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Regulation in Microinsurance Markets: Principles, Practice, and Directions for Future Development

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Summary. — Regulation of any market can either promote or impede its development, thus affecting social welfare. In this paper, we are concerned with the impact of regulation in microinsurance markets. We evaluate existing and potential regulatory mechanisms with regard to its underlying economic rationale, and offer recommendations intended to enhance support and minimize barriers for microinsurance market development. Specifically, we recommend avoiding incentives for regulatory arbitrage; responding to the characteristics of the microinsurance market, including licensing, capital, reinsurance, and distribution systems; enhancing the market through financial literacy initiatives; and providing support in the form of data collection and management training.

Key words — developing countries, microinsurance, regulation

1. INTRODUCTION

As previously discussed in this journal (see Arun, Bendig, & Arun, 2012), microinsurance is receiving an increasing amount of attention from policymakers and researchers due to its potential to assist in alleviating poverty. Some of that attention generates from results such as those of Jütting (2004), who demonstrates that micro health insurance achieves some success against poverty. Successful provision of microinsurance products, however, is hindered by a variety of issues, including relatively high administrative costs and limited financial literacy and education among the target population. In response, policymakers around the globe have considered a variety of initiatives intended to create a robust, sustainable insurance industry. Determining the role to be played by insurance regulation is of chief concern to these efforts (see Chatterjee, 2012 [1]).

Regulation of any market can either promote or impede its development, calling for close evaluation of any regulatory process implemented. To date, the literature on microinsurance regulation is limited. Our intention here is to add to the collective knowledge by presenting both theoretical and empirical evidence of regulatory effectiveness in conventional and microinsurance markets. Specifically, we discuss a variety of forms of regulatory activity found around the globe and their specific applications within a microinsurance context. Within this discussion, we highlight existing empirical evidence of the relative effectiveness of various regulatory initiatives, and also discuss several microinsurance case studies. From this effort we generate a series of recommendations for policymakers as they consider implementation of specific microinsurance regulations.

Our recommendations can be summarized in three general statements. First, encourage market demand by supporting two types of initiatives: those that promote basic quality services such as health care, and those that enhance financial literacy. Second, encourage market entry by permitting more innovation, allowing profit levels commensurate with market risk, and setting capital requirements that account for proportionality. Third, improve market efficiency by engaging in data-gathering and analysis services as well as workforce training, and by permitting the use of a reasonably broad spectrum of risk-transfer mechanisms such as non-local reinsurers.

The remainder of this paper is designed to support these recommendations. We do this first by describing the current microinsurance regulatory environment in Section 2. In Section 3 we present general evidence of regulatory effectiveness, both in the conventional as well as microinsurance markets. In Section 4 we detail and evaluate the specific microinsurance regulations enacted in six countries, and from this evaluation, provide a series of recommendations. We present several case studies for illustration in Section 5, and offer conclusions in Section 6.

2. MICROINSURANCE MARKET

"Microinsurance" encompasses a variety of products and programs focused on low-income policyholders. Churchill (2007, p. 402) defines microinsurance as "protection of low-income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of risk involved." The international body of insurance

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regulators, the International Association of Insurance Supervisors (IAIS), offers a definition consistent with Churchill yet also somewhat broader as follows: "any form of protection against risks that is designed for and accessed by low-income people, provided by different categories of carriers but operating on basic principles of insurance and funded by premiums" (IAIS, 2007).

The most common types of coverage that meet the criteria of these definitions include life insurance (often tied to credit provided by microfinance institutions, MFIs), health insurance, and crop insurance. Insurers providing microinsurance include large multinational organizations, medium-sized local stock and mutual organizations, cooperatives, non-governmental organizations (NGOs), and governmental agencies. Informal mechanisms that mimic insurance exist as well, yet the intention of the IAIS is not to include informal risk-sharing arrangements in discussions of microinsurance regulations.

Of these types of coverage, the most successful in terms of business strategy tends to be life insurance protection tied to MFI loans (Churchill & McCord, 2012). These programs tend to be successful because they hold down costs: administrative requirements have been completed through the loan issuance process; the distribution system is simple; and premium payments are incorporated directly into loan repayment. While many of these programs clearly benefit the insured population, the fact that they are successful businesses does not necessitate that the programs also provide good value to the consumer. Measurement of consumer value is a question of concern both within the microinsurance market as well as within the conventional insurance market. We do not intend to address that question here. Rather, our point is that without business sustainability (i.e., sufficient profit to remain operational), insurance availability will be the sole province of governments and charitable organizations. We believe that a significant portion of the population can be well served by a market-oriented microinsurance sector.

The challenges faced by microinsurers in designing a sustainable business model also play a prominent role in developing appropriate regulatory systems intended to provide a more inclusive insurance market per the G20 initiatives (see Access to Insurance Initiative, 2013). Among the greatest challenges are the relatively high administrative costs of providing low-cost insurance and the difficulty of educating the target population on risk, risk management, and insurance principles. Moreover, we believe customer protection to be particularly crucial, especially in regard to avoiding insurer insolvencies, insurers not paying claims, or premium collectors absconding with payments. Indeed, non-performance risk might significantly hamper insurance demand.

The sale, issuance, and claims payment processes of insurance all involve both fixed and variable costs. Fixed costs are incurred on a per policy basis; variable costs fluctuate depending on the specifics of the underlying coverage. When issuing low-premium policies, a greater percentage of the premium goes to paying the administrative fixed costs rather than loss costs, yielding policies of lower return in loss coverage per unit of currency. Lower loss coverage per unit of currency tends to have a dampening effect on the perceived benefit of coverage. As a result, the segment of the population willing to purchase the coverage tends to be that with higher-than-average expected losses, a classic adverse selection situation. Furthermore, some of the more common ways of reducing administrative costs, such as minimal underwriting and claims adjusting procedures, are also associated with increased adverse selection and moral hazard,[2] which arise out of situations when the policyholder has more information about loss potential than does the insurer. In other settings, insurers deal with these informational issues through underwriting and product mechanisms, including deductibles and coinsurance clauses, but these are the very types of product mechanisms that run counter to the underlying needs of the microinsurance consumer. Furthermore, such policy provisions yield losses not compensated by insurance, which can diminish the consumer's trust in the insurer. Innovative ways of overcoming adverse selection and moral hazard will need to be found before microinsurance can fulfill its potential to meet the needs of low-income populations.

Furthermore, many individuals in the target population are unfamiliar with insurance and the concepts of risk and risk management. Generating appropriate demand within this population has proven difficult, with no clear answer as to causes or solutions (see Eling, Pradhan, & Schmit, 2013). The IAIS has mentioned financial literacy initiatives as one area where regulators have the potential to influence markets outside their normal domains of pricing, underwriting, products, market activities, and solvency (see Access to Insurance Initiative, 2013).

3. INSURANCE REGULATION

(a) *Literature on the purpose and effects of regulation—both conventional and microinsurance*

Insurance long has been considered a business "vested in the public interest" because of the key role it plays in economic development and personal security. As a result, the industry has been regulated almost since its birth, starting with the 1575 establishment of the Office of Assurances in Great Britain to "coordinate and begin to control the writing of insurance" (Daykin & Cresswell, 2001). While regulatory efforts evolve over time and across jurisdictions, their basic purpose remains the same: protect consumers by assuring sound and transparent insurance practices. Klein (1995) identifies the following four regulatory activities: solvency, including setting financial standards, monitoring insurer security, and intervening when an insurer is in financial peril; rates and policy forms; market practices such as sales and underwriting; and other functions, such as enhancing consumer information and the like. We use these categories to review and evaluate insurance regulatory activities around the globe.

Taking the four categories of regulatory activity in reverse order, we note that the evidence on benefits from enhanced consumer information is mixed. Although it continues to be believed that greater transparency yields better consumer decisions, increasing evidence suggests that the truth is far more complex than this simple concept. Glenzer, Gründl, and Wilde (2013) offer examples showing that consumers respond differently to the same investment performance information offered in varied formats and, furthermore, that additional information is not necessarily of value in making consumer decisions.[3]

Research regarding price and underwriting restrictions suggests that such regulations tend to have a perverse effect of limiting access to coverage and often yield higher consumer costs (see Browne & Frees, 2004; Derrig & Tennyson, 2011; Harrington, 1990). Thus these regulations also are of questionable value to the public.

Studies on the implications of solvency regulation, however, demonstrate that, under certain circumstances, this type of regulation is generally of social benefit. Solvency regulation tends to be beneficial under two conditions. First, information asymmetry is present such that insurers have far more