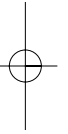
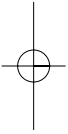




1 Principles and practices



I.I What is insurance for the poor?

Craig Churchill

The author wishes to thank the following persons for their useful feedback and suggestions: Bernd Balkenhol (ILO), Felipe Botero (Metropolitan Life), Alexia Latortue and Aude de Montesquiou (CGAP), and Gaby Ramm (consultant).

I Defining microinsurance

Low-income persons live in risky environments, vulnerable to numerous perils, including illness, accidental death and disability, loss of property due to theft or fire, agricultural losses, and disasters of both the natural and man-made varieties. The poor are more vulnerable to many of these risks than the rest of the population, and they are the least able to cope when a crisis does occur.

Poverty and vulnerability reinforce each other in an escalating downward spiral. Not only does exposure to these risks result in substantial financial losses, but vulnerable households also suffer from the ongoing uncertainty about whether and when a loss might occur. Because of this perpetual apprehension, the poor are less likely to take advantage of income-generating opportunities that might reduce poverty.

Although poor households often have informal means to manage risks, informal coping strategies generally provide insufficient protection. Many risk-management strategies, such as spreading financial and human resources across several income-generating activities, result in low returns. Informal strategies for coping with risk tend to cover only a small portion of the loss, so the poor have to patch together support from a variety of sources. Even then, informal risk protection does not stand up well against a series of perils, which unfortunately is a situation often experienced by the poor. Before the household has a chance to fully recover from one crisis, they are struck by another.

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. This definition is essentially the same as one might use for regular insurance except for the clearly prescribed target market: low-income people. However, as is demonstrated in this chapter and throughout this book, those three words make a big difference.

How poor do people have to be for their insurance protection to be considered micro? The answer varies by country, but generally microinsurance is for persons ignored by mainstream commercial and social insurance schemes, persons who have not had access to appropriate products. Of particular interest is the provision of cover to persons working in the informal economy who do not have access to commercial insurance nor social protection benefits provided by employers directly, or by the government through employers. Since it is easier to offer insurance to persons with a predictable income, even if it is a small sum, than to cover informal economy workers with irregular cash flows, the latter represent the microinsurance frontier.

Microinsurance does not refer to the size of the risk carrier, although some microinsurance providers are small and even informal. There are, however, examples of very large companies that offer microinsurance, such as AIG Uganda, Delta Life in Bangladesh and all insurance companies in India.¹ These large insurance providers have a product or product line that is appropriate for low-income persons.

An important aspect of microinsurance, explored in detail in Part 4, is that it can be delivered through a variety of different channels, including small community-based schemes, credit unions and other types of microfinance institutions, as well as enormous multinational insurance companies. In fact, Allianz, one of the largest insurance companies in the world, has recently launched an initiative with the United Nations Development Programme (UNDP) and the Gesellschaft für Technische Zusammenarbeit (GTZ) to provide insurance to the poor in India and Indonesia.

Microinsurance also does not refer to the scope of the risk as perceived by the clients. The risks themselves are by no means “micro” to the households that experience them. Microinsurance could cover a variety of different risks, including illness, death and property loss – basically any risk that is insurable.² This book, however, focuses primarily on life and health insurance as demand research across many countries repeatedly identifies illness and death risks as the primary concern of most low-income households (*see Chapter 1.2*).

Often people use the term insurance loosely to refer to general risk-prevention and -management techniques. For example, savings set aside for emergency purposes might be referred to as an insurance fund. This book, however, uses a narrower definition in which microinsurance, like traditional

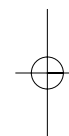
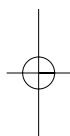
¹ As described in Chapter 5.2, Indian insurance companies are required to allocate a percentage of their insurance portfolio to persons in the “rural and social sectors”, which in practice means low-income households. Consequently, all Indian insurers are involved in microinsurance in one way or another, so many interesting microinsurance innovations are coming from India.

² Chapters 1.2 and 2.1 describe the characteristics of insurable risks.

insurance, involves a risk-pooling element. Those in the risk pool who do not suffer a loss during a particular period essentially pay for the losses experienced by others. Insurance reduces vulnerability as households replace the uncertain prospect of losses with the certainty of making small, regular premium payments. Yet this risk-pooling function means that insurance is a much more complicated financial service than savings or credit.

Since microinsurance is just one of several risk-management tools available to low-income households, organizations truly concerned about helping the poor to manage risks should assess whether the provision of microinsurance is the most appropriate response. For risks that result in small losses, for risks with high predictability of occurring or high frequency of occurrence, savings and emergency loans would be more appropriate risk-managing financial services. Savings and credit are also more flexible than insurance as they can be used for a variety of different risks (and opportunities). Insurance, on the other hand, provides more complete coverage for large losses than poor households could provide on their own. For these larger risks, participating in a risk pool is a more efficient means of accessing protection than if households try to protect themselves independently.

One must be careful not to overstate the developmental effect of insurance. On its own, insurance cannot eliminate poverty. Yet if it is available to poor women and men along with other risk-management tools, health and life insurance for the poor can make a valuable contribution to achieving the Millennium Development Goals (*see Box 1*).



Box 1

Microinsurance and the MDGs

The Millennium Development Goals, established by the United Nations in 2000, provide more than 40 quantifiable indicators to assess the progress made toward global economic and social development by 2015. The MDGs serve as a development framework, helping to focus the attention of policy-makers, donors and development practitioners on the most critical objectives.

Certain MDGs would be more achievable if insurance were widely available among low-income households, including the following targets:

- Halve the proportion of people whose income is less than one dollar per day
- Halve the proportion of people who suffer from hunger
- Ensure that children everywhere, boys and girls alike, will be able to complete a full course of primary schooling
- Eliminate gender disparity in primary and secondary education
- Reduce by two-thirds the under-five mortality rate

- Reduce by three-quarters the maternal mortality ratio
- Halt and begin to reverse the spread of HIV/AIDS
- Halt and begin to reverse the incidence of malaria and other major diseases

For example, insurance can help reduce the proportion of people who suffer from hunger and whose income is less than one dollar per day. While development experts tend to focus on efforts to promote economic development as a strategy to achieve these targets, they have to recognize that gains can quickly be lost when vulnerable households experience a loss or crisis. It is necessary to complement efforts to boost productivity with corresponding efforts to provide protection.

Perhaps even more directly, microinsurance can help address the health-related objectives of reducing child mortality, improving maternal health and combating HIV/AIDS, malaria and other diseases. Health microinsurance schemes typically provide immunizations, train birth attendants and make it possible for women to afford transportation and hospitalization for difficult births.

Some microinsurance schemes provide valuable information and resources for risk prevention. By providing education about risks and promoting good health habits, these schemes can reduce incidents of disease and extend life expectancy (*see Chapter 3.9*).

Interestingly, microinsurance can also assist in promoting gender equality and empowering women (*see Chapter 2.4*). If insurance can help protect vulnerable households from falling back or further into poverty, they will be less likely to have to choose which child to send to school. Furthermore, long-term savings and insurance policies enable the poor to accumulate assets that can be used to pay for education, for daughters as well as for sons.

2 The two faces of microinsurance

There are two main varieties of microinsurance – one focused on extending social protection to the poor in the absence of appropriate government schemes and the other offering a vital financial service to low-income households by developing an appropriate business model that enables the poor to be a profitable (or sustainable) market segment for commercial or cooperative insurers.

Yet these two varieties have much in common. One might consider microinsurance like Janus, the ancient Roman god of gates and doors, also the god of beginnings, who is depicted with two faces, yet one body (*Figure 1*). Regardless of whether one is looking at microinsurance from a social-protection or a market-based approach, the body of the insurance scheme, its

basic operations, will be largely the same. Hence a book on microinsurance operations must draw lessons and experiences from both.

Figure 1



2.1 Deepening access to insurance services: A new market

The guru behind the articulation of the “new market” perspective is C.K. Prahalad (2005), who illustrates in his book *The fortune at the bottom of the pyramid* that the “private sector, in its desire to ... gain market coverage, will invent new systems depending on the nature of the market”. 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, including multinational corporations, innovate new business models and create low-income consumers.

This thinking is certainly not new to those involved in microfinance, where commercialization has been underway since 1992 when the Bolivian microfinance NGO Prodem created BancoSol, the first commercial bank dedicated to serving the low-income market. The creation of BancoSol started a revolution that has inspired at least 39 other NGOs to create regulated financial institutions (Fernando, 2004) and numerous commercial banks and finance companies to reach “down market”.

Besides microfinance, Prahalad also draws examples from other industries, including construction, consumer goods and healthcare. Based on case studies of successful innovations, Prahalad identifies common principles to be considered when innovating for the bottom of the pyramid (BOP). Even though he does not analyse insurance case studies, Prahalad’s “Twelve Principles of Innovation for BOP Markets” are remarkably applicable to the provision of microinsurance (*see Box 2*).

Box 2

Applying Prahalad's "Twelve Principles of Innovation for BOP Markets" to microinsurance*1. New understanding of price-performance relationship*

Obviously, the poor cannot afford to pay high prices, but that does not mean that they deserve poor-quality products. For microinsurance, it could even be argued that the low-income market requires a *better*-quality product (e.g. quick claims settlements, few if any claims rejections) to overcome their apprehension about paying up-front for some undetermined future benefit. Prahalad also contends that the BOP market is surprisingly brand-conscious, something that microinsurers must keep in mind as they strive to secure the market's trust and confidence.

2. Combine advanced technologies with existing infrastructure

Although this is just beginning to emerge in microinsurance, several microfinance institutions are experimenting with technologies, (including ATMs with biometrics, smartcards, palm pilots and point-of-sale devices) to enhance efficiency and productivity. Microinsurers will undoubtedly follow suit.

3. Scale of operation

In a BOP business model, the basis for returns on investment is volume. Even if the per unit profit is minuscule, when it is multiplied across a huge number of sales, the return can become attractive to shareholders. 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 for the poor.

4. Eco-friendly

Prahalad notes that the resources associated with products in developed countries would be unsustainable if used for the enormous BOP market. Consequently, all innovations must minimize packaging and consider the impact of the product on the environment. This principle may not be directly applicable to microinsurance, however there is a connection. Many catastrophic risks to which the poor are vulnerable are associated with climate change.

5. Requires different functionality

Products and services for the BOP market cannot just be scaled down or less expensive versions of traditional products. With microinsurance, for example, insights into how low-income households might use an insurance payout illustrate key differences with the conventional insurance market. For example, instead of a lump sum of cash, the poor might prefer in-kind benefits (e.g., funeral service, groceries) possibly spread over a period of time.

6. Process innovation

When designing a product for the BOP market, it is necessary to adapt the process as well as the product, taking into account the limited infrastructure typically available for the poor. In microinsurance, for example, one must recognize that the premium is not the only expense. The indirect costs of accessing and using that product, including transportation and the opportunity costs of lost wages, may be much higher than the actual cost.

7. Deskilling work

Service industries are naturally labour-intensive; those focusing on the BOP market are even more so, given the scale of operations. Since labour costs can represent over half of the total operating expenses, one strategy to contain costs is to simplify the operations so that products can be sold and serviced by less expensive workers. Such an approach is quite appropriate for microinsurance because the customers also want simple, easy-to-understand products.

8. Significant investments in educating customers

Prahalad is explicit about the importance of creating BOP consumers through education and the raising of awareness, using innovative mechanisms to reach persons in “media dark zones”. This has also been the experience of microinsurers which need to explain to their clients how insurance works and how they will benefit from it.

9. Designed for hostile conditions

The products and services designed for the BOP market must take into consideration the unsanitary conditions and limited infrastructure (e.g. electricity blackouts, poor water quality). For microinsurance providers, this involves investing in loss-prevention measures such as promoting low-risk behaviour, water purification and hygiene in order to reduce claims for health and life insurance.

10. User-friendly interfaces

The heterogeneous BOP market speaks a myriad of languages with a variety of different literacy levels. Serving this market requires careful consideration to make it easy for poor households to use the service. For microinsurance, the application form should be short and perhaps completed by the sales person. More challenging is the simplification of claims documentation to make it easy for clients to access benefits while protecting insurers from fraud.

11. Distribution

One of the great challenges in serving BOP consumers is to get the product to the market; yet, insurance companies are particularly weak at distribution. The main solution to this problem is to collaborate with another organization that already has financial transactions with low-income households so the insurer can leverage existing infrastructure to reach the poor.

12. Challenge the conventional wisdom

In sum, to serve the low-income market, insurers have to think differently – about customers' needs, product design, delivery systems and even business models. There is a viable market out there if insurers are willing to learn about that market and develop new paradigms for serving it.

To understand clearly how to develop new business models for microinsurance, it is necessary to assess why the current insurance business models do not reach the poor. Although the insurance industry is beginning to notice the vast under-served market of low-income households, insurers have encountered numerous obstacles that need to be overcome if they are to offer microinsurance on a large scale.

Besides the problems associated with high transaction costs and inappropriate distribution systems identified in Box 2, the 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 issues include appropriate 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, insurers generally do not have data to 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, if insurers build

in a cushion on top of the high administrative costs required to serve the low-income market, premiums may not be affordable.

Insurers assume, rightly or wrongly, that the low-income market cannot afford insurance. Interestingly, when insurance first became widespread in the late 19th century, it was seen as a poor man's financial service. The wealthy did not need insurance because they could essentially self-insure. Somewhere along the way, as insurance became more sophisticated and the wealthy recognized their vulnerabilities, the perceptions reversed.

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 methods and 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.

A major challenge in extending insurance to the poor is educating the market and overcoming its bias against insurance. Many are sceptical about paying premiums for an intangible product with future benefits that may never be claimed – and they are often not too trusting of insurance companies. Creating awareness about the value of insurance is time-consuming and costly. To be fair, the bias goes in both directions. The people who work for insurance companies are usually unfamiliar with the needs and concerns of the poor. Similarly, the culture and incentives in insurance companies reward salespersons for focusing on larger policies and more profitable clients and portray the idea of selling insurance to the poor as ridiculous.

This low-income market has massive potential if insurers can address these issues with efficient and effective innovations. While these obstacles are significant and daunting, they can be overcome – they are being overcome – by a number of formal and informal insurers around the world that are developing new techniques to reach a vast under-served market.

2.2 Providing social protection for informal workers

Even with significant innovations to insurance business models, product designs and delivery channels, it is clear that not everything or everyone is insurable based on market principles. Nor should that be the case. Indeed, governments have a critical responsibility to provide social protection to their citizens.

Social protection is the other face of microinsurance. It generally includes a variety of government policies and programmes to reduce poverty and vulnerability by diminishing people's exposure to risks and enhancing their capacity to protect themselves. Social protection refers to the benefits that society provides for its members, including:

- unemployment and disability benefits,
- universal healthcare,
- maternity benefits,
- old-age pensions,
- protection for children and the disabled.

However, more than half the world's population is excluded from any type of social security protection, including contribution-based schemes and tax-financed social benefits. In some parts of the world, the situation is particularly severe. In sub-Saharan Africa and South Asia, the coverage of statutory social security is estimated at 5 to 10 per cent of the working population (ILO, 2001).

Developing countries face major challenges in connection with providing comprehensive social protection. The vast majority of persons work in the informal economy, so there are no effective mechanisms to reach them systematically. Since they are self-employed or working in informal businesses, there is no formal employer to make contributions to pension, unemployment or healthcare schemes. Yet, the working poor cannot afford the full cost of social security schemes. At the same time, governments in many developing countries do not have the resources to create sufficient infrastructure (e.g. healthcare facilities) nor pay for the recurring expenses associated with social protection schemes.

Microinsurance as a social protection mechanism strives to fill the gap to provide some coverage for the excluded – which would be even more effective if it were supplemented by government schemes to facilitate a redistributive effect. In the absence of formal social protection, microinsurance responds to an urgent need while not absolving governments of their responsibilities. Indeed, as described in Chapter 1.3, microinsurance can create delivery mechanisms to extend government programmes (and subsidies) to the informal economy, and in so doing integrates the informal and formal social protection systems.

Consequently, regardless of which face of Janus one uses to view microinsurance, the intention is to reduce the vulnerability of the working poor by enticing the public (social protection) and the private sector (new market), or both, to do what neither has so far been particularly effective in doing: providing insurance to the poor. Indeed, since these two faces have the same head, it is reasonable to explore areas of convergence to create alternative models or systems of protecting the poor, such as public-private partnerships, mutuals and cooperatives, and government incentives to correct market failures.

3 What a difference three words make

The operational aspects of extending insurance to low-income households are largely the same, whether one is approaching it from a market or social-protection perspective. The following key characteristics illustrate how insurance for the poor may differ from both conventional insurance and mainstream social-protection programmes:

Relevant to the risks of low-income households

Of course coverage should be linked to the greatest areas of vulnerability for low-income households, but often what is available from insurers or social security administrations does not really address the needs of the poor. Can unemployment insurance really be made relevant for casual day labourers? Do commercial insurers really know what risks poor men and women are most concerned about, what keeps them awake at night?

As inclusive as possible

While insurance companies tend to exclude high-risk persons, microinsurance schemes generally strive to be inclusive. Such an approach makes sense when microinsurance is seen as an extension of government social protection schemes. Indeed, to achieve the social mission of microinsurance, it is necessary to provide protection when vulnerable households need it the most. However, is inclusion feasible for market-based microinsurance? Since the sums insured are small, the costs of identifying high-risk persons, such as those with pre-existing illnesses, may be higher than the benefits of excluding them in the first place. Plus, if microinsurance schemes can reach the tremendous volumes of customers required to achieve the MDG targets, many exclusions and restrictions can be just administrative nuisances that undermine efficiency rather than important insurance risk control tools.

Affordable premiums

At the end of the day, microinsurance schemes have to be affordable for the poor, otherwise they will not enrol in the scheme, nor benefit from the coverage. Various strategies could make microinsurance affordable, including having small benefit packages, spreading premium payments over time to correspond with the household's cash flow and supplementing premiums with subsidies from governments. From the social protection perspective, the redistribution function, from rich to poor, theoretically helps to make contributions affordable for the poorest. In the market model, insurers may be willing to accept low short-term returns, or even losses, to develop the market.

Grouping for efficiencies

Group insurance is more affordable than individual coverage, but how does one find groups of people in the informal economy? Even though the informal economy is sometimes known as the disorganized sector, there are groupings out there that could be used, such as women's associations, informal savings groups, cooperatives, small business associations and the like. Some microinsurers use these groups more effectively than conventional insurers by enlisting the support of the groups in member selection and reducing insurance risks such as over-use and moral hazard.

Clearly defined and simple rules and restrictions

A CEO of a major United States insurance company once admitted that even he did not understand his homeowner's insurance policy. Insurance contracts are generally full of complex conditions, conditional benefits, written in legalese that even lawyers struggle to discern. Although the rationale for the fine print may be consumer protection, if the consumers do not understand what is written, its very object is defeated. Moreover, its content can give the insurance company an excuse not to pay a claim. For a host of reasons, microinsurance has to be kept as simple and straightforward as possible so that everyone has a common understanding of what is and is not covered.

Easily accessible claims documentation requirements

The process for accessing benefits, from social security departments or insurance companies, tends to be so arduous that it discourages all but the most persistent claimants. Such obstacles are inappropriate for low-income households that cannot afford to spend days away from work, paying "unofficial fees" to access official documents. While controls have to be in place to avoid fraudulent claims, for microinsurance to be effective, it has to be easy for low-income households to submit legitimate claims.

Strategies to overcome the wariness of customers

Lastly, microinsurers must have effective strategies to overcome the apprehension of low-income households as regards insurance. One of the primary ways to achieve that objective is through client education, to raise awareness among prospective policyholders about how insurance works and how it can benefit them. Equally important, however, is upholding promises and fulfilling obligations, and creating a culture of insurance among the poor. For microinsurance to build the confidence of the market, it has to avoid many of the common criticisms of insurance providers, who are seen as quick to take one's money, but slow to pay it out. Indeed, microinsurance needs to develop

systems to pay benefits expeditiously, to minimize or avoid claims rejections and to provide a quality of service that earns the trust of a wary market.

For both the social protection and market perspectives, insurance schemes for the poor have to find a way of balancing three competing objectives: 1) providing **coverage** to meet the needs of the target population, 2) minimizing operating **costs** for the insurer and 3) minimizing the **price** (including the transaction costs for the clients) to enhance affordability and accessibility. These represent difficult choices that are best answered by involving those who ultimately benefit from the coverage to choose between them.

In summary, microinsurance must be designed to help poor people manage risks. With that overarching objective forging a unique mindset, microinsurance clearly emerges as quite distinct from mainstream insurance and social protection schemes. Perhaps when they first emerged, both social and commercial insurance were also founded on the ideal of protecting the poor. For example, some of today's large insurance companies began in the 1800s as mutual protection schemes among factory workers. Nevertheless, over the years, efforts to prevent fraud and misuse have created a maze of bureaucratic rules and requirements that undermine their effectiveness and their appropriateness for the poor. In addition, for the market-based approach, efforts to maximize shareholder returns have led them away from their original clientele in search of more profitable customers.

Indeed, microinsurance can be described as an insurance “back to basics” campaign, to focus on the risk-management needs of vulnerable people, and to help them manage those risks through the solidarity of risk pooling. Although not all microinsurance schemes are true to these values, the closer they can come, the more likely they will benefit the people who need them the most.