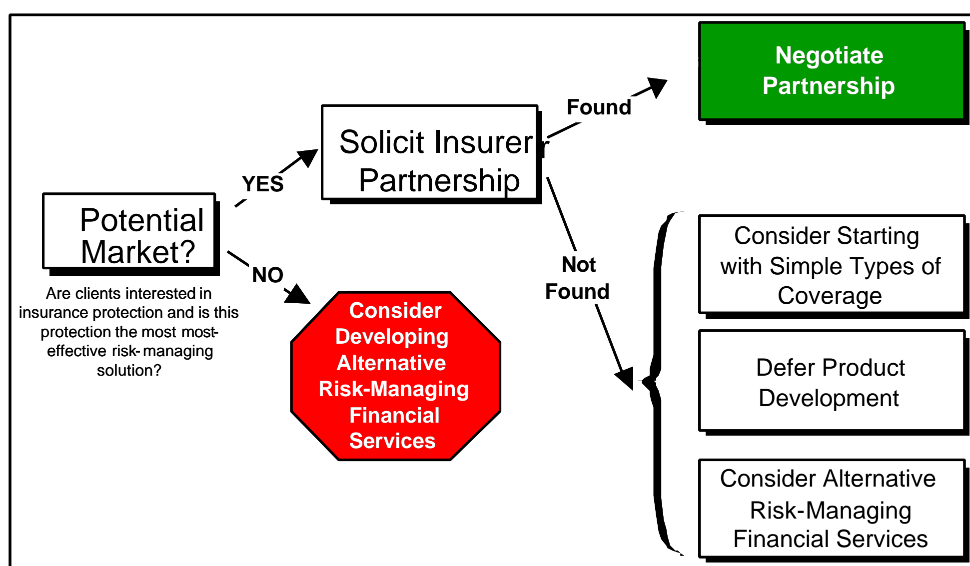
unexpectedly high claims. Risks posed by moral hazard and adverse selection are especially high in the provision of property and health insurance, respectively.

- **Balance of Risk.** The pool of insured households should include both high- and low-risk cases so the average risk occurrence within the pool is similar to the average in the population at large. Controls should be in place to ensure the pool does not become overwhelmed by high-risk policyholders.

III. Resources Required to Manage Insurance Products Profitably

MFIs should question seriously whether they have the internal resources, skills, and infrastructure required to manage an insurance product profitably. This brief advocates the development of microinsurance products through MFI partnerships with licensed insurers, as shown in Figure 2, below.

Figure 2: Decision Tree for Microinsurance Product Development



For cases where partnerships are not feasible, this section highlights the different activities involved in providing insurance and identifies areas where MFI-designed and -managed programs tend to run into difficulty. It is important to note that the level of complexity and required resources and skills for each activity are much greater for health and property insurance than for life insurance. As a result, the cautions identified here apply doubly to MFIs considering offering health or property insurance. In general, where partnerships are not feasible, it is wise to limit insurance offerings to basic outstanding balance or life savings products.

ACTUARIAL ANALYSIS AND PRICING

For an insurance scheme to be viable, the managers need to be able to predict, with a reasonable degree of accuracy, what future claims will be. If these predictions are inaccurate, unexpectedly high claims can decapitalize an institution. Licensed insurers use reinsurance to

control this risk in both new and established lines of business. To date, no such reinsurance is available to MFIs that offer insurance on their own, leaving them highly exposed, especially in the early years, to small fluctuations in claims expenses. MFI microinsurance programs tend to encounter difficulties in three areas of actuarial analysis and pricing:

1. Estimating Future Losses. Insurance premiums need to be set high enough to cover future claims. When reasonable historical information is not available or where historical averages are no longer likely to reflect future losses (for example, HIV/AIDS is radically changing the average death rates in parts of Africa), pricing should incorporate a sufficient margin of error to reflect the uncertainty in future claims behavior.

2. Establishing Underwriting Criteria. Integrally related to the task of estimating future losses is the need to establish underwriting guidelines, the general eligibility criteria that will be used in the underwriting process to determine whether a specific individual may purchase coverage. Underwriting guidelines are perhaps the single most important risk management tool available to an insurer; they should be developed with the assistance of experienced professionals.

3. Establishing Reserves. In addition to covering claims and administrative expenses, insurance premiums should be set high enough to allow for the establishment of reserves. Reserves are funds set aside each year to protect the insurer against unexpectedly high claims. If claims expenses exceed annual premium revenues, claims are paid out of the reserves and the scheme remains solvent. For this reason, insurance regulations (see below for more detail) typically require a new insurer to provide a minimum initial amount of capital before starting operations. MFIs however, typically have limited liquid reserves, leaving them highly exposed to unexpected losses, particularly during the first few years of operation.

MARKETING

Marketing of microinsurance requires intensive staff training, because it involves more that just selling policies. Successful insurance marketing also educates prospective clients about the potential benefits and cost of the product and ensures that anyone purchasing the product knows how to use it. Marketing of insurance is also less straightforward than credit or savings because clients need to be willing to pay premiums even when they are not receiving any direct benefits.

Several licensed insurers, particularly in different parts of Africa, have succeeded in selling a good volume of policies to poor households. However, in many cases these new policyholders did not understand what they were purchasing or know how to make a claim. These policies were profitable for the insurer, but only by taking advantage of its clients. Without mechanisms to monitor client satisfaction, MFI-offered insurance policies that are mandatory for borrowers or savers may run the risk of exploiting MFIs' existing relationships with clients, with potentially adverse consequences for the MFIs' loan and/or savings portfolios.

UNDERWRITING

Underwriting is the process of verifying whether insurance coverage should be provided to a particular potential policyholder. Typically, this involves confirming that the potential

policyholder meets the eligibility criteria established in determining the coverage of the policy and setting prices. For example, if a life insurance policy excludes deaths because of pre-existing illnesses, the underwriting process needs to document all illnesses existing when a policy is purchased. MFIs considering developing a microinsurance product need to be concerned about how MFI staff will:

- Confirm the accuracy of the information provided by the prospective insured. In a small program, the inclusion of even a handful of high-risk policyholders can lead to serious unexpected losses.
- Monitor changes in the characteristics of the market and its portfolio, which may change the nature of the risk that has been insured. For example, if the average age of policyholders in a life insurance portfolio increases from 35 to 40 over time, the probability of claims has also increased.
- Avoid adverse selection by insuring a large percentage of the potential market. If the insured population is only a small percentage of the potential market (as would be the case for most MFIs, given their small size), stronger underwriting procedures are needed to ensure that adverse selection does not occur.

INVESTMENT MANAGEMENT

Managing the investment of premiums received from policyholders is integral to the financial sustainability of any insurance plan. Although most of the income from premiums is needed to cover administrative and claims expenses, the difference in time and value between receipt of premiums and payment of claims and expenses gives an insurance plan the opportunity to earn investment income. The challenge in managing the investments of an insurance plan is to balance the desire to earn greater investment returns and the need to maintain sufficient liquidity to meet claims and expenses as they occur.

Many MFIs are tempted to use insurance premiums as an additional source of capital to fund their loan portfolio. Initially, this may seem like a wise decision—funds invested in an MFI's loan portfolio may bring in more revenue than funds invested in a savings account or similarly liquid instrument. However, unless an MFI is operationally sustainable, funds invested in its loan portfolio actually earn a negative return. In addition, MFI loans are not liquid investments. If an MFI needs to use its insurance reserves to pay unexpected claims, it cannot quickly call in the loans it has made with the policyholders' premiums. Finally, in most regulatory structures, reserves cannot be commingled with the other resources of the insurer. Failure to maintain separate reserves could increase the likelihood of a liquidity crisis at the same time that it invites an aggressive response from regulators.

The investment strategy for insurance premiums must also encompass inflationary cost increases, particularly in high-inflation environments. This is a particularly thorny issue for health and property insurance that promise to provide certain services or replacement assets in the future in exchange for taking a premium today. If the premiums received today do not earn a real rate of return, they will likely be insufficient to cover the higher cost of claims in the future.

CLAIMS MANAGEMENT

Claims are the biggest single expense item for an insurance plan and are also the most volatile. As a result, the processes, systems, and staff in place to manage claims have a significant impact on the financial results of an insurance plan. These systems and staff are responsible for verifying whether a claim should be paid out and ensuring that the processing of claims is conducted quickly so policyholders receive their benefit in a timely fashion. Verification ensures that fraudulent and other types of ineligible claims do not unexpectedly increase expenses for claims above expectations, while processing time is a key factor in policyholders' satisfaction with the product.

For health and property insurance, the difficulties in verifying claims are considerable. For health insurance, the verification of claims involves numerous controls, including, for example, photo identification verification to confirm that a patient is indeed insured and detailed information tracking to ensure that certain doctors or patients are not making an unusual amount of claims. Verification of property insurance claims can also be problematic because the cause of the loss is not always readily apparent. For example, how can an MFI determine whether a fire that destroys an insured asset was an accident or a deliberate act carried out to collect the insurance benefit?

PRODUCT MANAGEMENT AND ADMINISTRATION

Coordination and communication among all of the activities mentioned above are also crucial to the smooth operation of an insurance product. The actuarial area needs to be kept informed by the marketing and underwriting areas about the types of clients that are being insured and by the claims department regarding the types of claims being received in order to refine and adjust prices. Any pricing changes then need to be communicated back to the rest of the organization. Without effective management and administration of this communication and information sharing, insurance plans quickly run into financial difficulties. Two areas where many MFIs lack the capability to manage the full range of activities involved in offering an insurance product are management information systems and management time/expertise.

Access to up-to-date, accurate information is crucial to the success of an insurance plan. Particularly for health and property insurance, even a one- to two-month lag in access to claims information can hide potential problems long enough for them to become serious. Manual accounting systems and processes, although simple and cost-effective for the operations of many small MFIs, are inappropriate for all but the most basic forms of insurance.

In addition to the time and effort needed to develop a product, MFI management will need to dedicate time to managing the product once it has been launched. Although the amount of time will vary for different products and different situations, it should not be underestimated. If an MFI is having difficulties with its credit portfolio, for example, management's time may be better spent focused on that issue rather than on a new product.

REGULATORY COMPLIANCE

Can an MFI provide insurance legally? Insurance regulations are designed to protect the financial sector and consumers from instability and misleading sales practices. Because their legal structure and financial resources differ markedly from those of traditionally licensed

insurers, MFIs often find that insurance regulations restrict their ability to provide insurance to their clients. Despite these restrictions, many MFIs choose to offer insurance products at the margin of the law. All MFIs considering offering insurance should consider the following questions:

To what extent does the plan for the proposed insurance comply with the regulations applicable to licensed insurers?

Minimum capital requirements and other rules established by insurance regulations may not have been designed with MFIs in mind, but an MFI should still be able to demonstrate it has sufficient capital and reserves to cover any reasonable, unexpected increase in losses. Insurance regulations also typically require that insurers provide regular reports on their financial status to the relevant body; there is no reason MFIs should not be able to do the same. In addition, MFIs should be able to demonstrate that policies are being sold in an open and fair manner and that clients are not being misled in the sales process.

If an MFI does plan to operate an unregulated insurance product, is it reasonable to assume that local regulators will allow this to happen? For how long?

Some MFIs may escape the notice of insurance regulators if they confine their operations to offering basic life insurance tied to their loans. What will happen if the MFI decides to expand its coverage? Will a regulatory vacuum persist indefinitely? MFIs should consider the penalties to which they might be exposed if found to be offering insurance products illegally. They should also consider the costs that an adverse legal finding could have on their insurance, loan, and deposit customers.

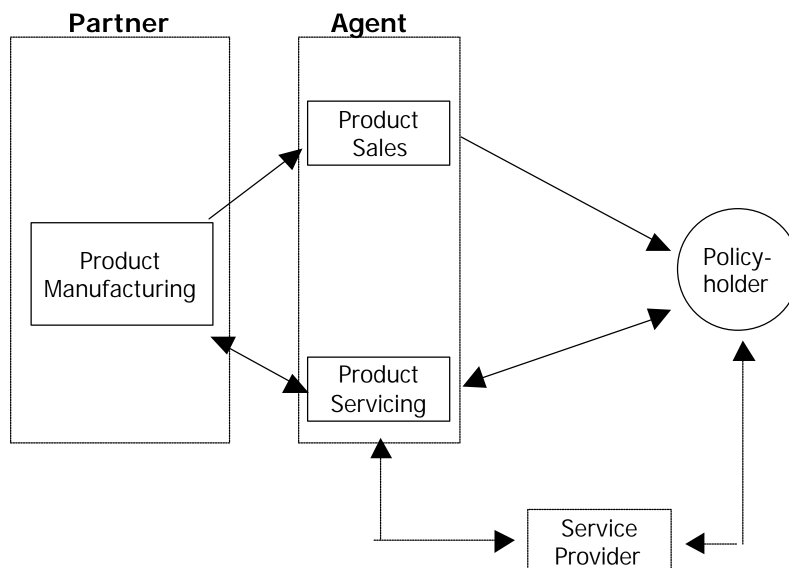
Ironically, the success of MFI-based insurance products would likely hasten the attention of regulators. Seeing a profitable market, licensed insurers would complain that MFIs compete against them on a playing field that is not level, unfairly escaping the costs of regulatory compliance.

IV. Entering the Microinsurance Market by Partnering with a Licensed Insurer

As the above discussion makes clear, profitable management of insurance products requires resources, skills, and institutional structures that differ significantly from those that have been developed by most MFIs. Rather than developing products independently, a promising approach that is being adopted by a growing number of MFIs is to enter a strategic partnership with a licensed insurance provider.

In an MFI-insurer partnership, each partner is able to provide the services and expertise it knows best—and for which it has already acquired the necessary resources. The MFI acts as the agent, marketing and selling the product to its existing clientele through the distribution network it has already established for its other financial services. The insurance provider acts as the partner, providing the actuarial, financial, and claims-processing expertise, as well as the capital required for initial investments and reserves as required by law. Figure 2 illustrates a partnership arrangement.

Figure 2: Partner-Agent Model



MFIs can achieve several benefits by entering the insurance market as an agent for an existing licensed insurer. These advantages include:

- **Low Initial Capital Investment and Low Variable Costs.** The MFI will not have to incur the substantial startup costs of developing actuarial, underwriting, and claims-management skills. Training for staff will be limited to sales and marketing.

- **Rapid Product Launch and Scale-Up.** Both the MFI and the insurance provider already have resources and staff in place.

- **Compliance with Legal and Regulatory Requirements.** Generally, if an MFI is only an agent, it is not subject to reserve or capital requirements, investment restrictions, and other policy provisions.

- **Potential for Stable Revenue Stream**. Commission income is usually higher than profits in the early years of offering an insurance product.

- **Learning the Business.** Insurance providers themselves use partnering as a way to expand into a new line of business before deciding whether they want to take on the new line of business directly.

In turn, the MFI partner offers several advantages to the insurance company, including:

- **Access to New Markets.** The MFI is usually serving clients who have previously been overlooked or avoided because of the costs of reaching them.

- **Access to Clientele with Strong Financial Records.** The insurance company will reach a base of stable clients who have existing financial relationships and borrowing or deposit histories with the MFI.

- **Lower Transaction Costs for Serving a New Market.** Much of the screening can be done by utilizing the MFI's existing records.

- **Corporate Citizenship and Regulatory Compliance.** Licensed insurers may benefit from the perception that they are contributing to the well-being of low-income groups and to the development of the financial sector as a whole. For foreign insurers, partnering with an MFI may also fulfill regulatory requirements for investment in domestic financial institutions.

MFI clients also are likely to be better off if the MFI partners with an insurance company to offer insurance products, rather than developing products and coverage on its own. These advantages include:

- **Better Products at a Lower Cost.** Insurers with experience and expertise are more efficient, and require less of a safety margin in premium calculations.

- **Greater Financial Security.** Clients benefit from the strength of a licensed insurer, which is likely to be greater than that of the MFI.

Arranging a partnership with an existing insurance company is not instant or easy. In many markets there may be a limited number of potential partners. To date, these partnerships have mostly focused on basic life insurance, rather than on more complex products, and there is concern that the insurer may place little importance on the payment of claims, because they individually will be small. Since MFIs know little about insurance, they are at a disadvantage in negotiating a partnership, in which they are trying to represent both their own and their clients' interest.

FINCA/Uganda and AIG

Working in conjunction with American International Group (AIG), FINCA's Uganda affiliate began offering outstanding-balance life insurance coverage for its village bank clients and their families in 1996. In the event of accidental death of a client, AIG pays the outstanding balance of the loan due to FINCA plus an additional benefit ranging from US$ 210 to US$ 830 to cover burial costs. This relationship has been beneficial for all involved. Clients' families receive a substantial benefit when a death occurs, FINCA/Uganda benefits through increased client loyalty and reduced loan defaults, and AIG gains low-cost access to a new customer base.

As in all new ventures, the keys to a successful partnership are communication, clarity, and transparency: the MFI needs to know what the insurers require from potential partners, and what the MFI should expect in return. At a minimum the MFI should consider the commissions that it will receive, the exclusions from the policy, and whether the information requirements for submitting claims are appropriate for low-income policy-holders. Conversely, the more the MFI understands insurance operations, can represent the needs and preferences of its clients for insurance coverage, and is prepared to sell and service insurance policies, the stronger its bargaining position will be.

KEY LESSONS ON MICROINSURANCE

1. Insurance is a product that is used to manage risk.
2. Insurance emerges as an appropriate risk management strategy only if the degree of uncertainty and the relative cost associated with the risk do not reach extremes.
3. Managing insurance products profitably requires skills and institutional structures that most MFIs have not had reason to develop.
4. Partnering with a licensed insurer can provide significant benefits to the MFI, its clients, and the insurer alike.

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