Microinsurance has burst onto the insurance scene as a groundbreaking product. Its hallmark features are its social function, low premium and low coverage limits but microinsurance also involves other complex and less familiar aspects deriving from its target segment, i.e., low income groups. These complexities hinder the implementation of traditional insurance criteria not only in terms of risk aspects but also strictly operational factors, calling into question the economic viability of the projects involved.

The various international operators and bodies working on the development of microinsurance are currently striving above all to identify and address these limitations and barriers, seeking viable ways of overcoming them on the back of groundbreaking initiatives and developments. This will open up a potential market of 4 billion people and 5 billion dollars of annual income, allowing these operators to meet their social responsibility programmes while also fulfilling their strategic business plans.

FRANCISCO JAVIER GARAYOA ARRUTI
DEA Insurance Sciences - Universidad Pontificia de Salamanca

MICRO

INSURANCE and its singular features

WHAT IS THE MEANING OF MICROINSURANCE?

This question brings us up at once against the classic twofold nature of microinsurance, firstly its function of social protection, which is the original approach and is tied in with CSR programmes, and secondly the challenge of coming up with a commercial insurance solution for low income markets, identified as the segment occupying the base of the wealth pyramid. Both approaches aim at the same objective, which is none other than alleviating the vulnerability of the poorest.

This twofold approach is represented graphically by C. Churchill's Janus model, which is the best known among students of microinsurance: and family protection, with health and life products, and also could be viewed as «productive», on the basis of support for investment in economic activities with capital-based microinsurance tied in with crop- or animal-farming work or small companies. In practice, as in the former dichotomy, both strands tend to come together in terms of protecting the poorest groups from the risks they are exposed to.

As our starting point we are going to take one of the most complete and widely accepted definitions of microinsurance put forward by the World Bank's Consultative Group to Assist the Poor, CGAP , which defines microinsurance as «A financial arrangement to protect low-income people against specific perils in exchange for regular

Figure 1. - Source: C. Churchill 2006. The two faces of microinsurance.

Microinsurance changes its spots completely depending on which side we approach it from, subsidised in its social approach or self-sustainable in its commercial vision. Reality, however, resists being boiled down to neat theories so general analysis works from the social aspects towards market approaches to bring both strands together.

Another theoretical dichotomy is posed by the function of microinsurance, which could be «protective», in the strict sense, embracing personal

premium payments proportionate to the likelihood and cost of the risk involved». (C. Churchill 2006)

According to this definition, the characteristic trait of microinsurance is assistance for the low income segment but incorporating the basic principles of the traditional insurance activity, such as regularly paid premiums, the uncertainty of the risks and the proportionality of the premiums to the risks and costs.

As our study of microinsurance deepens we soon see that some aspects of this definition are difficult to apply in the low income segment. As we have already pointed out, this difficulty impinges on the product and the activity itself, limiting implementation of the principles of the traditional insurance activity.

This claim is borne out by the key determining factor, the necessary «affordability» of the premiums for the members of the low income segment, which is often hardly compatible with the principle of proportionality between the premiums and risk covered or with the passing on of the operating costs (It should be borne in mind here that the claims ratio and costs will be higher than those of other segments given the special vulnerability of the people involved, the complexity and cost of setting up new delivery channels and the costs deriving from smaller coverage units, among others.).

As we see the complexity of microinsurance soon raises its head. It is not just a question of low premium, low coverage insurance but is in fact hemmed in by barriers that are difficult to surmount

for traditional operators who wish to move into the microinsurance market.

One vision of the economic challenges to be taken on is reflected in the so called «Microinsurance Challenge», dealt with by C. Churchill and Denis Garand as part of the strategies of sustainability (C. Churchill 2006), shown graphically in the figure below.

As we see from figure 2, the right balance needs to be struck between coverage, premium

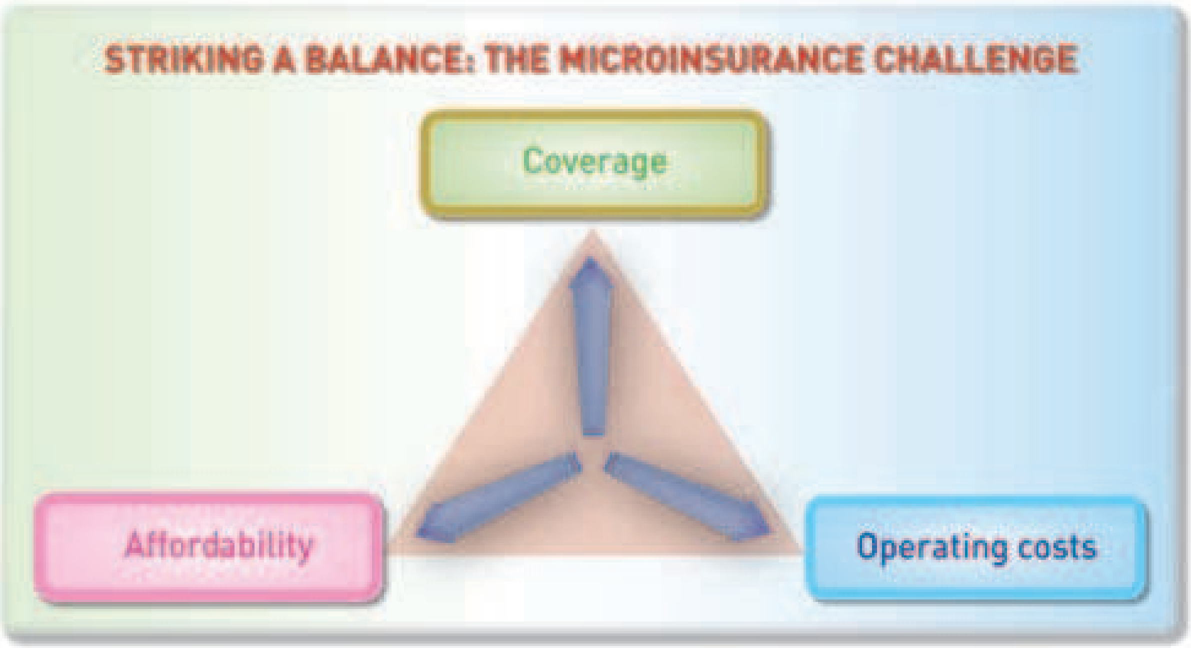


Figure 2. – The microinsurance challenge. Source: «Strategies for Sustainability». Churchill, C. & Garand, D. (C Churchill 2006).

affordability and operating costs. This is no easy task as we will see later on.

To strike this balance between economic sustainability and affordability we cannot fall back on the traditional insurance set-ups. Innovation is essential, redesigning the typical products, rethinking delivery channels, streamlining internal processes and, in short, bringing them into line with the target market. Along these lines we are going to look at some breakthroughs achieved in terms of the product, demand and delivery channels, finally considering some examples of the adaptation measures.

1. Problems in the technical specifications of the product:

To be able to weigh up properly the future risk assumed and allow actuaries to establish the corresponding criteria and quantifications we need first to look at the characteristics of the group involved, of the claims ratio and other aspects. In many cases there is no tried and trusted information on these aspects and this is in fact the first problem we come up against.

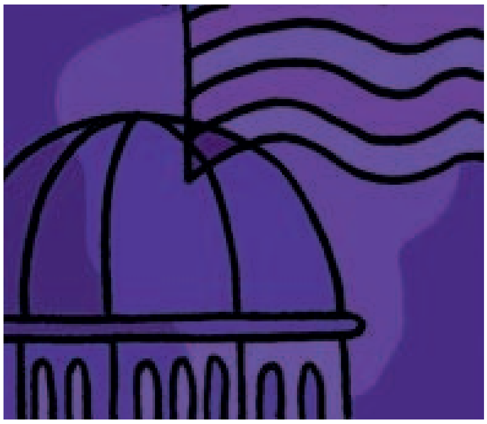
As an added complication we have to bear in mind that the poorest segment is characterised by high claims volatility, greater exposure to risk covariance and the irregular and informal economic base of the insureds.

The above appreciations give us a good idea of the sheer complexity of determining the product's technical specifications. We therefore need to turn to groundbreaking and imaginative formulae that provide real solutions.

2. Difficulties in identifying the demand:

Problems are also raised in terms of identifying, accessing and responding to the demand, which can often only be vaguely defined.

It should be pointed out here that this population segment often looks askance at the



insurance activity, seldom understanding the advantages of the product.

The lack of any financial culture, especially in terms of insurance, leads to situations in which there is no clear demand. The insurance provider is not positively viewed and little sense is seen in the tradeoff of paying premiums against an uncertain future event.

It is essential to set up an insurance culture, feeding in the necessary knowledge, with the corresponding time and economic cost, thus building up a favourable climate for the microinsurance activity. The problem is exacerbated if we factor in the complex technology that is hard to understand for a population with a high degree of illiteracy, standing in need of help and advice.

One positive trait of microinsurance, from the cost and affordability viewpoint, is the group contracting nature of this arrangement, albeit normally on a family basis. This saves costs and introduces an across-the-board premium for everyone with the same coverage.

From the demand point of view group contracting means that these groups have to be identified beforehand, to find out their needs and offer products meeting these needs and their priorities.

3. The Delivery Channels:

It is essential to set up functional delivery channels, from the point of view of costs, operational feasibility and proximity to the segment. This entails meeting certain basic characteristics, regardless of the model followed:

a. Physical proximity to the low income segment.

b. The trust that has to be built up in said segments.

c. A suitable level of efficiency to ensure that the whole process can be carried out properly.

4. Examples of adjustment measures:

Getting down to the operational brass tacks, we can cite examples of some cost-cutting measures:

1-Limitation of benefits: Here there might be different variants, such as limiting the supply to credit life insurance, annual compensation caps, health service coverage limits, among others.

2-Operational efficiency approach: Here we are referring to those aspects that involve a minimum contracting or administrative cost, such as groups automatically covered for belonging to public or private bodies such as trade unions or cooperatives and those that use low cost revenue collection methods, such as the deduction of saving interest in microfinance institutions.

3-Optimum delivery models: Delivery models involving no added cost should be set up, such as the partner-agent model, the community-based model or agreements with major service companies.

In addition to the above and in the interests of avoiding claims costs, it is important to conduct prevention campaigns that avoid the risks or lessen the likelihood of their occurring. (E.g., the HIV/AIDS prevention campaigns)

Another cost cutting possibility is negotiation with end service suppliers, the typical case of health insurance, to establish tariffs in line with the services.

In conclusion, the affordable premium is a result of striking the right balance between risk allocation and costs. This is the key to access to the microinsurance market, understood as an activity geared towards self-sustainability.

HOW DOES MICROINSURANCE ACTUALLY WORK IN PRACTICE? WHAT ARE ITS IMPLICATIONS?

When we get down to an analysis of the actual microinsurance activity we soon find that the traditional insurance premises no longer fit. We are dealing here with a market based mainly on informal operators under no regulation or supervision, with all the concomitant insecurity for clients and the very continuity of the activity itself.

The scenario we are faced with is not very promising. Many of the operators are unregulated and controlled by no supervisor, and few tried and tested figures are to hand on such basic aspects as the claims ratio. Furthermore, we are working here with criteria of solidarity rather than proportionality and with minimum exclusions and across-the-board premiums in group contracting arrangements, etc.

The work of national regulators is essential in addressing this situation and setting up a stable and enduring microinsurance market, promoting those aspects that are most conducive to the development of the system in light of the particular situation in each national market.

The legal framework has to take in the singular needs for driving this activity, considering such aspects as: the activity licences of the microinsurance institutions, the typical and atypical delivery channels, simplified contract models, fleet-footed and efficient operations and processes for transformation from informal to formal activity, vetted by the supervisory body, with the support and initiative of the formal operators, especially the bigger insurance companies. (Witness the initiatives implemented in many measures by the regulators of India, Peru, Brazil...).

The graph below shows the process for transforming the informal model into a formal model, emphasising the fundamental role of the regulator and the various operators. (J.Garayoa 2009)

This figure shows how the integration process is kicked off by the microinsurance legislation laid down by the regulator, taking into account the idiosyncrasies of this sector. This incorporates a transformation plan to suit the market involved, setting up incentives to offset the difficulties of the process. This whole plan needs to be vetted and controlled by the supervisor as part of its general control remit.

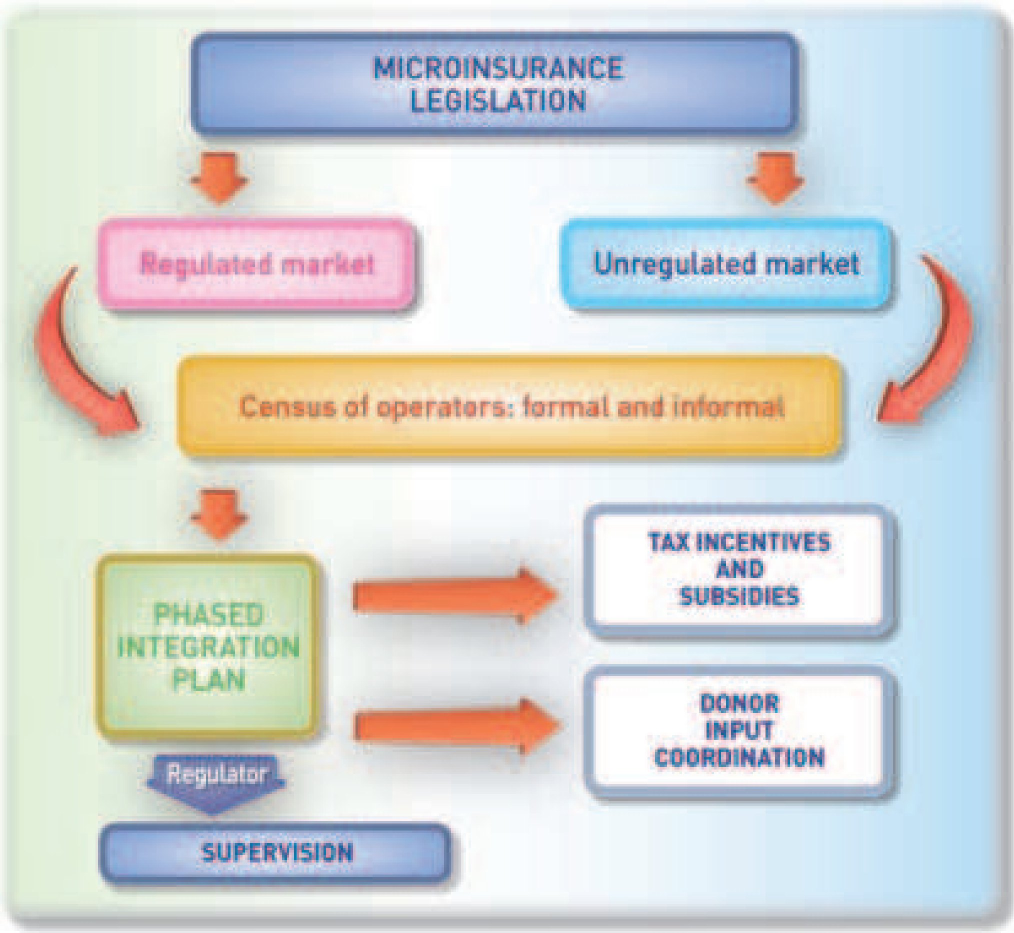


Figure 3.- Regulator's planning stages. Drawn up by the author.

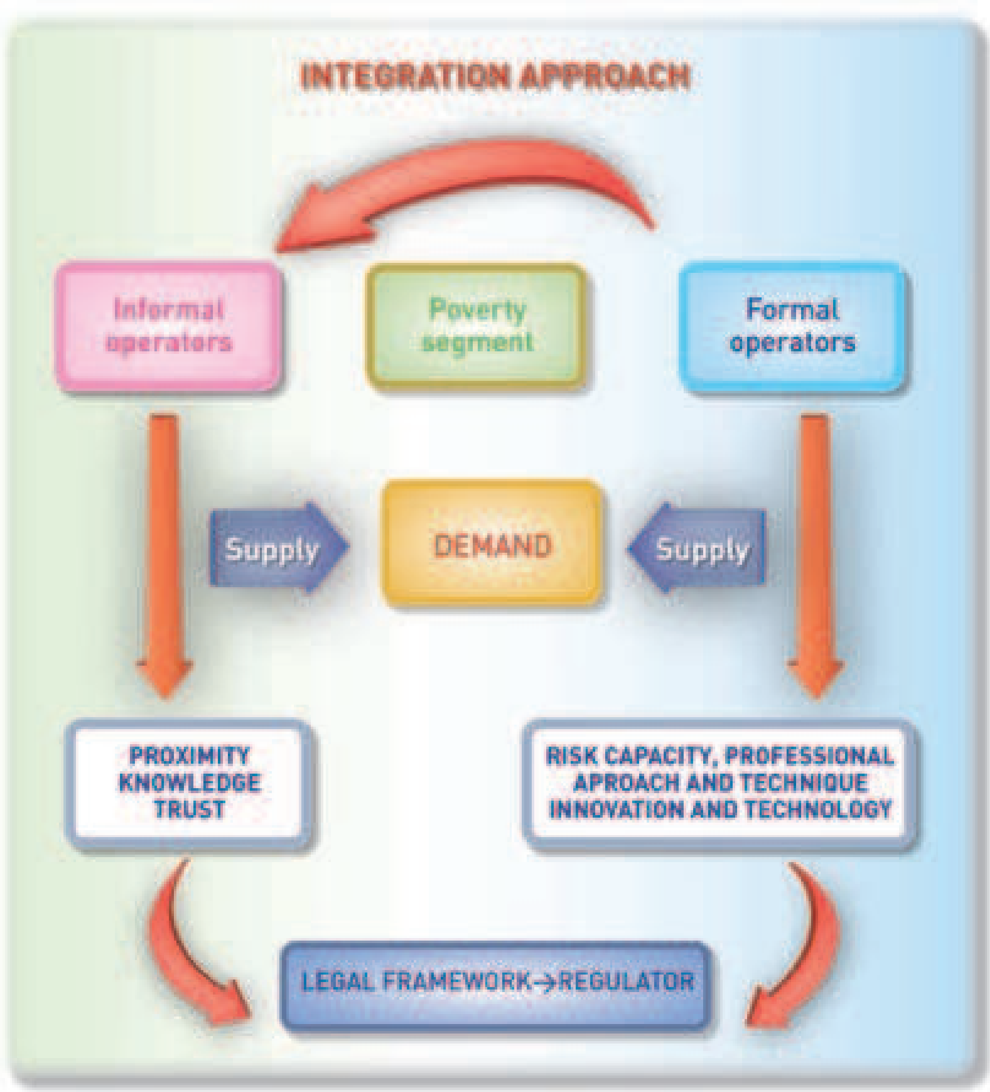


Figure 4: Source, drawn up by the author.

Figure 4 shows the inputs of both the formal and informal operators and also the regulator's role, without forgetting the role of the formal operators in terms of knitting the whole thing together.

In view of the situation sketched out above, it seems that any serious approach by the formal insurance sector to the microinsurance market would call for a complete change of mindset. It is essential to find feasible alternatives that strike the right balance between «affordability and sustainability» and «the informal and formal market». Groundbreaking innovations are also needed in the delivery channels and low cost technological models, establishing viable risk control and evaluation methods and agreeing to «waive» the mean yields of traditional insurance activity in the interests of social responsibility. Above all there is a need for medium- and long-term business strategies that make these options affordable for emerging markets with high growth rates in terms of both volumes and margins.

It should be pointed out here that economic sustainability would at first depend necessarily on possible partial subsidies. Hence the importance of support from the international organisations and the great multinationals of the insurance sector. It is essential to reach a critical mass and build up a level of knowledge and experience to underpin the corresponding actuarial bases and risk criteria and phase in the rest of the conventional insurance principles, based on the law of large numbers.

The whole development process referred to above calls for time and this needs to be taken on board by any organisation of the insurance sector that wishes to move into the microinsurance market.

IS MICROINSURANCE FEASIBLE FROM THE SOCIAL AND BUSINESS POINT OF VIEW?

This question in turn begs another two:

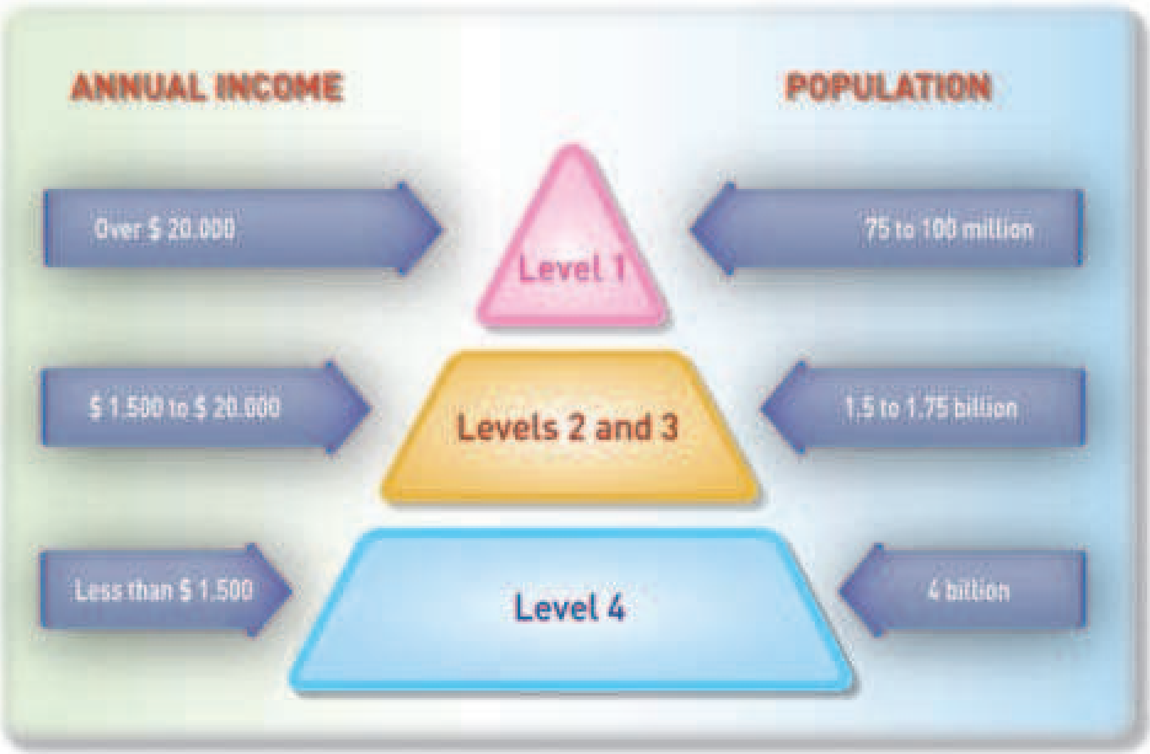
1- What is at stake when we are deciding whether or not to move into microinsurance?

2- Is it worthwhile from the social and business point of view to hurdle the microinsurance barriers?

The answer will come from an analysis of the figures we furnish below, which cost out the social commitment of improving the situation of low income segments and making them less vulnerable while also showing the business potential of this market and strategic approaches for breaking into the market in the short and medium term.

The wealth pyramid below gives some idea of the market potential. (The incomes are calculated as dollar equivalents.)

Figure 5.- Wealth Pyramid. Source: Drawn up from figures of the United Nations World Development Report 2005. (WB. 2005).



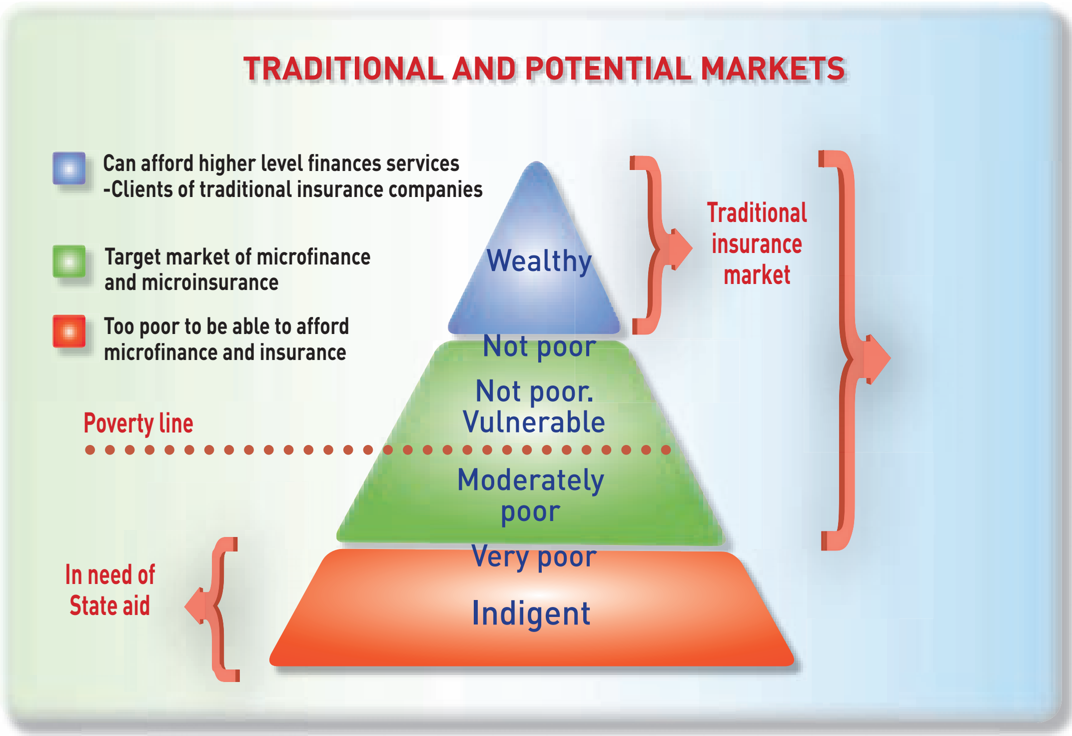
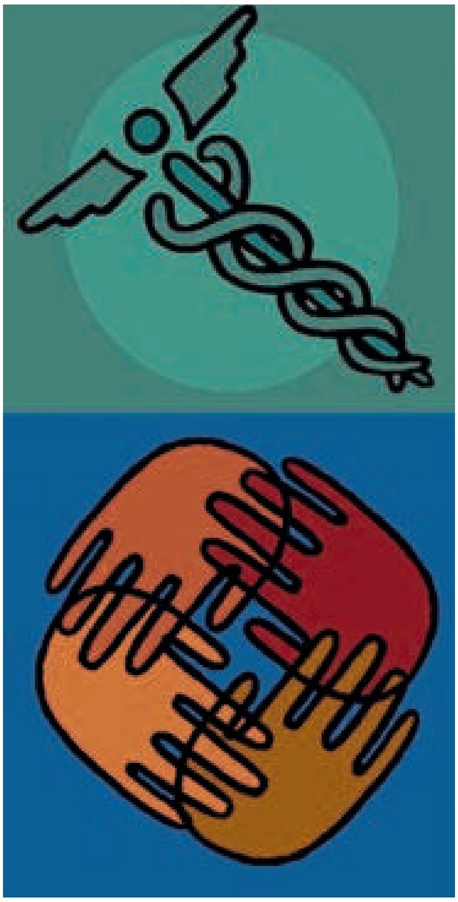


Figure 6.- Source: Drawn up from the data of Figure 3. *(Adapted from Microcare).*



Analysing the market structure shown in the above graph, and without taking into account the lowest extreme-poverty stratum, dependent on state aid, we are going to focus on the potential market with minimum payment capacities, a *sine qua non* of self-sustainability.

The indigent or extreme-poverty stratum would fit only in social or mixed microinsurance schemes focussing mainly on healthcare, which will be dealt with in their own right.

As regards quantifying the potential market, we can put a figure on it of three billion people, since we have deducted the indigent stratum from the total figure of 4 billion in the low income segments.

Despite the abovementioned difficulties, there is no doubt that an attractive new market is opening up for national insurance companies and the major insurance multinationals, in terms of the breadth of the business, the number of people involved and the income they generate. (We should not forget the figure of 5 billion dollars of annual income.)

There follow some significant figures on the emerging market:

1- 50% of the base of the population pyramid live in China and India; Latin America weighs in with 10%.

2- The insurance level of the population in the base of the pyramid is 1.3% in Africa, 2.5% in Asia and 6.8% in Latin America. (Martínez J 2007)

On the basis of these figures, and after publication of the book *The Fortune at The Bottom of the Pyramid* (Prahalad 2004), many traditional insurance companies have reacted by starting up research projects on how best to adapt their

traditional models, products and delivery channels and even changing their institutional culture to bring it into line with a new business vision towards the low income segment (in this cultural change the social aspects coexist with traditional business aspects).

Likewise the regulators and supervisors of many of the developing countries have proactively supported the birth of a microinsurance industry. Witness, among others, the telling cases of India, Peru, Colombia and the process underway in Brazil.

Another important contribution along these lines has been made by the International Association of Insurance Supervisors, IAIS, analysing the new models towards which the regulation of the microinsurance subsector has to be adapted to create a climate favourable to the development of this industry (depending on the regulatory policy of each country, there are regulators more or less interventionist in microinsurance matters, with different market responses).

At this point it is well worthwhile mentioning the work carried out by the international organisations, one-off operators and donors in microinsurance matters. The most important are: 1- Microinsurance Innovation Facility: This was created in 2008 within the ILO, with economic inputs from the Bill and Melinda Gates Foundation, 2- The Microinsurance Center: Created in 2000 from an initiative of Microsave-Africa, offering microinsurance training and bringing experiences to wider notice. 3- Microinsurance Network: Before 2008 formerly called the Microinsurance Working Group of the Consultative Group to Assist the Poor, CGAP, one of the first microinsurance agents on a worldwide scale, which began its activities in 2003; its stakeholders include the World Bank and 60 donors, insurers and other interested collaborators. It is this organisation's definition of microinsurance that we have been working with. 4- The Munich RE Foundation: Established in 2005, this foundation takes an active part in the study and promotion of microinsurance, one of its most important remits being organisation of the annual International Microinsurance Conference. 5- STEP Strategies and Tools against Social Exclusion and Poverty: This is an international programme set up by the ILO's Social Security Department for carrying out field work and broadcasting the results by means of the online service, GIMI, Global Information on Micro-Insurance, involving the participation of researchers, agents, donors, development organisations and other microinsurance stakeholders.

This nutshell analysis shows that the development of the microinsurance market is now well underway. Certain geographical and social characteristics mark it off from the traditional insurance market while it also holds other elements in common, such as identifying social needs to be met and a demand for specific risk management products to be satisfied, for a highly representative segment of the world population. At the moment this population is hardly able to afford the minimum wherewithal for creating and preserving wealth and ensuring dignified living conditions.

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