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"Microinsurance - the challenge for law and regulation"

by Jonathan Teacher[1]

The potential market for insurance in developing economies is an estimated 1.5 to 3 billion policies with between 3 and 4 billion insureds.[2] Many insurers view opportunities for growth in their core mature markets as constrained. So it is no surprise that an increasing number of key industry participants are moving into the microinsurance sector as part of their investment in developing economies to drive their future growth.

Incentives to enter the microinsurance market are both philanthropic and commercial. They include its potential size; the significant prospects for growth; and early mover advantages in establishing brand trust and loyalty with a view to future upselling as policyholders become more financially literate and incomes rise. Impetus is also provided by regulators in jurisdictions such as China and India. They are making the grant to international insurers of some new insurance licences, or extensions to existing ones, conditional on a commitment to allocating a percentage (typically, 30%) of the new capacity to a microinsurance offering or specific microinsurance projects.

This article examines some of the key legal and regulatory issues and tensions which commonly arise for insurers engaging in the microinsurance market.

What is microinsurance?

Microinsurance is a term of art. It is used to refer to several different types of arrangement. These encompass assistance programmes sponsored by government and non-governmental organisations, mutual and self-help organisations and insurance products provided by commercial insurers. The unifying characteristic of microinsurance products is that they are simple insurance or alternative protection mechanisms designed for low income markets. Microinsurance products are characterised by low premiums and low coverage values.

It is generally accepted that a key strategy for enhancing economic development is to make financial systems more inclusive. In countries where state funded social protection is absent and individual access to cover from commercial insurers is limited, many informal "insurance" schemes have emerged which operate in the legal gaps escaping regulation. Examples of informal schemes include:

- microfinance institutions which routinely provide insurance to their customers on a "self-insurance" basis;
- community self-help groups which establish informal mutual arrangements (which may be discretionary and not provide a legally enforceable right of indemnity); and
- healthcare facilities which allow free or discounted access to medical care or medicine in exchange for regular payments (which are treated as a pre-payment for services).

English law and microinsurance: what is an insurance contract?

In the context of microinsurance, the issue of what constitutes a contract of insurance as a matter of law is often important. It can determine whether the provider of the protection needs to be a licensed insurer. The issue is also relevant to determining the legal rights of the policyholder or protection buyer. This applies particularly in jurisdictions where the rights, obligations and duties of the insurer and the insured in respect of a contract of insurance are different from their respective positions under general contract law. Whether a particular product is to be regarded as one of insurance will be a matter of applicable law and regulation (according to the purpose for which the characterisation of the contract is required).

There is no absolute definition of a contract of insurance as a matter of English law. It is, however, widely accepted that the description provided by Mr. Justice Channell in *Prudential Insurance v Inland Revenue Commissioners,*[3] together with a number of subsequent cases, forms the basis of a reasonable description of the principal fundamental characteristics of a contract of insurance. In summary, those characteristics require a transfer of risk in relation to which:

1. in return for some consideration to the provider;
2. the assured obtains a right to a benefit (which may be the payment of money or money's worth, for example a corresponding benefit such as a service);
3. upon the occurrence of an event;
4. where the event involves some uncertainty as to whether it will occur and/or when it will occur; and
5. the occurrence of the event would be adverse to the interests of the assured.

Lord Justice Buckley in the later case of *Gould v. Curtis*[4] added an important qualification. For contracts of contingency insurance, as distinct from indemnity insurance, there is no requirement for the assured to sustain a loss on the occurrence of the insured event. A further qualification to the indemnity principle underlying contracts of insurance exists in the form of so-called "valued policies". Their statutory basis arises under the Marine Insurance Act 1906[5] although they are also supported by the common law. In a valued policy, the parties to the contract of insurance determine the value of loss to be paid on the occurrence of the uncertain event when entering the contract. The assured is entitled to receive the agreed value if the insured event occurs irrespective of his actual loss. This is provided that the agreed value was a genuine pre-estimate of the potential loss and there was no misrepresentation as to the amount the assured stood to lose if the insured peril occurred.

The criterion that a contract of insurance requires consideration can present difficulties in the context of microinsurance. Insurers and distributors seeking to find innovative channels to penetrate their target markets are developing partnerships with suppliers of goods and services to provide bundled benefits, for example:

- mobile network airtime contracts which incorporate life assurance; or
- agricultural seed and fertilizer sales which incorporate crop failure insurance,

without any additional cost or premium being charged to the purchaser for the cover. In one notable instance where life assurance is provided ancillary to the purchase of airtime (described further below under the heading "Distribution"), the sum assured varies with the quantity of airtime used in the previous month.

Consideration is generally a requirement of any contract in English law, including a contract of insurance. In a case where no separate premium is added or charged to the mobile airtime purchaser, there is an open question whether the courts will find consideration for the insurance element of the transaction by apportioning the payment for the airtime. Alternatively a court may determine that an airtime contract which includes an ancillary right to receive a sum on the airtime purchaser's death is not one of insurance. Where a third party insurer provides the cover, consideration will almost certainly be provided by the seller of the goods or services. In either case, the regulatory position needs careful consideration. Additionally, from an English law perspective the recent decisions of the Court of Appeal in *Sibthorpe and another v London Borough of Southwark*[6] and *Digital Satellite Warranty Cover Limited v Financial Services Authority*[7] are relevant to the determination of whether the presence of some element of insurance in a contract for goods or services requires the entire contract to be characterised as one of insurance. A critique of those decisions and the arguments made is beyond the scope of this article. For present purposes, it is relevant that the Court of Appeal in *Sibthorpe*[8] upheld the decision of Mr. Justice MacDuff which applied the "principal object" test proposed by *MacGillivray on Insurance Law*[9] that:

> "The inclusion of indemnity provisions within a contract for the supply of services neither makes the indemnifier an insurer nor justifies describing the contract as wholly or partly one of insurance. Where a contract of sale or for services contains elements of insurance it will be regarded as a contract of insurance only if, taking the contract as a whole, it can be said to have as its principal object the provision of insurance."

By contrast, the first instance decision of Mr. Justice Warren in *Digital Satellite*[10] is more equivocal. Warren J suggested that the test for determining whether a contract which contains both insurance and non-insurance elements should be characterised as one of insurance is potentially different from the test for determining the class or classes of insurance into which the contract falls. The classification of insurance contracts in the United Kingdom is based on the list of classes set out in Schedule 1 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. Some contracts may provide cover which falls within more than one of those classes of insurance. In relation to the first issue, Warren J held that:

> "The "principal object" test may or may not be the appropriate test when it comes to deciding whether elements of insurance bring a contract containing both insurance and non-insurance elements within the concept of a contract of insurance. But even assuming that it is, it may not, in reality, differ much from the approach of the FSA. The "principal object" test cannot require, in every case, that a single principal object be identified. A contract may have two important elements, albeit that one is more significant than the other but it would not be right to categorise the nature of the contract by reference only to the more important element. What the "principal object" test is surely getting at is that there is to be found a principal object where the other elements are either "ancillary" or "minor" … to a main objective of providing cover in the case of breakdown or malfunction or, to use other words, where those elements are "integral with" or "subsidiary to" a main object."

For the second issue, Warren J considered the "identifiable and distinct obligation" test advanced by the Financial Services Authority (FSA) is appropriate. That test is set out in the FSA's Perimeter Guidance Manual[11]. This requires the identification of each different discrete element of a contract of insurance. However, Warren J also held that:

> "When it comes to determining whether a contract which contains both insurance and non-insurance elements is a contract of insurance requiring the insurer to be authorised, a strict application of [the identifiable and distinct obligation test] could result, as is pointed out in MacGillivray, in contracts of insurance being found where the insurance element is insubstantial. It may or may not be right to go that far. I rather doubt that it is, especially given the acceptance by the FSA that an ordinary manufacturer's warranty provided as part of a sale agreement does not give rise to a contract of insurance. Further Part C of the Annex to the [European] First [Non-Life Insurance] Directive makes express provision for certain ancillary risks. So, it seems to me at least, the FSA's statement in the Perimeter Guidance has to be tempered to some extent."

The Court of Appeal in *Digital Satellite*[12] noted the position taken by Warren J at first instance. It did not, however, find it necessary to give any further clarity on the applicable test since it was able to determine the appeal on a different basis.[13]

The principal object test may prove helpful to the development of microinsurance where cover is provided as an integrated ancillary element in the sale of goods and services, if such a contract is not one of insurance or, at least, will not be regulated as one. There is a risk that less scrupulous providers may seek to take advantage of such arrangements. As recent issues with mis-selling of bundled insurance in the United Kingdom demonstrate, providers should be concerned to ensure the suitability of any such bundled insurance product, especially where the price of the service or goods is higher because insurance is included.

Two further elements required of a contract of insurance and relevant to the development of microinsurance arise from the decision in *Medical Defence Union Ltd v Department of Trade.*[14] The judgment of Sir Robert Megarry, the Vice-Chancellor, found that to be insurance, the insurer must be under an obligation to provide the contracted benefit if an insured peril occurs. The benefit must be money, money's worth or the provision of services to be paid for by the insurer (the last element arising from the judgment of Mr. Justice Templeman in *Department of Trade and Industry v St Christopher Motorists' Association Ltd*).[15] Where the provision of the benefit under a contract is entirely at the provider's discretion, the contract will generally not be one of insurance.

In his judgment, Megarry V-C distinguished a legitimate expectation of receiving discretionary benefits and of that discretion being exercised in a proper way from a contractual right to receive those benefits. Many of the mutuals and community self-help groups active in the informal microinsurance sector operate on a discretionary basis. An example of this type of organisation is presented by the informal burial societies which operate in South Africa (amongst other places). They can be of significant size whilst operating outside of insurance regulation. It is estimated that these burial societies provide unregulated plans to some 8 million members contributing in excess of US$1 billion per annum in member contributions.

Partly in response to concerns about appropriate consumer protection and the promotion of financial inclusion policy objectives, the South African National Treasury has produced a policy document entitled "The South African Microinsurance Regulatory Framework". If the policy proposals are enacted, a friendly society (i.e. a species of mutual) would be required to register under the South African Co-operatives Act as either a financial service co-operative or a co-operative burial society. Interestingly, co-operatives which do not guarantee member benefits (i.e. operate a discretionary model) will not be considered insurance providers. They will not be required to obtain a microinsurance licence to continue their activities, although if they wish to provide insurance they would have the option to register under South Africa's proposed Microinsurance Act.

Law and regulation

The above analysis is concerned with what constitutes a contract of insurance as a matter of English law. There is commonly some tension between what the law regards as a contract of insurance and the contracts of insurance whose underwriting, sale and performance are regulated (that is, are within the scope of the regulatory perimeter). By way of example, a contract for breakdown and recovery services with a motoring organisation in the United Kingdom may be characterised as a contract of insurance as a matter of English law. It is, however, exempted[16] from regulation where it satisfies certain criteria. These include the requirements that the service provider carries on no other insurance business; that cover must be limited to the United Kingdom and Ireland (absent the payment of additional premium); and the contract must be limited to the provision of benefits in kind in the event of a vehicle breakdown or an accident.

The ambit of insurance regulation naturally varies between jurisdictions. In some countries, as noted above, quite significant schemes operate outside the ambit of regulation. Advantages of operating outside the regulated arena include lower entry barriers and a lower cost of business. Typically there is no minimum capital requirement, no requirement to hold a solvency buffer, and no minimum standards of governance or systems and controls. There are also no (or lower) requirements for compliance with regulatory, information and sales standards (although there may be applicable general consumer and data protection legislation in the jurisdiction). Consequently, providers of unregulated microinsurance are generally subject to lower supervisory, capital, sales, administrative and training costs. These factors enable them to offer cheaper and more innovative products which may not be permitted under regulatory controls.

Unregulated schemes present some serious drawbacks too. Principally, consumers are not protected from the risk of mis-selling and insolvency and, in reality, have little recourse if a provider fails to adhere to its promises. Such schemes do not have direct access to reinsurance because they are not technically insurance. They can, therefore be more vulnerable to the occurrence of catastrophic events against which it is difficult for them to acquire protection. Concerns with the unregulated sector are growing. Some unregulated microfinance institutions have required customers to purchase unnecessary microinsurance products at inflated premium. All of these factors detrimentally affect the reputation of the market and increase the difficulty for insurers to justify the allocation of resources for significant development of their microinsurance offering.

Consequently, the regulation of nascent microinsurance markets is critical to ensuring stable and sustainable growth and developing confidence in the industry for both customers and incoming insurers.

Regulating microinsurance

In many developing economies, insurance regulations were developed with the higher value commercial and retail insurance market in mind. Local regulators have understandably focussed their constrained resources on larger regulated (re)insurers which generally pose more significant risks to the local financial system. Such regulatory systems are generally not appropriate for microinsurance. Several key factors are changing this landscape. Critically, governments and regulators are gradually recognising that a "one size fits all" approach does not allow microinsurance providers to enter the regulated market. The barriers and ongoing costs (which may include substantial capital requirements, significant demands for key management and complex reporting obligations) can generally not be surmounted by local unregulated microinsurance providers. At the same time the regulatory burden can make investment by international insurers economically unattractive or unviable (given their other expenses of developing a local microinsurance offering).

It has also been recognised that regulatory barriers could prevent the utilisation of some of the more innovative distribution channels. These include mobile telecommunication companies, airtime vendors, supermarkets and churches, which may be necessary to penetrate deeper into low income markets such as newly urbanised migrant workers and remote rural communities. The Ghanaian commissioner for insurance, speaking at the West African Insurance Companies Association education conference in Lagos in January 2009, captured this sentiment. The commissioner stressed the need to strike a balance between regulation of the industry and innovation in relation to the sale of microinsurance products.

Distribution

Innovation in developing alternative distribution channels and applying technological advances continue to be key features of the emerging microinsurance sector. As noted above, the difficulties encountered and solutions deployed by microinsurance providers and the pace of innovation present a challenge for insurance regulators. Efficiency is paramount in the often challenging socio-economic and geographical environments in which potential microinsurance markets exist.

The sale of microinsurance, largely credit life (a form of term life assurance where, typically, the sum assured equals the outstanding balance of a loan), by regulated insurers has grown significantly. It utilises the existing distribution infrastructure provided by microfinance institutions with whom insurers partnered. The range of microinsurance products available has since expanded with the development of non-traditional distribution channels and continues to do so at an increasing pace.

A fundamental challenge for insurers in the microinsurance market today is designing effective distribution channels to ensure that economies of scale will protect investment and pave the path for a profitable future. Hurdles to overcome include educating potential policyholders in "insurance literacy", implementing efficient and sustainable sales processes and managing the systems for the collection of premium as well as the handling and payment of claims. Above all, insurers are faced with the challenge of developing the trust of consumers for whom the concept of insurance is often completely unknown. They do this through effective sales and claims processes while operating a commercially viable business model. The channels through which the policies are distributed play a critical role in this process.

From the perspective of the insurers, the most significant stage in the distribution process is the sale of the product, as increased volumes of take up allow for greater operating efficiencies. Microinsurance providers are recognising that the priorities of the policyholders, who value an ability to claim successfully and expeditiously along with simplicity in all elements of the process (from the products themselves to the steps for making a valid claim), are essentially different. This is leading to microinsurance providers across the world experimenting with new and innovative distribution channels, including cash retailers (such as supermarkets) and telecommunication networks (such as mobile phone companies). The aim is to design balanced distribution initiatives which meet the objectives of both parties.

Technology and, in particular, the advent of mobile e-wallets such as M-PESA and the MTN Mobile Wallet, for the transfer of money and payments, is proving critical to much of this innovation. For example, a Ghanaian mobile phone operator has partnered with MicroEnsure and Vanguard Life to offer "Family Care Insurance" to its customers based on how much airtime is used. Customers sign up for the service and nominate one family member to be included on their policy. The amount of cover that they are entitled to ranges from GHC 200 – 1,000 (US$ 130 – 650) and is based on the value of airtime that was purchased during the previous calendar month. If a customer buys less airtime the next month, the cover will be reduced. Claims are notified via a text message and the policies are "renewed" on a monthly basis, again via a text message.

Signature issues

One of the significant challenges facing the innovators in microinsurance distribution concerns the formalities required for the acceptance of microinsurance contracts and, in particular, the extent of the requirement for "wet" signatures. Under English law, the formation of a contract of insurance typically takes place by an insurer issuing an invitation to treat in response to which a prospective assured submits a proposal form (constituting an offer) which the insurer may accept. The rules of contract formation require that the offer and acceptance contain sufficient clarity as to the terms of the contract (essentially, it must not be incomplete or ambiguous in any material respect). There must be a demonstrable intention by the parties to be bound and acceptance must be unqualified. The issue of a policy by the insurer constitutes its acceptance. Acceptance may also arise from the application of premium received to underwriting operations where there are no pre-conditions to fulfil or remaining unsatisfied. As a general proposition, silence will not constitute acceptance under English law, a point demonstrated in the cases, amongst others, of *Felthouse v Bindley*[17] and more recently *Rust v Abbey Life insurance Co Ltd*.[18]

There is an increasing trend to sell microinsurance policies off the shelf through retailers such as supermarkets. The usual analysis of offer and acceptance is often reversed for such sales. Typically the insurer makes the offer which the assured accepts by purchasing the policy at the till and having the policy validated (for example, by scratching off a cover to reveal the policy number and/or sending a text message with the policy number to the insurer). A similar form of distribution is increasingly being applied to the sale of travel insurance by retailers at United Kingdom airports.

English law does not require a contract of insurance (other than a contract of marine insurance) to be in writing or for an assured to have read the terms of a policy. Having the means to access the insurer's standard policy terms is sufficient. Regulation, however, superimposes a requirement to record insurance contracts in writing with a view to achieving so-called "contract certainty" and in pursuit of consumer protection. Additionally, regulatory obligations control the sale of insurance to consumers and require certain information and policy documentation to be sent to them. These obligations are contained, in the UK, in the FSA Handbook of Rules and Guidance and under the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005.

However, the position in a number of other jurisdictions requires the parties' original signatures to constitute a valid and binding contract of insurance for legal and/or regulatory purposes. The requirement for such "wet" signatures represents a significant barrier to the development of innovative distribution channels for microinsurance, particularly in emerging markets where geography and infrastructure are challenging. It is sometimes permitted to use digital signatures or alternative methods of recording offers and acceptances (for example, recorded telephone calls in conjunction with the provision of policyholder documentation and policyholder payment may suffice). However, this is dependant on local law and regulation. In many instances local law and regulation has yet to accommodate the possibilities that recent technological advances permit.

Conclusions

A solution to many of the regulatory issues facing microinsurance in its emerging markets is the development of a tiered regulatory system. This would allow microinsurance products satisfying criteria as to premium, cover, class of business, terms and, potentially, distribution to be subject to lower capital and ongoing compliance and reporting requirements. As the business grows and reaches better economies of scale, the regulatory requirements can step up commensurately with the resulting greater risk to a larger number of consumers. The Philippines has adopted a two-tier regulatory system which permits mutual benefit associations to operate with a lower capital base than first tier commercial insurers. The proposed South African Microinsurance Act adopts a similar approach.

An alternative approach is to apply principles-based regulation incorporating a proportionality principle that enables the regulatory regime to be applied appropriately to the nature and scale of an insurance business. However, in a principles-based regulatory system, insurers (and international insurers in particular) will require a high degree of confidence in the relevant jurisdiction's rule of law to provide the necessary comfort that the principles will be applied in a transparent and fair way.

Scale is critical to the long-term sustainability of microinsurance. As the microinsurance market grows, the laws applicable to it and its regulation are becoming increasingly important. Flexibility is necessary to embrace microinsurance business and related distribution models appropriate to local market dynamics. These should support greater financial inclusion in a controlled environment which protects policyholder interests. Greater co-ordination between legislators and regulators would be welcome. It would enable the regulators to share limited resources in considering new developments. It is also to be hoped that it would lead to a more uniform approach across jurisdictions which can encourage financial inclusion by creating opportunities for providers to develop distribution channels that are scalable on a multi-national level.

Endnotes

[1] Jonathan Teacher is a senior associate at Norton Rose LLP. Jonathan specialises in corporate, mergers & acquisitions and regulatory matters for the insurance industry. He also has significant experience in structured insurance products, insurance linked securities, Lloyd's and microinsurance.

[2] Swiss Re's Sigma report "Microinsurance - Risk protection for 4 billion people" (No 6/2010)

[3] *Prudential Insurance v Inland Revenue Commissioners [1904] 2 KB 658*

[4] *Gould v. Curtis [1913] 3 KB 84*

[5] Marine Insurance Act 1906, section 27

[6] *Sibthorpe and another v London Borough of Southwark [2011] EWCA Civ 25*

[7] *Digital Satellite Warranty Cover Limited v Financial Services Authority [2011] EWCA Civ 1413*

[8] *Sibthorpe and another v London Borough of Southwark [2011] EWCA Civ 25*

[9] MacGillivray on Insurance Law, Eleventh Edition, 1-008 Problems in classification

[10] *Re Digital Satellite Warranty Cover Ltd and others [2011] EWHC 122 (Ch), paragraphs 81 - 87*

[11] Chapter 6, Guidance on the Identification of Contracts of Insurance

[12] *Digital Satellite Warranty Cover Limited v Financial Services Authority [2011] EWCA Civ 1413*

[13] At the time of writing, it is understood that the appellants in *Digital Satellite Warranty Cover Limited v Financial Services Authority [2011] EWCA Civ 1413* have made an application to the Supreme Court for permission to appeal the Court of Appeal's decision. The application is awaiting determination by a panel of justices.

[14] *Medical Defence Union Ltd v Department of Trade [1980] Ch 82*

[15] *Department of Trade and Industry v St Christopher Motorists' Association Ltd [1974] 1 WLR. 99*

[16] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, article 12

[17] *Felthouse v Bindley (1862) 142 ER 1037*

[18] *Rust v Abbey Life insurance Co Ltd [1978] 2 Lloyd's Rep 386*