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Ahsan, Syed M and Mahmud, Minhaj

Syed M Ahsan (Department of Economics, Concordia University,  
Canada and Institute of Microfinance, Dhaka Bangladesh), Minhaj  
Mahmud (Bangladesh Institute of Development Studies, Dhaka)

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# Microinsurance: The Choice among Delivery and Regulatory Mechanisms

**Syed M Ahsan**

Department of Economics, Concordia University  
1455, de Maisonneuve Blvd, Montréal, H3G 1M8, Canada  
Phone: (514) 848-2424; Fax: (514) 848-4536  
Email: [Syed.Ahsan@concordia.ca](mailto:Syed.Ahsan@concordia.ca)

& Team Leader,

Microinsurance Research Unit (MRU)  
Institute of Microfinance (InM),  
2/1 Block 'D' Lalmatia, Dhaka 1207, Bangladesh  
Tel: 02-880-2-810-0479, Fax: 02-810-0481

&

**Minhaj Mahmud**

Bangladesh Institute of Development Studies (BIDS)  
E-17 Agargaon, Sher-e Bangla Nagar, Dhaka 1207  
Phone: +880-2-9118855; Fax: +880-2-8113023  
Email: [minhaj@bids.org.bd](mailto:minhaj@bids.org.bd)

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# **Microinsurance: The Choice among Delivery and Regulatory Mechanism**

## **Abstract**

We analyse the choice of the appropriate delivery mechanism(s) relevant to various types of microinsurance products in a developmental context like that prevailing in Bangladesh. By examining various delivery mechanisms under different institutional contexts, we analyse the conditions under which they operate best. Then we develop a few criteria that are likely to offer cost efficiency as well as customer acceptance, and judge between different schemes in light of these criteria, and dwell on the interface between the choice of the delivery model and the regulatory stance. Finally, we put forward a set of regulatory and supervisory directives that respect both product and process innovations and uphold the goals of cost efficiency, financial viability and client inclusivity.

**Key Words:** Microinsurance, delivery and distribution modality, regulation and supervision

**JEL classification Codes:** G21, G22, G28, I30

## 1. Introduction

In developing countries, due to lack of access to formal insurance mechanisms, the poor often use informal risk sharing mechanisms, which are inefficient, even for idiosyncratic and diversifiable risks (Jalan and Ravallion, 1999; Mobarak and Rosenzweig 2013; Murdoch, 1999). Microinsurance is generally meant to provide risk protection to these poor, who typically possess very limited assets and frequently face irregular cash flows. A key requirement of an insurance contract, micro or otherwise, is that designated risks are protected *in exchange of premium payments proportionate to the likelihood and cost of the risks involved* (Churchill, 2006). The key elements characterizing the idea of microinsurance include that ‘Microinsurance’ products (a) are targeted at low-net worth households, (b) are designed to reflect pooling of risk faced by the insured, and (c) are priced in keeping with the willingness to pay criterion as well as being proportional to the likelihood and costs of the risks involved (Churchill, 2006), (d) are developed in all phases in close collaboration with the communities they are supposed to benefit (MIA, 2006), and (e) must be of substantive value to the poor in terms addressing the issue of vulnerability to poverty (Ahsan, 2009). In essence, therefore, *microinsurance services are those risk-shifting devices offered by insurers that are especially suited to the needs of low-income households and are affordable to them.*

The provision of microinsurance is essentially shared between the insurer and other agents as determined by the chosen delivery channel. The insurers range from multinational and domestic commercial insurers, to member-owned mutual, NGOs or community based organizations or even informal groups. Traditionally, however, the majority of microinsurance providers in the world have been mutual institutions of one kind or another (Fischer and Qureshi, 2006).<sup>1</sup> Focussing on South Asia, while all major micro lenders in Bangladesh offer credit protection, these are essentially oriented to their own security than that of the borrowers, though many offer additional life insurance.<sup>2</sup> From a regulatory perspective, the Indian example is of great interest since the regulatory directives there require microinsurance to be sold only by registered insurers. Since microinsurance is meant to be a low-cost product, not only does it need to be sold in high volumes, efficiency in all

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<sup>1</sup> The Mutual Benefit Association of the Centre for Agriculture and Rural Development of Philippines (CARD MBA), for example, which obtained a license to sell insurance in 2001 from the Philippines regulator, has recently achieved a million members in its microinsurance program (see <http://www.cardmba.com>).

<sup>2</sup> See Ahsan et al (2013) for an **overview** of the microinsurance market in Bangladesh.

stages of transaction is also required to permit minimization of both fixed and running costs of designing and managing the product so as to allow an affordable premium structure. The delivery modality directly impacts on the cost of provision and servicing of the product and an effective regulatory mechanism is necessary for ensuring the quality of the products, the viability of the insurer, and to foster both competition and innovation.

There are now available some academic studies including randomized evaluations focusing on demand and supply of microinsurance in developing countries (see e.g.; Churchill 2002; Cohen and Sebstad, 2005; McCord and Osinde 2005; Sinha et al, 2007; Ito and Kono, 2010; Thornton et al, 2010; Hamid et al., 2011; Karlan et al. 2011). These mostly corroborate that the uptake of experimental products is indeed rather limited. Given that the emergence of microinsurance, as a risk management tool, is still in its formative stage in many developing countries, and particularly so in Bangladesh, it is opportune to explore the roles that a suitable delivery mode as well as an appropriate regulatory regime can play for the successful development of the microinsurance market in such a context.

In this paper, we explore the interface between the delivery and regulatory mechanism in search of cost-efficient provision of products that the poor would value. Generally, efficiency would require that the services provided, both in terms of product diversity and quality are meaningful to the poor and are delivered in a timely fashion and that they are provided at the least possible cost. Overall cost minimization would also entail administrative efficiency in marketing, premium collection, information gathering and, above all, in claim processing. All these cost elements would be subject to influence of the underlying delivery and implementation modality.

The remainder of the paper is organised as follows. We review the key features of each delivery channel in Section 2. In Section 3, we develop the criteria for choosing among various delivery channels and debate the factors that are relevant to its success in a particular environment. In Section 4, we examine the kind of institutional modality that may improve service delivery in all its dimensions. Then by highlighting the microinsurance regulatory stance in the context of contemporary developing societies, in Section 5, we discuss, in Section 6, a proposed set of regulatory directives appropriate in such context. Finally, we conclude the paper in Section 7.

## 2. Microinsurance Delivery Channels

The delivery channel identifies the organization (e.g., NGO) that sells the product and is in contact with policy holders for after-sales service.<sup>3</sup> The principal institutional arrangements for delivering microinsurance include (a) the partner-agent model (partnerships between an insurer and distribution agents), (b) the community-based model whereby typically the risk-carrier is the network of saving and credit cooperatives, (c) the full-service model, where the insurer and the implementation agency is one and the same (but may rely on external service providers for specific components), and (d) the provider model, where the service provider is also the risk carrier. Below we explore how each of these may be best taken advantage of in specific contexts.

**2.1 The partner-agent model:** Under this model two parties come to a ‘partner-agent’ agreement of a fiduciary nature primarily to achieve a superior allocation of risk in their joint business venture. Here the ‘partner’ is typically the risk carrier that underwrites the risk and, often in collaboration with the agent, designs and innovates upon the product.<sup>4</sup> The concept of the ‘agent’ in partnership with an insurer is in line with the use of the term in the modern economic theory of contracts, where the primary driver of the contrivance is risk shifting from one party to the (more competent) other.

The strength of this model is that the agents (in most cases MFIs/NGOs) are usually able to exploit their existing relationship of trust with the poor already established in providing the credit or saving services thereby allowing the marketing of the product lot easier than otherwise. The model can potentially address the scale issue by offering insurance to all existing clients of the MFI in question and if marketed on a compulsory basis, it also eliminates adverse selection, all of which guarantees cost efficiency. However, as the insurer underwrites risk, the agent also stands to lose the trust of its clients should the product fail. Thus it is in the interest of both parties to keep the cost of the insurance attractive enough for the poor so that they can enter and remain in the market while also addressing the insurers’

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<sup>3</sup> For detail review on microinsurance delivery channels see Churchill (2006).

<sup>4</sup> Strictly speaking, the ‘partner’ or ‘principal’ is the party who has the claim to residual profit/loss, while the agent works for a pre-assigned fee. Thus if an insurer engages an MFI to sell its products for a fee, the latter is the ‘agent’. However, if the MFI in question designs a product and engages a risk-carrier for a fixed fee, the former is the principal (or, ‘partner’) and the insurer is the agent.

concern of the low returns of micro-insurance (McCord, 2006). Indeed this model has also the potential of developing a client friendly claim settlement process. The model has been found to be the simplest, cheapest and quickest way for an MFI to start offering insurance products to its clients outside traditional credit and savings products. In the Indian market, since all insurers are required by law to be in the micro business, MFIs have an advantage in its negotiations with the insurer over premium rates, and often the insurer is let go by the MFI due to a lack of accommodation (see UNDP, 2006).

**2.2 The community-based organization (CBO) model:** The CBO approach typically refers to the type of cooperative organizations (viz. network of mutual insurers), where insurance is the core service, though in common parlance, any cooperative framework is often cited as a CBO.<sup>5</sup> In common with the partner-agent model, the CBO framework allows the network of cooperatives to jointly develop and distribute their own insurance products to the members in a cost effective manner without the intermediation of any agent. The critical difference between these two models however lies in the risk-sharing aspect. CBOs pool, manage and absorb the risk itself, though frequently by forming an insurance company. The extent of risk-pooling is therefore constrained by the size of the CBO insurance membership. Here, the policy holders manage the insurance program and negotiate with external service providers (e.g., hospital chains as in health insurance) as relevant. Members, aware of group demand, can directly influence the product design, scope of coverage and the size of contributions. Marketing of the product within the group becomes easier than in the partner-agent model. Thus the model potentially strengthens social cohesion in the group, which reduces costs associated with fraud, adverse selection and moral hazard because in the context of smaller communities, higher level of social interaction translates into an informal and frequent flow of information (Sobel, 2002).

Most regulatory provisions approve of CBO mode of insurance, while these typically do not acknowledge MFIs as suitable insurance providers (e.g., as in India). In reality, CBOs often lack managerial resources as well as reserve funds due to their geographic location and the level of attendant social and economic advancement. The regulatory purview also allows the cooperative network insurers gain access to international reinsurance (Maleika and Kuriakose, 2008).

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<sup>5</sup> See Fischer and Qureshi (2006) for different organizational variants of cooperatives.

**2.3 The Full Service Model:** Here, basically non-commercial but registered organizations operate their own insurance scheme, which fully absorbs the risk, profit as well as loss. The insurer is in full control but would typically engage a provider (another NGO), to provide the service (e.g. health care), who has no claim on any residual profit or loss. The insurer is responsible for all aspects of designing and delivering the service as well as all insurance-related costs. The model requires substantial initial investment in human and financial resources and acquisition of actuarial expertise, which limits its popularity. In most developing countries, shortage of skilled insurance professionals would make it difficult for CBO/MFI/NGOs to acquire and retain such services at a cost advantage vis-à-vis commercial insurers, thus making it harder for large scale institutions of long-term viability to emerge. Also commercial insurers would face difficulties in liaising with the potential clients living in 'remote' locations, because these urban entities are unknown to the former and generally not trustworthy, resulting in cost-ineffective provision of insurance services. For example, DELTA life, a full service operator, in Bangladesh spends about 3 to 4 percent of the sum assured (endowment policies) as administrative expenses, while the similar cost for SKS (in partner-agent set up with Bajaj-Allianz in India) is less than one percent between the insurer and the agent for a retail endowment product that has 2.7 million subscribers (see Ahsan and Hakim, 2010).

**2.4 Provider model:** Here, the insurer and the service provider are one and the same entity (e.g., hospitals or doctors offering policies to individuals or groups). The model requires a well-established distribution network and is widely used in the non-life insurance market.<sup>6</sup> Like the full service model, the risks faced by an insurer are the same and that the insurer is responsible for all aspects of designing and delivering the service. However, the responsibility of actual provision of service becomes a new element here. Thus for commercial insurers located in urban centres, provision of microinsurance in this mode is even more difficult than in the full-service mode requiring it to operate as a service provider in addition to sell insurance itself. For non-life coverage this entails a rather extensive chore

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<sup>6</sup> Most microinsurance programmes in Bangladesh are effectively examples of the provider model run either by commercial insurers or by MFIs; the products offered by the latter are usually coupled with credit, for example, to insure against default risk (see Ahsan et al., 2012).



of activities, although for life products there is little distinction between the two institutional structures.

But a more fundamental design incongruity of the provider model is that (say in the case of health insurance), the health care provider is involved in developing the business model as well as the financial plan. Importantly, for health coverage, the care provider's control over the benefit package makes it clearly distinct from an insurance company employing a service provider or setting up its own health care facility. Unifying the roles of provider and purchaser of services would thus be seen as creating a potential conflict of interest. This feature allows the provider driven scheme to restrict the client's choice to the provider's facility. For example, all major providers offering some form of micro health insurance in Bangladesh limit the availability of in-kind benefits essentially to their own health facilities with built-in limitations as to the range and quality of available services (Ahsan et al, 2012a). The model suffers from high transaction costs when applied to a voluntary basis to low-income, low-margin markets (Ahsan 2009). The single largest shortcoming here is the typical lack of professional insurance services when the provider is other than a commercial insurer, thereby significantly compromising the prospect of long-term sustainability in a competitive environment.

Since no single delivery model of microinsurance appears free from serious drawbacks, this implies that there is scope for one model to incorporate the advantageous features of other models. For example the partner-agent model can be strengthened by incorporating some features of the community based model such as involving the target group in designing the benefit package. Similarly the community based model, if the risk pool is large enough can always engage high quality professionals conversant in insurance knowledge with regards to the issues of technical and operational sustainability.

### **3. Criteria for Choosing among delivery channels**

Presumably the design of microinsurance products would ideally be made by professional staff engaged by the insurer no matter what the chosen delivery channel is. Hence the choice criteria of the delivery modality is focussed on dimensions other than that of the inherent product quality, e.g., in sales, ease and cost of product implementation and marketing, after-sales service (claim settlement), customer satisfaction and retention. Given that different delivery modes have different cost implications, an optimal choice would inherently require matching the value of incremental benefit with the implied increase in the premium to poor

households such that net insurance benefits are maximized. Here we develop some criteria for choosing among delivery models which focus on both these goals, namely adequacy of the service and premium affordability. These include ‘creating awareness and spreading education’, ‘building trust’, ‘cost efficiency’, ‘satisfactory and timely settlement of claims’ and ‘subscriber inclusivity’.<sup>7</sup>

**(a) Insurance Education and Awareness:** One of the important elements of microinsurance sustainability is that the clients fully understand the essence of risk pooling. The delivery channel can play a vital role in creating awareness regarding the essence and benefits of the insurance mechanism for dealing with the risks and vulnerability faced by potential insured. Once policy holders obtain the correct perception about the value of the service, they can better articulate their demand for insurance resulting in a higher rate of policy renewals. This is true for both mandatory as well as voluntary products. Looked at from this angle, it is evident that modalities where insurance is marketed by members of the CBOs/NGOs/MFIs would hold more promise than by agents representing non-local entities. The downside however are that MFIs and the like would have to invest in updating and innovating upon the training modules appropriate for the task at hand and recruit and/or train dedicated local staff to market microinsurance products. A sustained campaign for spreading insurance education and related training of staff is therefore a pre-requisite for a successful implementation.

**(b) Trust and Product Marketing:** Insurance is a product for which people pay in advance in order to be eligible to receive pre-determined benefits depending on contingent (future) events. Therefore potential clients must trust the process, namely the sequence of premium payment, the eligible grounds for indemnity and the exclusion, and the modality of claim processing and settlement. Ideally, therefore, from the end-user perspective, the same person/group (e.g., the nearest MFI unit office) that would collect the premium ought to be in charge of physically settling claims. Lack of trust in an agent to deliver a timely service would deter potential clients. If a commercial insurer is involved in the risk-spreading process, unless the insurer has a dedicated staff stationed in the MFI office, and or otherwise seen as part of the MFI team with which the clients are already familiar, direct intermediation by the insurance agent may not help matters much.

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<sup>7</sup> This is not meant to be an exhaustive list, but instead identify some key elements that deserve utmost priority for the success of the insurance mechanism.

Marketing success may be measured by the capacity to reach a high percentage of targeted clients within a stipulated enrolment period. The marketing process would thus be smooth if the potential insured are able to articulate the demand for the insurance service in question and secondly, if they trust the process as outlined above. Often convincing the clients of the providers' ability to deliver benefits without delay may be difficult but without such confidence, selling insurance would be difficult. In such cases trained distributors and detailed information on the long term sustainability of the provider can improve the situation. Here again material involvement of community based organizations (including NGO/MFIs) would be an advantage. Confidence in insurance institutions in general is very important (Cai et al., 2009). If people already have a low level of trust in such institutions, the cost of trust building would undoubtedly be high.

**(c) Achieving Costs Efficiency:** Transaction costs often account for large part of the insurance premium (e.g., large staff overhead in marketing and servicing the clients) and/or otherwise, figure prominently in the indirect costs (e.g., travel costs or delays in accessing eligible health care) of the insurance service in question. Higher transaction can also result from a burdensome compliance process, rendering a product less affordable or unattractive to the poor. The physical proximity of both the distributor and, in case of health, the service provider can significantly reduce transaction costs incurred in travel time and compliance costs incurred by the beneficiary. As noted by Dercon and Kirchberger (2008), transaction cost can be minimized if the insurer develops and prices the product and an institutional agent, having existing relationship of trust with policy holders, is employed. The partner-agent model would thus appear advantageous in this context. The delivery channels would however entail a different level of after-sales service depending on the product as the frequency of interaction with clients will vary according to the nature of the loss, benefit package etc.

However, both from an examination of available products in the market and from interactions with insurer and delivery agents, it is undeniable that mandatory group products happen to be the least costly by far vis-à-vis retail products no matter how innovative the latter may be. It also stands to reason that intermediation by a network of cooperatives, NGO/MFIs are about the only viable means of tapping into a vast number of potential 'group' clients. It would thus seem that the goal of discovering the lowest possible transaction costs (and thus possibly the lowest premium rate) seems to be achievable in either the CBO format or in a partner-agent framework.

**(d) Timely Claim Settlement:** Though an element of the transaction cost, an explicit focus on claim processing is in order since any non-transparent (from the beneficiary's perspective) delay could undermine the credibility of the insurance process. Claim processing can be faster if it is done at the field level with minimal paper work. For example, under the partner-agent or CBO framework, claim processing may take longer if the MFI (agent) or local field supervisor is not in a position to settle claims (Churchill, 2006). Documentation requirements by the insurer can potentially drag out claim settlements unnecessarily.<sup>8</sup> A backlog of claims also delays claim processing. Policy holders require immediate access to the claim/service in order to meet obligations at the time of shock and a lag in processing claims lowers the perceived benefit of the policy. For example, demonstration of benefits through prompt and a hassle free claim settlement procedure has been found to be a very effective tool in creating a true perception of insurance and hence demand (see UNDP 2006).

It is observed that beneficiaries receive faster response if the distributors settle the claim rather than the insurer. Leftley and Roth (2006) refers to this approach as an amended agency arrangement, where MFI or local staff of CBOs verifies and thereby settles the claim from the 'un-submitted premiums,' in which case they submit net premiums after deducting the amount of settled claim payments. In such contexts, provision of settlement guarantees could potentially minimize processing times and overcome the trust in process issue. For example, many MFIs routinely settle mortality claims once they are convinced of the event, while the insurers do not typically release the indemnity until the 'death certificate' reaches them.<sup>9</sup> In any case, the importance of demonstrating the capacity of the insurer to settle claims in an expedient manner cannot be overemphasized.

**(e) Risk Pool & Subscriber Inclusivity:** Subscriber inclusivity is fundamental to the success of microinsurance, which must entail few exclusion criteria. As microinsurance is meant to be a low-cost product, it has to be sold in high volumes for allowing the least possible premium as well as achieving optimal utilization of the fixed costs of designing and servicing the product. Otherwise, it would be hard for an insurer to break even and go forward. Reaching a large risk pool also reduces the risk associated with adverse selection as

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<sup>8</sup> Khalily et al. (2008) observed that the number of documents required by commercial insurers can be as high as eight documents per claim.

<sup>9</sup> In the Indian context, in ASA's experience with the Life Insurance Corporation of India (LIC), death claims regularly took three months or more to be paid, until the former took over the task.

well as improving risk diversification. Thus a delivery channel that facilitates reaching large groups with diverse risk experiences ensures the overall functioning and affordability in terms of reaching low premiums.

#### **4. Which Institutional Modality may Improve Service Delivery?**

Here we examine the kind of institutional modality that may improve service delivery in all its dimensions. It is unlikely that all microinsurers will market the same product. Therefore, when comparing various delivery channels, the product type needs to be distinguished. In the case of life insurance products, claim verification is relatively easy. Given that death is the underlying event, fraudulent claims are unlikely, though distinguishing between accidental and natural death is not a trivial task even for field staffs. The issue of *moral hazard* as well as outright *fraud* (e.g., falsification of events/records for claiming undue benefit) are more likely in property and health products. A general comparison of different delivery channels in terms of the key indicators analyzed in section 3 is presented in Table 1 below.

<<Insert TABLE 1 about here>>

Among the major microinsurance products, health insurance is the most difficult to implement as it requires considerable managerial as well as actuarial capacity. The (health) insurers need to have a sound understanding of morbidity pattern and the solutions to the problem of adverse selection unique to the health context. Accurate verification of the incidence of illness turns out to be difficult and rather subjective. Moreover, for effective implementation of any health insurance program, it is necessary to secure access to existing infrastructure of health service providers, where policy holders can obtain necessary and timely services. These points together imply that the provider mode of offering micro health insurance would be untenable since the capacity to carry risk need not imply an equal advantage in implementing and servicing the products. In the Bangladesh context, it can arguably be stated that Grameen is facing real challenges in keeping up the subsidized care programs (à la provider set up) it had launched some years ago (see Ahsan et al. 2012).

In the case of livestock insurance, procedural challenges raise greater concern for adverse selection and moral hazard. Here insurance companies require some means of verification of identification traits, health and value of the insured animal. This would entail, for example, tagging the animal's ear and obtaining health certification from a veterinarian (or through an equivalent process) as to the insurability. Whichever the means, the process is costly both in terms of money and time for the clients. The CBO approach may be more

suitable here as local staffs would play the central role in every aspect of insurance, thus improving the service delivery. Though both the partner-agent and the CBO model are advocated on grounds of operational efficiency for most categories of risk coverage, there are several areas of concern that need to be addressed before going to policy holders. In particular, the role of each party (insurer and agent or, between the insurer and service provider, as appropriate) should be clearly understood and spelled out on the basis of the comparative advantages each has in performing the respective chores. MFI personnel in partnership with commercial insurers need to perform a dual role by ensuring their own institutional requirements in terms of distribution, cost coverage, capacity requirements as well as representing the client and their needs.

Studies have shown that MFI clients often have little understanding of their insurance products that are purchased non-voluntarily and that, contrary to expectation, MFI field staffs do not always attempt to cross-sell insurance products (Churchill 2006). If MFIs become too focused on their loan portfolios and hence revenue maximization, neither the provider model nor other types of delivery channels would be able to provide meaningful insurance products that maximize value to the policyholder. In such context, policy holders will only find themselves discontinuing or, not renewing subscription for voluntary products and, for non-voluntary products, would tend to perceive insurance to be an additional cost of borrowing. This situation may be largely corrected by engaging trained and dedicated staff to serve the insurance portfolio.

Insofar as the CBO model is concerned, the poor state of the cooperative movement in the Bangladesh context, would suggest that this type of insurance provision may well be a non-starter since building institutions is not an easy task. Innovative approaches may however emerge if for example an apex entity were to fashion itself as a mutual insurer with its partner organizations (POs) as its shareholders with the express purpose of serving the PO clientele. It nevertheless begs an answer as to why the latter structure would not be dominated by an alternative model where the same were to partner with a commercial risk carrier in terms of overall performance and cost effectiveness.

## **5. The Microinsurance Regulatory Stance**

In the insurance context regulation is very important for consumer protection. Because subscribers deposit the premium revenue, typically at the start of the contract period, which ought to be invested prudently since the built-up fund serves as the source of indemnity

payments, reserves and reinsurance premium thus binding the clients in a fiduciary relationship with the insurer. The concern over protection also arises because the insured will not come to know the quality of what he/she has bought possibly until after several years. Thus it is crucial that the service has indeed been rendered as promised. Further, insurance services may at some stage in its development even call for prudential regulation and supervision.

Accordingly, most stakeholders strongly believe that the emerging microinsurance market needs a comprehensive but compliance friendly legal regulatory framework. Such support notwithstanding, to date the regulation of microinsurance has largely been rudimentary in many contexts including Bangladesh. In Bangladesh, a new Insurance Development and Regulatory Authority (IDRA) Act has recently been adopted replacing the earlier Insurance Act of 1938 (amended in 1973 and in 1984). The new Act promises to develop IDRA as an autonomous entity, though in its current form, it is however near empty insofar as microinsurance is concerned.<sup>10</sup> Turning to MFIs, Microcredit Regulatory Authority (MRA) was established in 2006 to monitor and supervise the *microcredit activities* of the MFIs requiring the latter to obtain licence for their operations. The MRA Act (2006) and the revamped MRA Rules (2010) both suggest that MFIs at their discretion, may offer microinsurance services. Indeed, most MFIs offer some microinsurance services, typically some variation of life-cum-credit as cited already.<sup>11</sup> The 2010 Rules however does not offer additional insight as to the functioning of insurance or regulation thereof.

**Regulatory Coordination: How many regulators?** While India has chosen to regulate microinsurance under a common rubric, this is unlikely to emerge as the common practice. In most contexts it will be necessary to address how to coordinate the regulatory directives applicable to micro-insurance activities of commercial insurers vis-à-vis those operated by CBOs/ NGO/MFIs. In such a context, while a variety of institutions may provide microinsurance services, the regulatory guidelines, if they exist at all, may be uneven, or may only relate to one segment of the market. In the absence of a coordination process, the

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<sup>10</sup> The term is not used even once in the entire document. Historically the Bangladesh regulator has enjoyed neither the capacity (witnessed by its inability to produce a mortality table of policy holders in nearly 40 years of its existence) nor the operational independence of the administration.

<sup>11</sup> Conceivably, this still leaves out NGOs, who lack credit operations, but may have ventured into various insurance type services (e.g. health). Strictly speaking, such entities are outside of MRA jurisdiction, and cannot therefore claim to have the legal authority to provide insurance services.

simultaneous provision of service by a heterogeneous class of insurers may ultimately undermine the protection of the policy holder and thwart market development.

How can regulations relevant to activities of different types of organizations be coordinated? The Bangladesh example is a good one in the sense that there are at least two types of organizations who claim to provide microinsurance services, where to date there has been little regulation and supervision, prudential or otherwise. While the commercial insurers, many of whom offer products generally referred to as ‘microinsurance’ services targeted to the poor, had been under the supervision authority of the former Controller of Insurance, this agency has had very little impact due to a lack of will and expertise (Ali, 2002). The newly enacted IDRA act mandate all insurers to offer ‘life’ or ‘non-life’ products (though not together) to the ‘rural and social sectors’, without specifying the latter as microinsurance *per se*. While the MRA Act (2006) permitted the offering of ‘microinsurance’ to ‘borrowers and their families’, the newer Rules of 2010 appear to have opened up a little more: authorising the sale of “insurance services to its clients” (Article 25.1) but otherwise offer few additional details. While the eligibility of non-borrowers is an important step forward, some argue that further extension to even non-members of the organization, but from within the community perhaps at a higher premium rate than members would be helpful. The latter strategy may serve as means of cross-subsidizing members who are presumably poorer than the non-members. The MRA stance however may well have to change if IDRA claims that all insurance services are under its exclusive purview, in which case the MRA guidelines on insurance may need to be re-worked. At another level, regulation of the industry may appear difficult due to the fact that the orientation of commercial insurers and that of CBO/NGO-MFIs, who operate under a variety of social objectives, differ markedly. However, the key criteria proposed above, namely cost efficiency, adequacy of the service and long-run sustainability, are equally applicable to both sets of institutions.

Focusing on Bangladesh, given that both IDRA and MRA operate under the Ministry of Finance (MoF), it would be opportune to review the desirable elements of such statutes in light of the regulatory developments in the region (especially India and Philippines) which would be relevant to the industry regardless of whether insurance is offered by commercial insurers, CBO/MFIs, or, in collaboration with each other. A somewhat similar initiative is



underway in South Africa to create a dedicated regulatory framework for microinsurance.<sup>12</sup> Philippines Insurance Commission(PIC) has most recently (January 29, 2010) promulgated a new, simple and compliance friendly set of directives for the regulation of microinsurance services in the country, a much lighter fare than that adopted in 2005 by the Indian regulator, Insurance Regulatory and Development Authority (IRDA).

**The Interface between Regulation and Delivery:** While in 2005 the Indian regulator had famously imposed a particular delivery channel as the sole legitimate means of distributing insurance services to the poor and at the same time mandated all insurers to serve this market within an enforceable time bound modality, this was seen by many as heavy handed. Many feared the adverse consequences of short circuiting the experimentation with the delivery mechanism which had been in operation for many years at the behest of several major NGO-MFIs, which were being discouraged if not banned outright by this piece of legislation. Five years on, while many still find many of the regulatory statutes out of date or irrelevant, IRDA has dealt with the ground realities prudently and with consideration. Not only have many experiments been allowed to continue; the regulatory stance has led to a proliferation of products offered by nearly all registered insurers in partnership with MFIs/SHGs/CBOs. Moreover, nearly all insurers presently happen to be organized as joint ventures between Indian partners and major multinationals, presumably thereby strengthening and deepening both human and financial capital in the insurance industry there. The entry of overseas companies may in part have been hastened by the demand for skill necessary to develop specialized products directed at the poor as well as at the emerging middle class.

While the overall premium rates have fallen as MFIs continually shop for better quotes and products, the industry is far from a competitor's show case. There is little evidence of the law of one price, the ultimate proof of market competition. Instead the market is replete with differentiated products so that it is hard to compare the premium cost of the services on offer (see Ahsan and Hakim, 2010). This suggests that regulation ought to keep up competition at all levels, among delivery channels, among those who are eligible to distribute the products, and the mix of products an insurer may want to offer. In this regard,

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<sup>12</sup>The proposed framework is envisaged to facilitate active selling of microinsurance products putting an end to the current heavily segmented market between low-end and regular insurance services. At the same time the removal of the strict demarcation between life and non-life policies should allow providers to bundle life and non-life products as they see fit (Bester et al., 2008).

the PIC directives of 2010 are a case in point. It allows insurance to be sold by all licensees. While MFIs are authorized to serve as licensed agents, nothing stops the larger entities to form a separate insurance company fashioned as MBAs or CBOs if they so choose.

## **6. Proposed Microinsurance Regulatory and Supervisory Directives (MRSD)**

The regulatory directives proposed here reiterate, among other, some of the points of the PIC directives, which in spirit apply to developing countries with a comparable regulatory background as that in South Asia. These highlight the key goals of cost efficiency, financial viability, and inclusivity, and are aimed at fostering innovations in product design and delivery. However, the compliance burden has to be kept at a low level so that smaller entities do not face undue hurdles thereby compromising the needs of the poor and/or impeding the growth of this emerging sector. Sharing of such tasks by multiple regulators would appear inefficient and even unproductive. Also, for practical reasons, these directives ought to be gradually and sequentially enforced as the industry matures, with the prudential aspects to come in last.

(a) *Conceptual Definition*: A workable interpretation of the microinsurance, as we refer in the introduction, is crucial and it is also desirable that the regulator determine the eligibility of it to be marketed by a licensed microinsurer. In deciding product's eligible, *product variety and quality should be considered* such that different types of providers may propose different products, thus ensuring a prudent balance in product diversity.

(b) *Quantification*: The conceptual definition would not suffice for regulatory purposes if the goal is to encourage the development of a set of standard products. Among the advantages of standardization are that the potential beneficiaries may easily compare products available in the market, while at the same time, allowing insurers to operate the entire range or specialize to a subset depending on their expertise and circumstances. The Indian directive on this score is perhaps too strict. For allowing innovations, it would be useful to offer a flexible structure by twinning the size of the indemnity to parameters of income distribution such as the average annual income, poverty line or the size of average annual microcredit. Thus, for example, *for credit/life (term, endowment etc.) type policies, the benchmark products may offer indemnity in a range of 1.5 to 5 times the average size of the annual microcredit loan*. Coverage below this threshold can be presumed to offer little value to the average poor since it would be inadequate to overcome the vulnerability due to the loss. It would seem that a good portion of 'microinsurance' policies currently marketed by

commercial insurers in developing countries are below the above threshold, which will cease to be so defined if such a regulation is passed. Products not fulfilling this quantitative guide ought to be proposed to the regulator for approval on a case-by-case basis with clear rationale.

(c) *Simplicity of Microinsurance Products*: The regulatory directives ought to require that each microinsurance product as well as the contract be written in plain language where all benefits and documentary requirements for the time-bound claim settlement process are clearly stated.

(d) *Eligibility for Insurance*: Once the products are defined with low-net worth persons in mind, subscription to it should not be restricted. It would make little sense to prevent MFIs, as implied by the Bangladesh MRA guidelines, from extending insurance service beyond their existing members.<sup>13</sup> Because, poor who do not need a new loan, instead, would demand insurance to safeguard their savings against health and other shocks. The risk of adverse selection must however be guarded against, but that is primarily a design issue.

(e) *Duration of Coverage*: The majority of ‘microinsurance’ products currently being offered by MFIs in South Asia is of the credit or credit/life type of coverage, which typically expires at the end of the loan term, rendering the ‘insurance’ a transient phenomenon. *It is proposed that directives may be framed so as to require the insurer to offer a conversion of credit risk policies to equivalent life coverage once the borrower ceases to be one, and the insured will thus have a choice to continue the coverage or look for alternate plans.* It is a standard practice to set the policy premium on an annual basis, and timely payment of the same is necessary for the continuation of coverage. However, demand for insurance, being a temporal phenomenon, would appear more appealing if insurers were to offer flat annual premium for terms of up to 5 or even 10 years. This would be especially relevant for term life coverage as is routinely done in mature financial systems. Regulatory directives encouraging long-term contracts would generate additional demand since the insured would know the future cost of continuing the coverage.

(f) *Life vs. Non-life Products*: The historical demarcation as to carriers of life and non-life risk has been done away with in most developed financial systems. The IRDA statutes

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<sup>13</sup> Current non-borrowers may be allowed to purchase insurance on outright cash premium payment, while savers/borrowers may be entitled to an instalment facility. The pure insurance seekers may be grouped as ‘insurance members’ of the MFI.

permit marketing of each other's products, but the carriers are required to remain distinct.<sup>14</sup> The Indian scheme in effect allows a life micro insurer to act as an intermediary for a general microinsurance company (and vice-versa) rather than as a risk carrier, which results in competition being curtailed and the poor also suffer. This dichotomy makes little sense especially in microinsurance, since that may be one way of pooling risk across product lines, and hence may allow an insurer, if socially deemed fair, to cross-subsidize some services by another (e.g., health by life). If a company/MFI were to specialize in one, nothing prevents it from doing so. Indeed, the PIC has approved the bundling of micro products so long as each component of the bundle is underwritten separately (possibly by the same insurer).

(g) *Promoting Inclusivity*: Some countries have sought to expand the reach of microinsurance by requiring all insurers to serve the low-income market (e.g. India). The IRDA requires all insurers to attain a certain share of premium income from policies catered to 'rural areas' as well as 'urban areas'. However, such a heavy-handed approach need not be productive at all times and certainly not practical for the smaller entities. Even for larger ones, some may specialize in a niche market, and dilution of their business strategy may harm the goal of efficiency and sustainability. The Bangladesh IDRA guidelines appear to mandate each insurer to offer 'life' or 'non-life' products in the 'rural and social sectors' (article 6). While widening the access of the poor to insurance services is in public interest, it is worth debating if compulsion is superior to alternative incentive strategies such as tax reliefs in terms of reduced rates of corporate profit tax for insurers whose premium income from 'recognized' microinsurance business exceeds some pre-set threshold (say 10%) of total premium income. Though any provision of this type is fraught with bureaucratic wrangles that may unnecessarily use up scarce resources, the IRDA type edicts may lead to opportunism and market distortions. On balance, the tax incentive idea would appear to be of appeal to commercial insurers who may be able to develop expertise in designing and retailing microinsurance products. Even if these were not profitable in the short-run, they would enjoy lower tax on their net income. However, for such a policy to be functional at all, the definition of what goes by 'microinsurance' ought to be crystal clear.

While credit insurance would normally be regulated, in order to allow maximum access to the poor, MFIs offering only credit insurance for self-protection may be exempted

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<sup>14</sup> Premiums for general microinsurance services can be collected by the life micro insurer either directly or through agents, which will be transferred to its general microinsurance partner, and vice-versa.

from regulatory process, provided that no additional fees (premium) are charged of the borrower.<sup>15</sup> However, the uses of any premium fund maintained to meet claim ought to be under the regulator's purview. Bester et al (2008) suggest that in the South African context marketing innovations have played an important role in promoting inclusivity.<sup>16</sup>

(h) *Separation of Credit and Insurance Activities*: The credit and insurance services ought to be separated for greater financial transparency. *It is therefore proposed that MFIs separate the microinsurance operations from all other activities, and receive a separate licence from the regulator to run the former line of business.*<sup>17</sup> A registered MFI, once IDRA certifies the eligibility of the proposed products, will automatically earn the insurance licence. This would ensure that separate activities of an MFI would in principle face different regulatory directives, especially when it comes to prudential matters. Moreover, this will put an organization's all arms' length transactions on a transparent perspective.

(i) *Reserves*: In commercial insurance, reserves typically an actuarially determined fraction of net premiums, are kept in a more or less liquid form in order to meet contingent demands which may be made upon it. However, most MFIs appear to be historically negligent about the importance of adequate reserves against the temporal pattern of policy liabilities (Uddin, 2009). The regulator may address this forcefully without necessarily requiring full-fledged compliance with the prudential guidelines that may be made mandatory at some stage. Pauly argues that "regulations that assure adequate reserves ... and protection of customers from arbitrary denial of benefits or rate increases are all important" (2008, p.1018). Importantly experienced actuaries need to be engaged to project the future liabilities of microinsurers.

(j) *Capital Adequacy & Related Prudential Guidelines*: The primary accepted norm is that capital adequacy is linked to the riskiness of an insurer's business. Dwelling on the

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<sup>15</sup>In such cases, the MFIs in question ought to state that the interest charge includes free credit insurance so that the former is made comparable across MFIs.

<sup>16</sup> These include the use of the cell phone as communication and sales tool and collaboration with retailer chains or sports clubs as distribution channels. Design features such as choosing the policy contracts using a "tick-of-the-box" approach have led to low transaction costs and the ability to reach a large pool of clients. It would be interesting to experiment how similar innovations may be adapted in other contexts.

<sup>17</sup>There may be two types of licenses, type-A and type-B, where the latter may permit operation of credit and saving products, while the type-A license is the comprehensive one that allows the marketing of insurance services as well.

notion of *risk-based capital* (RBC), note that capital needed to offset the ‘insurance risk’ alone is often referred to as the *solvency margin*, which is not adequate for the overall risk scenario, but captures an important component.<sup>18</sup> The regulator ought to deliberate appropriate standards taking into consideration how such risk stipulations should apply to microinsurers as well as the sources of funds, which are different between commercial insurers and MFIs since the latter do not have access to equity capital. Importantly, microinsurers *may well face a higher capital requirement than if they restricted themselves to credit and deposit taking activities only*. MFIs as insurers ought to be required to adhere to capital requirements that respect the fiduciary and prudential goals of regulation. Even if the target set for MFIs appears moderate by registered insurer standards, such a stipulation may pave the way for self-selection of NGO-MFIs who essentially offer social services from those who actually offer ‘insurance’. The former would then be willing to re-label their products appropriately, and remain outside the purview of the regulatory regime, which may well be in the long-run interest of all. Apparently a reorganization of the industry along these lines occurred in Peru subsequent to the adoption of the insurance law in 1993 (Wiedmaier-Pfister and Chatterjee, 2006).<sup>19</sup> Another significant dimension of the capital requirement is that it serves to ration the available regulatory and supervisory resources at the disposal of the authority (Christen et al, 2003).

*(k) Design, Accumulation and Investment of the Reserve Fund: The regulator should be able to examine the actuarial basis of the chosen premium rate structure, the adequacy of the evolving reserve fund and its permissible investment as well as rules regarding the build-up of excess funds and disposal thereof. A recent analysis of MFI run ‘insurance’ (typically credit or credit-cum-life policies) in Bangladesh revealed that, at least for large insurers, only 10% of the annual premium was used up in annual indemnity claims, which renders the actuarial basis totally suspect, especially where not many covariant events were being covered by these institutions (Khalily et al, 2008). Indeed the same survey reveals that, of those volunteering to publicly share the data, 85% use it as a ‘revolving loan fund’ accessed*

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<sup>18</sup> Adherence to the solvency margin is seen as a first step toward adopting a more comprehensive RBC down the line.

<sup>19</sup> A similar development is likely in the Bangladesh context since to date nearly seven hundred, out of several thousand NGO-MFIs applicants, have obtained the MRA licence.

at zero interest, exposing the fund to the same risks that the insurance products attempt to guard against (Ahsan, 2009).

Investment of such funds should be guided by the need to match the time profile of investment returns with that of the stream of anticipated claims, an issue that is much more serious for life-based (e.g., term or endowment) policies than annual health or livestock insurance. The regulator may provide guidance to the insurer about the risk characteristics of investment portfolio. Conceivably, a proportion of actuarially determined surplus of an MFI insurer may be loaned out for its other (e.g., credit) services, but there ought to be an explicit understanding of the terms of the loan and the associated collateral. Moreover, in most regulatory guidelines, it is generally forbidden for an insurer to build-up excess funds not called for by the underlying actuarial calculus.

(l) *Policy Delinquency*: Microinsurance policies, like other insurance contracts, may be discontinued by the insured due to both voluntary and involuntary reasons. Regulatory directives would be essential to protect the rights of both parties, ensuring fairness. In the case of registered insurers, the Bangladesh provision is that if at least two consecutive years' premiums have been paid, e.g., in endowment life policies, the policy qualifies for a *surrender value* (Uddin, 2009). The latter is typically less than the premium actually paid, but at least the entire payment does not go to waste as far as the insured is concerned. Of course if the 2-year cap is not met, the policy *lapses* with no cash value.<sup>20</sup> Prudently an equitable benchmark in the case of microinsurance, presuming that successful programs would be low-cost operations, is to establish a suitable surrender value for life microinsurance products after 12 months of consecutive premium payments.

(m) *Audit & Supervision*: In the Bangladesh statutes, an external audit has been made mandatory for each MFI which is to be carried out, with adherence to Bangladesh Standard of Auditing (BSA) guidelines, by an eligible chartered accounting firm *with experience in microfinance activities*. Indeed the MRA Act goes beyond and suggests that it intends to issue a 'manual' at a future date detailing the modalities to be followed in establishing adherence to the Act and competence of the MFI by adopting standard procedures (article 21.10). With hundreds of licensed MFIs operating in the industry, it is unclear at what stage

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<sup>20</sup>While NGO-MFI run microinsurance offers no evidence of the lapse ratio, those offered by registered insurers are suggestive of high ratio of lapses, discontinuities and low surrender values (Uddin, 2009). Such a scenario is not poor-friendly to say the least.

MRA will muster enough resources and experience to effectively implement the supervision tasks cited here.

(n) *Reinsurance*: Access to reinsurance is crucial for successful microinsurance program. To attract reputable reinsurers into this market, microinsurers need to be fully registered entities in line with the IDRA regulations in force. It is also implicit that only when a formal insurer is in the picture, as for example in the partner-agent setup, microinsurance services operated by MFIs would enjoy reinsurance privileges. Any donor or state subsidy regime to promote reinsurance must also be well articulated as to its ultimate goal and be seen as sustainable in the long run.

(o) *Educating the Regulator*: Many developing country regulators do not have skilled manpower in the public service who would fully understand how the low income insurance market should function and what it may strive for. The burden on available resources may be too severe, jeopardizing the very goals of regulation. Hence a road map would be necessary to impart and endow the regulatory authority with the required human resources and training on an on-going basis.

## **6. Conclusion**

We interpret microinsurance services to be those that are especially suited to the needs of low-income households and are affordable. Both these requirements have important implications for the choice of the delivery modality on the one hand as well as on the choice of a regulatory regime, on the other. The needs of the poor are better understood by local staff of MFIs/CBOs/NGOs and cooperative societies who are active in rural locations. Such a consideration would appear to favour a delivery modality whereby the distribution of the product is intermediated by such locally based staff known to the prospective clients. In other words, delivery modalities such as the partner-agent, CBO/MBA arrangements are favoured over full service or provider alternatives. Moreover, as insurance purchase is an act of trust in the carrier, local intermediation by the trusted MFI and like agents may also be seen as indispensable. The same element of trust may also contribute to raising the level of awareness in the very idea of insurance and its scope or limitations and thus in eventual demand for the service as one of value so that the premium is worth paying for. Our analysis shows that such a view is indeed a valid interpretation of what appears to be the evidence as discerned from various case studies.



Affordability relates to scale, careful product design and continuous innovations, all of which suggest that registered insurers are perhaps best suited as risk carriers, and products should mostly be of group nature with minimal options/riders and of a mandatory nature to all members in a group. The latter feature, namely the group orientation, also points to the MFIs/CBOs/NGOs as the distribution agents either on their own behalf (e.g., as in CBO/MBA set up) or for the dedicated risk carriers (e.g., as in the partner-agent mode). Finally, affordability requires that the insurance market be 'efficient' and 'sustainable', where effective and binding regulation would be necessary so that competition prevails in the market. The regulator must have authority to question the merits of the product, its pricing and the financial solvency of the carrier before vetting the product for distribution.

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**Table 1: Choosing among Delivery Channels**

	<b>Partner-Agent</b>	<b>CBO</b>	<b>Full Service</b>	<b>Provider</b>
<b>(a) Education &amp; Awareness</b>	<b>A:</b> Campaign led by local staff belonging to the community	<b>A:</b> Campaign led by local staff belonging to the community	<b>A:</b>	<b>A:</b>
	<b>D:</b> Prior and specialized training is a pre-requisite	<b>D:</b> Prior and specialized training is a pre-requisite	<b>D:</b> Generally, lack of eligible local staff except where the insurer is a CBO/NGO-MFI	<b>D:</b> Generally, lack of eligible local staff except where the insurer is a CBO/NGO-MFI
<b>(b) Trust Building</b>	<b>A:</b> Clients are already in a trust relationship with the MFI as a microlender	<b>A:</b> Clients are already in a trust relationship with the CBO affiliates as microlender(s)	<b>A:</b> Trust relationship exists only if the insurer is a CBO/NGO-MFI affiliate	<b>A:</b> Trust relationship exists only if the insurer is a CBO/NGO-MFI affiliate
	<b>D:</b>	<b>D:</b>	<b>D:</b>	<b>D:</b> Conflict of interest since insurer is the buyer of service
<b>(c) Lowering Transaction Costs</b>	<b>A:</b> Possible to have least cost by using trained and dedicated staff	<b>A:</b> Possible to have least cost by using trained and dedicated staff	<b>A:</b> Least cost only if the insurer is a CBO/NGO-MFI affiliate	<b>A:</b>
	<b>D:</b>	<b>D:</b>	<b>D:</b>	<b>D:</b> Conflict between cost control & service adequacy
<b>(d) Claim Settlement</b>	<b>A:</b> Friendly & timely if local	<b>A:</b> Friendly & timely if local	<b>A:</b>	<b>A:</b>
	<b>D:</b>	<b>D:</b>	<b>D:</b> Slow & stressful if the insurer is not a CBO/NGO-MFI affiliate	<b>D:</b> Slow & stressful if the insurer is not a CBO/NGO-MFI affiliate
<b>(e) Risk Pool &amp; Inclusivity</b>	<b>A:</b> Facilitates reaching a large pool	<b>A:</b> Facilitates reaching a large pool	<b>A:</b>	<b>A:</b>
	<b>D:</b>	<b>D:</b>	<b>D:</b> May facilitate reaching a large pool only if the insurer is a CBO/NGO-MFI affiliate	<b>D:</b> May facilitate reaching a large pool only if the insurer is a CBO/NGO-MFI affiliate

*\*Legend: Under 'A' we enumerate the most significant potential advantage, while 'D' denotes the most significant potential disadvantage.*