

Basel II and Microfinance

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The New Capital Accord (known as Basel II) seeks to promote among financial intermediaries best practices in risk management, more effective regulation and supervision, and greater market discipline. Although no country in Latin America and the Caribbean is required to comply with Basel II, several countries in the region have already drawn up plans for its gradual implementation. Accordingly, it is critical to understand just how appropriate these formulas are for the typical portfolios of developing countries, in particular for microfinance portfolios, and what the results of their possible application would be. A study recently conducted by the Inter-American Development Bank¹ focused on these issues. The main findings are discussed here, as well as the basic elements of Basel II, and how microfinance

would fit into this scheme. Also presented here are the results of an exercise applying Basel II formulas to the portfolios of microfinance institutions in Bolivia, Colombia, Ecuador and Peru.

Basel II

Basel I, the first international accord on banking regulation and supervision, was reached in 1988. Its strength is in establishing a direct link between a bank's credit risk and its capital. Thus, a bank with high credit risk levels also needs to maintain high levels of capital. But adjustment by risk level is relatively simple and does not reflect the range of specific risks each institution might face. Although the failure of international banks in developed countries was highly considered when developing Basel I, its principles were adopted worldwide.

In 2004, the Basel II accord was signed, seeking to improve risk assessment, provide incentives for better risk management, and substantially increase the transparency of bank operations. This new accord rests on three pillars. The first one is concerned with minimum capital requirements, while the second deals with prin-

ciples of preventive supervision and the incorporation of new *ex ante* assessment parameters, such as the probability of default in credit risk, instead of *ex post* practices such as provisioning based on the number of days in arrears once a loan has gone into default. The third pillar focuses on market discipline and the transparency of information in private institutions as well as in financial groups and conglomerates. One fundamental change proposed for banking supervision is that attention should be paid to the (internal) assessment that each bank makes of its own credit risks. Another major innovation is the emphasis on disclosure of information about risk levels and bank capital.²

Pillar 1 of Basel II discusses alternatives on how to better link capital requirements to credit risks by way of the *standardized*

¹ This article summarizes some of the most important findings of a more extensive study recently carried out by the Inter-American Development Bank (Navajas, S., Navarrete, E., Simbaqueba, L. Cuevas, M and Salamanca, G. 2006. *Indicadores de microfinanzas en América Latina: rentabilidad, riesgo y regulación*).

² More details on the characteristics of the New Capital Accord may be found on the Basel Committee's - Internet Site (www.bis.org).

INSIDE THIS ISSUE

Microinsurance in Latin America and the Caribbean: Achieving Sustainable scale

— What Role Can Donors Play?

by Jim Roth

Page 9

and the *internal ratings-based (IRB)* approaches. Under the standardize approach, institutions adopt the fixed risk weights assigned by different portfolio types. In contrast, the IRB approach allows institutions to develop their own *internal models* so that they establish parameters to safeguard their economic capital. Specifically, the IRB methodology allows the calculation of *expected* (historic loss averages) and *unexpected losses* (fluctuations over these averages) for each type of portfolio. This methodology comprises the basic and advanced measurement approaches. Under the advanced approach, the institution calculates basic parameters to determine losses, while under the basic method the supervisory authority provides guidelines on the parameters to be used, in particular those related to the severity of loss given default and for exposure at default. Box 1 explains these concepts in further detail.

Basel II and Microfinance Institutions

In view of the comprehensive and complex nature of the New Basel Capital Accord, it is fair to ask: *How do microfinance institutions fit into this scheme?*

In terms of credit risk, microlending (or microcredit) is not explicitly discussed in the Basel II IRB approach. Under this scheme, the portfolio is divided into different segments, according to

the *correlation* that each type of portfolio is considered to have with the *systemic risk* or the general economic environment. The main segments considered are: a) corporates, banks, and sovereigns; b) small and medium-size enterprises (SMEs) with annual sales of up to €50 million; c) SMEs with annual sales of up to €5 million; d) residential mortgages (retail exposures); e) revolving retail exposures; and, f) other retail exposures with annual sales of up to €1 million.

Microcredit would fall into the sixth category referred to as “other retail exposures.” As defined in Paragraph 231 of the New Capital Agreement (BCBS, 2004) microcredits are: *“Loans extended to small businesses and managed as retail exposures are eligible for retail treatment provided the total exposure of the banking group to a small business borrower (on a consolidated basis where applicable) is less than €1 million. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.”*³

In general, Basel II considers an exposure to be retail when the value of the individual exposures is reduced, as described in the previous paragraph, and when there is a large number of exposures in the portfolio. Paragraph 232 (BCBS, 2004) accordingly states that: *“The exposure must be one of a large pool of exposures, which are managed by the bank on a pooled basis. Supervisors may choose to set a*

minimum number of exposures within a pool for exposures in that pool to be treated as retail.”

Additionally, it should be noted that there are only three types of retail credits. Thus, loans for microenterprises could only fall under the category of “other retail loans,” because the other two options are: a) exposures guaranteed by residential mortgages, and b) revolving retail exposures.

Finally, it should be noted that retail portfolios are discussed in Basel II within the context of the IRB methodology and also in section on the standard method where a “favorable” treatment is given to such portfolios because they are considered to be less risky, provided they meet the following four criteria: *orientation, product, concentration, and reduced value of individual exposures.*

The *orientation* criterion requires that the risk be assumed vis-à-vis one or more individuals or vis-à-vis small companies. The *product* criterion includes loans and lines of credit to small businesses. The *concentration* criterion establishes that the supervisor shall see to it that the retail portfolio is sufficiently diversified so that portfolio risks remain low, which will justify the use of lower risk weighting. It is suggested that this could be achieved by

³ Note that the concept of “reduced” value for retail credits is €1 million, which is not directly applicable in the countries selected for this study.

Box 1: Calculation of Expected, Unexpected and value-at-risk (VaR) Losses for a Loan Portfolio.

The *expected loss* is an average historic loss that can be estimated for each individual loan and may be calculated as follows:

(1) Expected Loss =

Probability of Default (PD) x
Severity of Loss Given Default (LGD) x
Amount or Exposure at Default (EAD).

The probabilities of default needed to determine the expected loss are calculated for individual loans and are generally obtained through statistical scoring techniques. The loss in case of default (or severity) is the inverse percentage of the recovery percentage (1 - recovery percentage). The recovery percentage in turn is the result of the analysis of payments subsequently received from customers in default. The exposure amount is the balance of the loan analyzed. In the case of consumer portfolios with products such as automatic credit lines (as in credit cards), one may take, for example, the maximum between the balance of the month analyzed and the amount obtained by calculating the percentage of average use of the automatic credit line.

The unexpected loss corresponds to fluctuations over the historic or average loss, and it is much more difficult to calculate. In practice, the expected and unexpected losses are not calculated separately but rather as a single indicator called Value-at-Risk (VaR), which measures the potential loss at a certain level of statistical reliability.

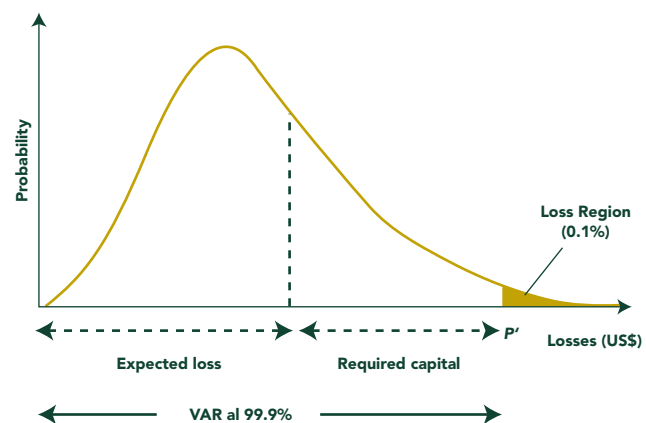
(2) Value-at-Risk (VaR) = Expected Loss + Unexpected Loss.

The Basel II IRB scheme enables calculation of provisions for expected loss and capital requirements for unexpected loss, using the following equation (2):

(3) Required Capital (for unexpected losses) = VaR – Expected Loss.

Accordingly, once the VaR has been calculated, the capital requirement can be easily obtained by subtracting the expected loss. The end objective is to establish adequate parameters so that institutions are able to protect their capital with a statistical reliability of 99.9 percent against possible losses owing to credit risk. The complicated part here is calculating the VaR, because the credit risk loss distributions are so highly skewed that it is difficult to determine the 99.9 percent loss percentile.^a

Figure 1: Expected Loss, Capital Required for Unexpected Loss, and Value-at-Risk at 99.9 Percent



^a Level of confidence suggested by Basel II.

establishing a numerical limit, so that the aggregate risk vis-à-vis a same counterpart (a customer in particular) does not exceed 0.2 percent of the total of the retail portfolio. Lastly, the criterion for *reduced value of individual exposures* coincides with the criterion cited above, in that the maximum aggregate exposure vis-à-vis a same retail counterpart must not exceed €1 million.

Systemic Risk

As previously discussed, different portfolio types are defined according to the *correlation* that each type is considered to have with *systemic risk*, which can be defined as the correlation between each individual credit and the general state of the economy (BCBS, 2005).

Under the Basel II scheme, correlations for systemic risk are not specified for individual credits, but rather for the large portfolio groups previously described. Table 1 lists correlations for systemic risk and each type of borrower, showing that they may take fixed values, as in the case of the mortgage portfolio and revolving retail portfolio, whereas there are certain portfolio types with correlations that vary depending on the probability of default (PD) of the loan. This category includes corporates, banks, and sovereigns exposures as well as other retail exposures. Lastly, correlations for SME exposures vary depending on the probability of default and also on an adjustment based on annual sales. In all

Table 1. Correlations for Different Types of Credit Exposures

Type of Borrower	Correlations (percent)
Corporates, banks, and sovereigns	12 to 24
Large-volume SMEs (with annual sales of up to €50 million)	12 to 24
Small-volume SMEs (with annual sales of up to €5 million)	8 to 20
Other retail exposures (including microcredit)	3 a 16
Residential mortgages	15
Revolving retail exposures	4

Source: Basel Committee on Banking Supervision (BCBS, 2004).

cases, the values are calibrated to represent the correlation that each portfolio type has with systemic risk, according to the Basel criterion.⁴

Thus, for example, it is argued that in the case of residential mortgages, such loans have high correlations because the losses in this segment are closely tied to the value of the mortgages that serve as guarantee and because the general state of economy greatly influences their value. For that reason, a constant 15 percent correlation is assigned between the mortgage exposure and systemic risk, a “relatively high” value according to Basel (BCBS, 2005).

Table 1 also shows that the Basel formulas are calibrated so that exposures to microenterprise portfolios (classified under “other retail exposures”) acquire correlations of between 3 and 16 percent

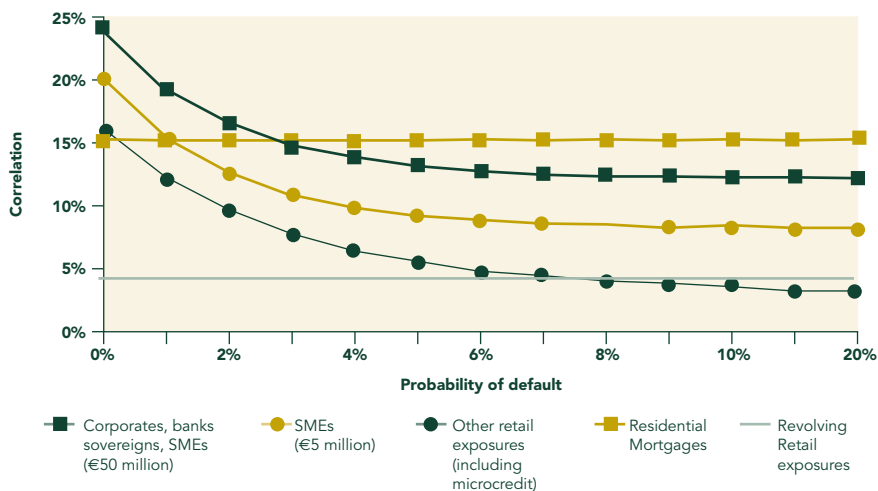
for systemic risk, depending on the probability of default (PD) of each individual loan.

Figure 2 presents correlation functions for different loan exposures depending on the probability of default for the different portfolio types listed in Table 1.

As can be seen in Figure 2, for a given level of probability of default (PD), the correlation for exposures to microenterprises is lower than for loans to SMEs, regardless of their size, (that is to say, the correlation function for microcredits is *below* the curves for SMEs). The fact that the correlation for systemic risk for microcredits is lower than that for

⁴ See Navarrete (2004a) for more details on formulas to calculate the capital requirement for microfinance and SME portfolios as a function of the correlation and other parameters.

Figure 2: Correlations for Systemic Risk for Different Types of Loans – Basel II.



Source: Basel Committee on Banking Supervision (BCBS, 2004).

SMEs is consistent with the Basel criterion, in which the greater the size of the company (and the higher the level of sales), the greater is the correlation with the systemic risk. In other words, the rule “intuitively” applied here is that the greater the size of the company, the greater the dependency on the general state of the economy. This would imply that small companies would be prone to have more defaults due to idiosyncratic (individual) risks than to systemic risk. Nevertheless, as stated in Basel (BCBS, 2005), the evidence for this assumption is hardly conclusive, so it would be interesting (and highly relevant) to gather evidence on the size of the company and the relationship with systemic risk, especially in the countries selected for this study.

Basel also suggests that the reason why correlations decrease

as a function of the probability of default, as shown in Figure 2, is based on the argument that by increasing the probability of default, the *individual* component of the credit risk increases, which is why the risk of default depends less on the general state of the economy and more on individual or *idiosyncratic* risk, as will be discussed below.

Individual Risk

Just as with market risk, credit risk may also be broken down into two components, *systemic risk* (non-diversifiable) and *individual or idiosyncratic risk* (diversifiable). Systemic risk may be measured by the correlation between individual credit and the economic environment. This correlation incorporates Basel II into the measurement of unexpected loss and into the calculation of the capital

requirement. Indeed, Basel II considers a *single* correlation for the different *portfolio types or segments* (and not at the individual credit level), as shown in Table I. In this case, there would be a uniform “outward” correlation of the portfolio.

On the other hand, the individual or idiosyncratic risk is the complement or portion of the risk not explained by systemic risk. Unlike systemic risk, individual risk may be mitigated, given that it depends on the correlation of a particular loan with other loans in the portfolio, that is, with the *diversification* of the loan portfolio or an “inward” correlation.

As for the concept of VaR, the *diversification benefit* of a portfolio may be defined as the difference between the nondiversified VaR, which is the sum of the individual values at risk and the diversified VaR, calculated by means of correlation matrices. The diversification effect is important in calculating the risk of the existing loans and would also help price new loans in the sense that: a prospective loan with a low or zero correlation with the existing portfolio would be more favorable for the institution (and it would require a lower rate) than a new loan with a high correlation (and therefore, with a higher risk).

Note that when a portfolio risk increases due to external factors, there would be an increase in the *systemic risk*, because the diversification benefit would no longer

be present. In this situation, the risk evolves from idiosyncratic or individual to systemic, and an approximation of the portfolio's VaR could be obtained by adding individual VaRs.

As illustrated above, the difference between a portfolio's diversified and non-diversified VaR would depend on incorporating, or not, the correlations between credits of a same portfolio in the calculation of the loss percentile. In turn, the capital requirement for unexpected loss (defined as the VaR minus expected loss) would also depend on the correlations, so that the following fundamental question arises:

Is it possible for the Basel formulas to consider the diversification effect within the portfolio in the calculation of the capital requirement?

Clearly, the answer is no. *Basel II does not consider diversification of the loan portfolio* because it depends on the correlation structure of each portfolio (i.e., of the "inward" portfolio correlations, which are specific to each institution). In fact, the only reference Basel II makes to portfolio diversification is in the concentration criterion for retail portfolios, which specifies that, in order for a portfolio to qualify as retail, it must be "sufficiently diversified." This criterion, however, is still of a qualitative nature and quite far from measuring correlations that capture the diversification effect.

Therefore the model adopted in Basel II only considers the correlation for systemic risk when calculating the VaR and the capital requirement. This is undoubtedly a limiting factor for the model, because in most cases the capital requirement of a loan portfolio would be overestimated.

How does the correlation for systemic risk affect the capital requirement calculation?

As is to be expected, the greater the correlation with systemic risk, the greater the capital requirement and the greater the risk weight. This effect can be easily understood given that, by increasing the value of the correlation, some loan defaults would produce other defaults ("domino" or "contagion" effect). In a worst case scenario, with a 100 percent correlation, if a loan were to fall into default, *all others* would also fall into default, producing an extremely high loss value of the portfolio (see Navarrete, 2004b).

The impact of the correlation value on the capital requirement can also be determined from the calculation formulas that Basel uses for "other retail exposures," which are applied to microenterprise loans to calculate: a) the correlation based on the probability of default; and b) the capital requirement based on the correlation, the probability of default, and other parameters. Unlike SME exposures, Basel formulas for "other retail loans" do not allow

for any adjustments for loan maturity or business size.

Basel II and Microcredit Portfolios

Perhaps even more relevant would be to ask: *How does the Basel II IRB scheme compare with current practice in the countries selected for this study?*

To answer that question, the portfolios of four major microfinance institutions in the region were examined, namely: FIE in Bolivia, Finamérica in Colombia, Banco ProCredit in Ecuador, and Banco del Trabajo in Peru. Available information on individual loans in each microfinance institution enabled us to use the risk calculation methods suggested in Basel II.⁵ One of the most significant findings relates to provisioning. One of the observations was that, for different portfolios, the Basel II scheme produces higher or lower provisions than the amount currently calculated when following the regulation schemes based on arrearage (unlike other studies or perceptions stating that the Basel II scheme *always* produces either a higher or lower amount of provisions than the current regulation schemes).

Even more important, based on the sample of institutions

⁵ In Navajas *et. al.* (2006) the procedure followed for the calculation of provisions and capital is described in detail, as are the results per institution and type of portfolio.

analyzed, the study concludes that *the Basel II scheme is more in line with what the institutions actually provision than with the provision calculated using the current rules based on arrearage*. Accordingly, if this result could be applied to other institutions it would show that, were the Basel IRB scheme to be adopted, radical changes could not be expected to occur as initially imagined, and that the transition to a new scheme would be rather smooth.⁶

As to the issue of calculation of the capital requirement for credit risk, most of the current regulations still do not require its calculation, since as mentioned above, this involves the complicated task of generating the distribution of potential loss and measuring the VaR and the unexpected loss, so that there still does not yet exist a direct basis of comparison for this parameter. It is nevertheless recommended that regulators start to place more emphasis on the calculation of the capital requirement for credit risk, whether by using the Basel II scheme or others that incorporate correlation by systemic risk.⁷

It is precisely here that microfinance institutions can set themselves apart from traditional institutions, under the assumption that they are more insulated from systemic risks and, therefore, would present lower correlation indices with this type of risk. The confirmation of this assumption would indeed be most relevant,

because it would indicate that the credit risk capital required for institutions with microcredit portfolios would have to be lower than the other type of capital requirements for similar institutions. In other words, the specific characteristics of microcredit may help decrease the capital required for a financial institution to cover its risks.

Moving Forward

Basel II certainly represents a progress in the use of tools for better risk management. Consequently, as was the case with Basel I, it is very likely that countries in the region will adopt and/or adapt many of the principles proposed by Basel II. This adaptation process will undoubtedly require the consideration of specific characteristics of each financial system and the possible effects on each type of institution. This article explores several of the elements that should be addressed when regulatory agencies and supervisory authorities in the region consider Basel II and its application to microfinance institutions. This exercise assumed a certain adaptation to Basel II, which was then applied to four financial institutions in the region. It should, however, be remembered that Basel II offers various avenues, and that it would be advisable to further analyze their possible impact and to do so on a larger number of institutions.

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⁶ Nevertheless, it should be noted that the study detected that microfinance institutions tend to underestimate the risk of customers without arrears (when measured through provisions) and to overestimate the risk coming from those customers with various days in arrears.

⁷ As an alternative to the Basel formulas, capital requirement by credit risk can be calculated by means of simulation techniques, even for institutions with large portfolios, and can be compared with the Basel requirements. See Navarrete (2004a and 2005).

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Bios



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A mathematician and economist of Mexican nationality, Mr. Navarrete pursued his university studies in pure mathematics and economics at the Massachusetts Institute of Technology. He also holds a Master's Degree from the University of Chicago.

He is a consultant on derivatives and financial risks to private and public sector institutions, including supervisory authorities. He is actively working with international organizations and universities such as the University of the Americas and the Iberoamerican University in Mexico City, where he teaches in the Financial Risk Management Degree Program. He is CEO of Scalar Consulting (www.grupoescalar.com)



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Microinsurance in Latin America and the Caribbean: Achieving Sustainable scale — What Role Can Donors Play?

Jim Roth

This article follows on from an article in the previous edition of *Microenterprise Development Review* (June 2005, Vol. 8 No. 1) by Nidia Hidalgo Celarié and Pedro Valdéz. In their article they discussed various options for distributing insurance to low-income clients. This paper focus on the partner-agent model, a model which it is argued, with appropriate donor support can most rapidly scale-up the spread of insurance to the poor in Latin America and the Caribbean. This seems a particularly urgent task for Latin America and the Caribbean countries where according to a recent Inter-American Bank Study (Masci and Tejerina, 2006) in some LAC countries, “...as little as 3% of households have access to a health insurance product of any kind.” A study by Swiss Re. (2002) in Latin America found that, even taking into account the relatively low levels of per capita income found in the region, insurance levels were very low. A fact made worse by the knowledge that 92% of the region premiums (in 2000) were generated by just six countries (Argentina, Brazil, Chile, Columbia, Venezuela and Mexico). There is clearly much work to be done in the region in improving access to insurance.

Over the last few decades, donor interest in microinsurance has focused on helping communities to establish mutual or community based insurance schemes. Such schemes often encountered a range of difficulties. They tended to be run by well meaning people who gave freely of their time, but were not insurance professionals. In particular these schemes regularly ran into problems. Pricing insurance is extremely difficult. Highly skilled professionals called actuaries use advanced statistical techniques to quantify risk and then develop a price based on, among other things their assessment of the risk. Similar sorts of problems emerged with reserving, it is difficult to establish how much to reserve to cover claims without actuarial advice. Once these schemes grew in size, the administrative burden tended to outgrow the capacities of non professional, voluntary staff. Finally, in many countries there is no legal framework for these schemes. Indeed regulators are often unwilling to allow such schemes for fear that they will not be able to adequately supervise many small schemes run by non-professionals. This latter issue (lack of regulation) has in turn lead to a range of difficulties. The schemes tend to be unable to obtain reinsurance¹. Reinsurers

are usually only permitted to sell reinsurance to registered insurance companies. When such informal schemes grow large enough these difficulties often compel the insurer to formalize. This is what happened to the Columna insurance company in Guatemala, whose history is described in the box below

Similar problems emerged when non-insurance organizations, like Non-Governmental Organizations (NGOs) and Microfinance Organizations (MFIs) that wish to help reduce the vulnerability of the poor set up in-house insurance schemes. The box below illustrates the problems encountered by CARD Bank (Centre for Agricultural Research and Development) in the Philippines when it attempted to set up an in-house insurance scheme to reduce old age vulnerability. The complete study can be downloaded at www.MicroinsuranceCentre.org.

These concerns with the mutual model and in-house schemes lead the Microinsurance Centre, along with some donors to pioneer the partner-agent model. In this model a regulated insurance

¹ Reinsurance is insurance sold to regulated insurers. It helps protect insurance schemes against (among other things) rare catastrophic losses that would ordinarily bankrupt schemes.

Box 1: The *Columna* Insurance Company in Guatemala

The origins of the *Columna* insurance company are rooted in the Guatemalan National Federation of Credit Unions (FENACOAC), which began offering a group life insurance scheme for the cooperatives' members and staff in 1970. FENACOAC's original scheme included coverage for savings, loans and funeral expenses for members and the employees of the cooperatives, a package that was creatively called "mutual protection." In the early 1990s, the Superintendent threatened to cancel FENACOAC's mutual protection services unless the federation created an insurance company. In fact, the cooperatives had been contemplating such a move for a few years. Besides the push from the Superintendent, there were important pull factors that motivated the federation to establish *Columna*. The cooperatives' members were demanding other, more complicated types of insurance than the federation could offer. Plus, as an informal insurer, the federation could not access international reinsurance. Finally, given the fast growth of the "mutual protection" program, a new structure was needed to satisfy demand.

Source: Herrera, C. and B. Miranda, 2004

company partners with a microfinance provider (or another suitable party) who becomes the agent and sells and services the insurance companies' policies. This is outlined in the following diagram that depicts the partner-agent model for a relatively simple product such as a life insurance product.

In this model the insurer relies on an intermediary like a microfinance institution (MFI) to act as its agents. The MFI sells and services the policies. It collects premiums and hands them on to the insurer and in many cases pays the benefit which it receives from the insurer. In compensation for tasks it earns an agents

commission. The insurer takes the risk and earns and profit or loss. Compartamos, a Mexican MFI recently developed a partnership relationship with an insurer. Their experience is described in the following box.

The partner-agent model is attractive to a range of parties, insurers, agents, low-income clients along with donors and other development agents.

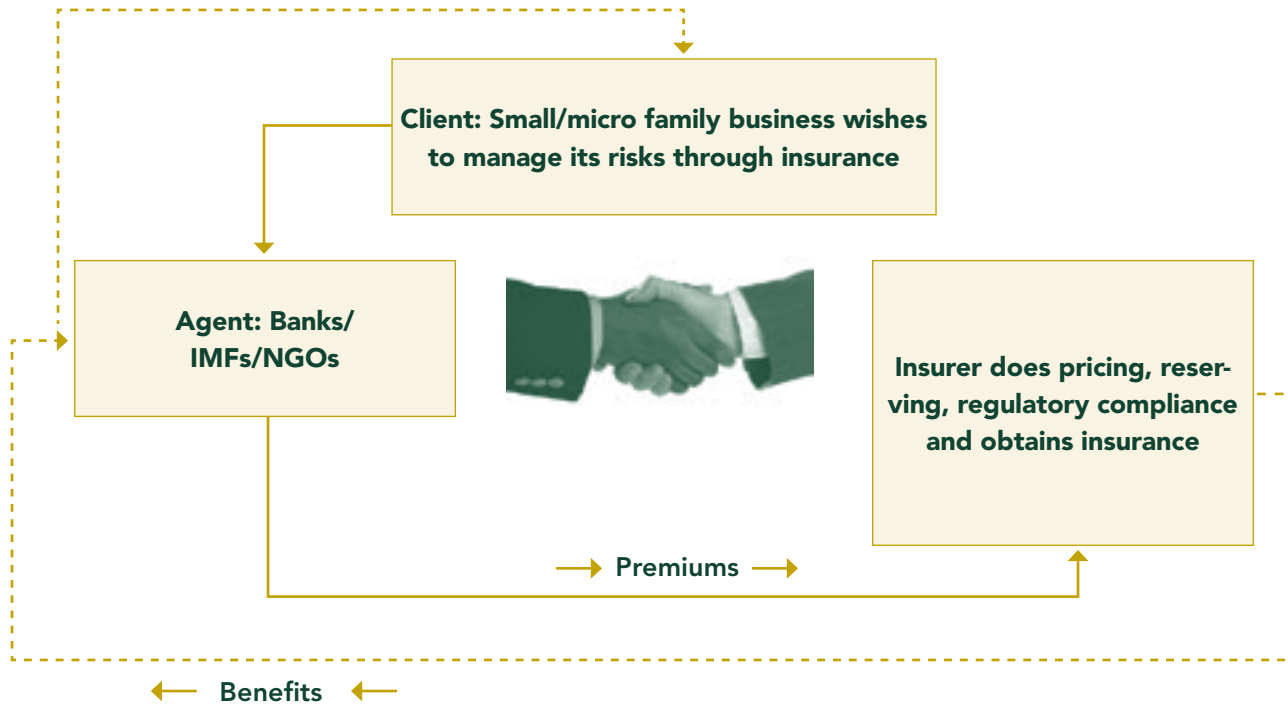
From the insurers perspective there are four attractions. Firstly, and most obviously, it can be profitable. Although the premium/savings amounts are small, if the transaction costs of collecting them are low enough, there is profit to be made. Sec-

Box 2: The Dangers of In-House Insurance – CARD

In December 1996, recognizing the needs of its older members for pensions, the potential for disability among all members, and (over) confident after the apparent initial success of an earlier insurance program, the Members Mutual Fund (MMF) that provided among other cover, life insurance, management decided to expand the product coverage. This time, in addition to the expanded MMF benefits, CARD would offer a pension benefit to members reaching sixty-five years old, and to those that were permanently disabled, for only US\$0.05 more per week. The additional five cents meant that the new compulsory contribution was US\$0.10 per week. This insurance scheme was implemented across the membership without testing and without actuarial input. It could not support future claims. To their credit the management of CARD realized the problem, stopped the insurance scheme and started a straight savings plan, which has proved a great success.

Source: McCord, M. and G. Buczkowski, 2004

Figure 1: The Partner-Agent Model for Microinsurance



only, selling policies to the poor helps fulfill corporate social responsibility obligations, especially in countries such as India where insurers are legally obliged to sell to the poor. But even where there is no legal obligation to sell microinsurance, it offers a rare instance of a self-financing corporate social responsibility. Thirdly, insurance companies operating in new markets are also keen to get their brand into the market place. Today's microinsurance client may be a high value customer tomorrow. Swiss (2004) indicates that most of the anticipated growth in insurance business will come from emerging markets. After Asia a large proportion of this will come from LAC countries.

Fourthly, in difficult markets, where governments may be suspicious of private insurers (especially foreign insurers), insurers want to develop a good relationship with the insurance regulator and other government officials. Showing an interest in low-income clients may help ease fears and facilitate entry into new markets.

For the agent, be it an MFI or another agent such as a retailer, there are a number of key benefits. Firstly, the agent's commission is a new source of revenue. This can be a considerable source of income for relatively little additional effort. For example an MFI that collects premiums by deducting them from the loan disbursement and servicing the policies

through its loan officers. There are also customer loyalty advantages of adding an additional product to one's product range. For example customers may come to a store to purchase life insurance and pay premiums and purchase other products at the same time. In some cases agents may need to sell insurance for example, an MFI that offer housing loans or furniture shops that sell their goods on credit. Without partnering they would need to self-insure which is usually illegal or least difficult to do legally. Whatever the case a partnership with a commercial insurer allows the risk to be carried by the party most competent to carry the risk: the commercial insurer.

Box 3: *Compartamos* – The Evolution of a Partner-Agent Relationship

Compartamos began in 1990. It started life as a pilot project of the Mexican NGO Gente Nueva. Like many MFIs it began to lend using the village-banking methodology. Although initially serving rural areas, it now serves clients in Mexico City and now has over 400 000 clients. In 1997 the organization became self-sufficient and in 2000 it obtained permission to operate as a regulated financial company. Having offered a variety of credit products, *Compartamos* decided that it wished to include life insurance in its product portfolio. They decided not to provide insurance directly because they recognized that the insurance risk was better placed with a professional insurer. They also considered that the best way for them to learn the business was by working with an insurer. In 2003–2004 they conducted an extensive research period trying to understand demand for microinsurance from clients. This gave them knowledge of the kinds of products that their clients wanted as well as their willingness and ability to pay for those products. A key product demanded was life insurance. Armed with this information they developed and disseminated a tender offer to insurers for the microinsurance product they had decided on. With their large client base their tender document received a great deal of interest from insurers. Among several tender bids submitted, finalists were local offices of three multinational insurance companies. *Banamex* insurance won the tender. The product is intended to be multi-tiered with a limited insurance coverage provided to all borrowers, and, depending on the results of the pilot test, they will offer additional values of cover on a voluntary basis.

Initially the first tier of cover will be provided to clients of selected areas. The premiums for this first tier of cover will be paid by *Compartamos*, with clients having the option to purchase additional cover.

From the client’s perspective they acquire a new means to manage one or more of the risks that they face. Not necessarily the only means, or even the best means, but an additional option. By working through commercial insurers, clients benefit from the fact that these organizations are regulated and as a consequence often safer than many well meaning but often organizationally fragile MFIs, NGOs and Community Based Organizations. Finally by working through commercial insurers informal sector workers build a bridge into the formal financial sector. For example low income cli-

ents that have endowment policies (a combination of long term contractual savings and life insurance) can often use the accumulated value in these products to secure loans.

From the perspective of the donor or development bank the partner agent model presents significant opportunities. Instead of establishing insurance entities directly, by establishing and promoting partnerships with commercial insurers they are able to lever the resources of commercial insurers. In microfinance in general there have been relatively few instances of entirely sustainable

service provision. The professional expertise of commercial insurers is likely to contribute to the sustainability of any partnerships that are established.

In microcredit, donors and other development agents often expressed concern where microcredit was used as a component of a larger non-microfinance project. For example, the use of a rotating loan fund in an education project to help fund school fees. There were often problems in running the rotating loan funds. With microinsurance done through a partner-agent model the same problems are less likely to arise be-

cause the insurance fund is being managed by a professional insurer rather than staff whose real expertise lies in other fields, in this example in education. By linking to a commercial insurer, microinsurance can become a component in a larger project. For example life insurance could be part of a general project to improve household enterprises. One of the biggest risks faced by such enterprises is the death of a household member who works in the household enterprise. Health insurance could be added to a broader health project.

While the partner-agent model is promising there remain some obstacles that donors and multilateral development banks could play a role in removing:

- Firstly donors can help inform potential agents and commercial insurers in areas that they work about the possibilities of microinsurance partnerships.

This can be done through microinsurance conferences as well as through the development of donor supported pilots. It could also be done through the development of training materials and courses for agents and insurance staff.

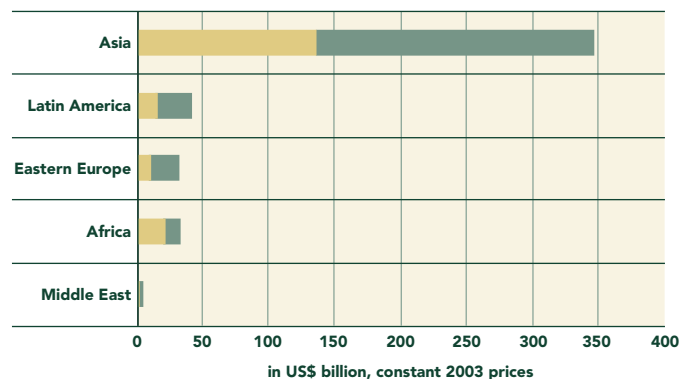
- Donors can fund the development of specialist microinsurance brokerage firms.
- Donors can help governments to more efficiently collect data that is essential to the insurance industry for example mortality figures
- Multilateral development banks could explore the possibilities of funding specialized reinsurers that provide reinsurance of microinsurance portfolios as well as technical expertise to commercial insurers on microinsurance.
- There is still a great deal of work to be done in product development. Life microinsur-

ance is quite common but other forms of insurance for example weather microinsurance are still new and require much more research and development in order to be scaled up. Health microinsurance in particular comes through in many demand studies as a key need, and needs much more support. With more research and development, endowment policies that combined savings and insurance may provide another tool in alleviating old age poverty.

- There are regulatory issues that are unique to microinsurance particularly issues of consumer protection. Some countries for example India have developed particular microinsurance regulation that has had a dramatic impact on the spread of microinsurance in India, yet the overall impact and replicability of the Indian

Graph 1: Insurance Premiums

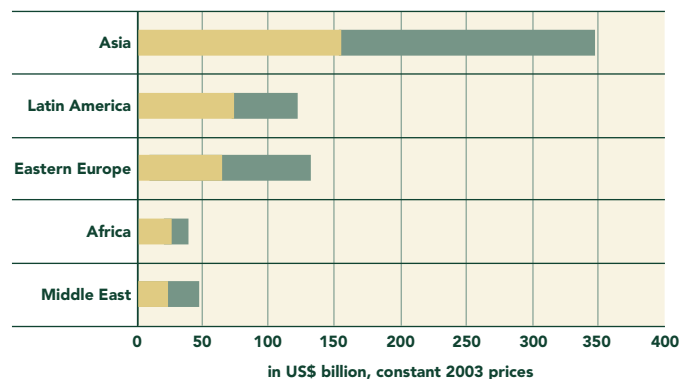
LIFE INSURANCE PREMIUMS



Legend: 2003 premiums (yellow), Additional premiums by 2014 (green)

Source: Swiss Re, sigma No. 5/2004

NON-LIFE INSURANCE PREMIUMS



Legend: 2003 premiums (yellow), Additional premiums by 2014 (green)

Source: Swiss Re, sigma No. 5/2004

regulations are yet to be explored.

- Finally, insurance whether micro or macro works best in stable macroeconomic and political environments. Policyholders need to feel confidence that the insurance company is well regulated and insulated from political manipulation. Providers and beneficiaries of long term insurance need to feel confident that inflation will not erode the value of their policies.

With commercial insurers eager to enter or expand their presence in Latin American and the Caribbean, there is a window of opportunity for donors to work with commercial insurers to extent the frontier of finance sustain-

ability. Donors should seize the moment.

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The views and opinions expressed in the articles are those of the authors and do not necessarily reflect the position of the Inter-American Development Bank.

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