BRIEFING NOTE 8

Microinsurance Innovation Facility

micro Insurance Innovation facility
PROTECTING THE WORKING POOR

International Labour Organization

IMPROVING CREDIT LIFE MICROINSURANCE

John Wipf, Eamon Kelly, and Michael J. McCord
March 2011

Credit life cover – insurance that covers the outstanding principal and interest of a loan upon the death of a borrower – is the logical starting point for organizations new to microinsurance, because it is generally easy to introduce, simple for borrowers to understand, and seen by financial intermediaries as a support to their core business. Credit life can help create an understanding of microinsurance and expand demand by helping to build an insurance culture. When borrowers see benefits from the product, they may become more receptive to other insurance products.

Unfortunately, credit life insurance is often designed poorly, providing little value to clients and their beneficiaries. When products provide little value, they reinforce a common negative attitude toward insurance. Thus, improving the value of credit life products may improve clients' attitudes towards insurance, and in turn improve overall demand for microinsurance.

TYPES OF CREDIT LIFE COVER

Basic credit life is the most common microinsurance product. The product covers only the principal and interest of an outstanding loan upon the death of the borrower. It can be structured in a variety of ways, as illustrated in Table1.

Table 1 Common design variations in basic credit life insurance

Feature	Description
Who is covered?	Borrower only
What is covered?	• Outstanding actual balance of principal and interest • Outstanding scheduled balance of principal and interest
How is premium paid?	By borrowers: • Premium deducted from the loan proceeds • Premium added to the loan amount and paid over the life of the loan • Premium factored into a higher interest rate and paid over the life of the loan By lenders: • Lender pays periodic premium to an insurer on a 'bulk' basis based on the average total outstanding portfolio during the period. Premium recovered in some manner from the borrower.
Who pays the premium?	• Borrower pays premium directly to the insurer • Lender pays premium and passes the cost on to the borrower (e.g. through a higher interest rate) • Premium is financed by external subsidies (rare) or by other means

© ILO / Sovannara K.

An improved value proposition, **enhanced credit life**, includes coverage beyond the basic credit life product so that beneficiaries receive financial benefit upon the client's death, or the client receives some benefit upon the death of a family member and/or coverage in the event of another risk. Enhanced credit life includes:

- **Enhanced life cover** provides the same benefits as basic credit life plus additional benefits such as payment for funeral expenses. Alexandria Business Association in Egypt, for example, provides cover of the full initial loan amount plus a "bail fund" to assist with funeral expenses.
- **Enhanced risks cover** includes the same risks as basic credit life plus additional risks such as disability cover for the borrower, a personal accident rider or fire coverage for business premises. An interesting example comes from Opportunity Uganda Ltd (Box 1).

Box 1 Enhanced fire protection in Uganda

Opportunity provides short-term loans to purchase stock to a large number of vendors located in fire-prone market areas. Opportunity's credit life insurance offers protection not only in the event of death of the borrower but also in the event of fire – if a fire destroys a vendor's shop the insurer pays off the outstanding loan. Having observed the devastating economic impact of a market fire on a number of its clients, Opportunity is exploring the possibility of extending fire cover to protect the entire inventory of the borrower, not just that which can be covered by the amount of the outstanding loan. Such cover could be easily added to the existing credit life product to protect the vendor's accumulated assets.

- **Family cover** expands the basic credit life and sometimes enhanced life cover to include death or disability of family members. VisionFund in Cambodia, for example, provides basic credit life cover plus funeral benefits for its clients, their spouses and children (Box 2).

Box 2 Credit life as a competitive advantage in Cambodia

Cambodia has a relatively high microfinance penetration and significant competition among MFIs. One MFI, VisionFund, uses its credit life product to promote its loan products because the outstanding debt is waived if the borrower dies. In addition, there are funeral benefits for the borrower, spouse and children. 'Insurance' is never mentioned in its promotional materials or in interactions with borrowers. The premium is 'invisible' since it is embedded in the interest rate. Credit life is regarded as highly valuable by this successful MFI because it has given the organization an important competitive edge.

INSTITUTIONAL ARRANGEMENTS

There are a number of institutional configurations for delivering credit life. While the lender is always present as the distributor, the underwriter is typically either a commercial insurer, a member-owned mutual benefit association (MBA)[1] affiliated with the lender, or a co-operative insurer. Sometimes there is no external insurer at all if the lender retains the insurance risk for basic credit life. When a lender decides to offer more cover to clients, it becomes necessary to cede the risk.

Insurers usually approach credit life as an anchor of their microinsurance business since it allows them to enter that market with relative ease. Without much risk they can learn about the market, understand mortality rates and test claims controls, while often generating significant profits. However, too often, insurers and lenders venture no further into microinsurance than credit life. This may be because the primary motivations of both insurer and lender are satisfied – profits and protection of the loan portfolio – and neither is particularly focused on addressing the remaining risk protection needs of clients or potential clients.

VALUE OF CREDIT LIFE

Three ratios can be used to quantify value for clients from a mature credit life product as illustrated in Table 2.

© ILO / Crozet M.

[1] Typically this is a risk-bearing organisation, either formal or informal, which is separate from the lender and owned by the borrowers themselves.

Table 2 Key performance indicators for credit life

Indicator	Definition	Calculation	Range for good financial value[2]	Interpretation from client perspective
Incurred claims ratio	Proportion of premium paid to beneficiaries as insurance benefits	Incurred claims / earned premium	Above 60%	Measures the client value of a credit life product. A higher ratio, in the absence of fraud and adverse selection, means the amount of premium being paid back to clients as benefits is high.
Incurred expense ratio	Proportion of premium used to manage and administer the product	Incurred expenses / earned premium[3]	Below 25%	Measures the efficiency of the credit life product. The more efficient the product is, the more valuable it can be if the lower expenses lead to lower premiums rather than increased profit.
Net income ratio	Profitability of the product for insurer	Net income / earned premium	Not more than 10%	Excess profit can be reduced by lowering the premium to increase value to clients.

© ILO / Crozet M.

If 'good financial value' is defined to mean that at least 60 percent of the gross premium is paid out in benefits, only one third of the credit life programs reviewed in the study meet that criterion. It is important to note that the incurred claims ratio ranged from 11 percent to 119 percent for the reviewed programs. While credit life is commonly assumed to be profitable for insurers and lenders, this is not universally true. Programs with claims ratios near or exceeding 100 percent are not sustainable and will likely face an adjustment to the premium rates.

Part of the reason for poor financial value of credit life products for clients is that MFIs have historically focused on creating value for themselves and not for their clients (see Box 3). When MFIs retain the risk of default on loans due to borrower death, they often charge significant fees (up to three percent of the initial loan) despite experiencing much lower losses.

Box 3 Benefit flows in credit life

Richard Leftley, CEO of the multinational microinsurance broker MicroEnsure, relates his experience with credit life and MFIs. "In 2002, most MFIs that we worked with charged borrowers a flat 1 percent of the loan value and used the resulting funds to pay off the outstanding loans when borrowers died; no insurer was involved. As we started to implement credit life at these MFIs, we noticed that they continued to charge borrowers 1 percent even though the insurance company was charging 0.3 to 0.5 percent of the loan value. In essence, the MFIs had outsourced the risk for a lower price but not passed the savings on to their borrowers, rather the delta was being booked as revenue. This practice is widespread today, which is a great shame, as we should all be focused on delivering good value for our clients."

Somewhat surprisingly, among organisations reviewed by this study, member-based organizations (mutual benefit associations (MBAs), cooperatives, credit unions) ranked *lowest* in terms of client value of their products. This finding suggests that the cooperatives and MBAs reviewed do not face competition, and their products are often priced to generate additional surplus to build equity and reserves. Some organizations have limited technical capacity and prefer to price conservatively, while some mimic other products in the market. Nevertheless, as the organizations are directly or indirectly owned by the insured households, excess surplus generated by member-based organizations

[2] These proposed limits on the ratios are the collective opinion of the authors. Note that the sum of the ratios may exceed 100% because interest on reserves increases the net income ratio.

[3] In accrual accounting, premium is earned through out the term of a loan in a pattern that reflects the risk of the insurance coverage and the expenses of administering it. Premium earning pattern is thus independent of how the premium was paid.

should *ideally* flow back to members by way of expanded services and other benefits. For example, CIC in Kenya uses surplus on credit life to finance other services for members and clients.

RECOMMENDATIONS

Based on this study, several recommendations on how to develop and implement credit life products have emerged:

Credit life should be seen as a start and not an end. Clients across the globe could benefit if insurers and lenders learned from the basic credit life products and used that learning to expand options available to clients.

Basic credit life and enhanced family cover should be treated as stand-alone products and priced relative to loan amount (e.g. a percentage of the loan amount). Other covers should be priced based on their specific risk and the sum assured (which is often a fixed amount unrelated to the loan amount). These types of cover are often priced together but because of their different risk characteristics this makes little sense. Instead, insurers need to price the various covers included within the credit life product with attention to the type of risk, sum assured, etc.

In most cases, basic credit life can be provided efficiently by lenders. There should be no legal issues barring lenders from providing basic credit life as it simply covers default in the case of death. In the case of very large loans, significant potential for catastrophic loss, or an active plan to expand basic credit life products in ways that enhance value for clients, it can make sense for an insurer partner to assume the risk.

Administration of credit life products should be simple with active efforts to contain costs. Lower expenses should enable clients to benefit either directly through lower premiums, or indirectly through expanded benefits or services (once operational costs are covered and fair profit is generated).

The structure of the products – basic credit life as a standalone versus an aggregated product with basic credit life, enhanced life cover, enhanced risk cover and/or family cover – has a strong impact on operations. Product design can affect aspects of product administration such as continuity of cover, premium calculation and premium collection, among others. These need to be considered before introduction of the product to ensure clarity and to minimize conflicts. For example, an enhanced credit life product with family cover must carefully consider how to manage claims and to price for additional insured lives.

Credit life products can be flexible and responsive to the needs of insurers, lenders and clients. Lenders should endeavour to understand clients' needs and based on this, provide valuable, relevant products. Basic credit life insurance is not sufficient for the needs of low-income clients. Credit life offers insurers and lenders an opportunity to assist clients in managing their risks in an efficient and effective manner. This opportunity should not be overlooked.

Housed at the International Labour Organization's Social Finance Programme, the **Microinsurance Innovation Facility** seeks to increase the availability of quality insurance for the developing world's low income families to help them guard against risk and overcome poverty. The Facility was launched in 2008 with the support of a grant from the Bill & Melinda Gates Foundation.
See more at www.ilo.org/microinsurance

Since its start in 2000, the **MicroInsurance Centre** has focused on dramatically expanding access to quality microinsurance by low-income people across the developing world. Through a combination of technical assistance in product development, research, and advocacy, the MicroInsurance Centre continues to strive towards the goal of billions of people accessing valued microinsurance products offered by successful insurers.
See more at www.microinsurancecentre.org

International Labour Office

microinsurance@ilo.org
www.ilo.org/microinsurance