

# Index Insurance Status and Regulatory Challenges

IAIS-A2ii Consultation Call, 25 January 2018

# Presenters

## Technical experts



**Craig Thorburn**  
World Bank Group  
Lead Financial  
Sector Specialist



**Richard Carpenter**  
International Legal and  
Regulatory Consultant  
(Financial Services)

## IAIS representative



**Peter van den Broeke**  
International Association of  
Insurance Supervisors  
(IAIS)

## Moderator



**Oscar Verlinden**  
Access to Insurance Initiative (A2ii)

# Presentation part 1

## Promoting innovation in an index-based insurance world

An introduction to the IAIS (draft) Issues Paper on Index Based Insurances



Craig Thorburn  
Lead Financial Sector  
Specialist

Email:  
[cthornburn@worldbank.org](mailto:cthornburn@worldbank.org)  
Twitter: @ThorburnCraig

# Overview

1. Project Background, Scope
2. Selected features of the paper
  1. Micro, Meso and Macro schemes
  2. Measuring and communicating basis risk
  3. Pilots and proportionality
3. Next steps

# Background to the paper

- Several approaches to act over years were not taken up in the work plan
  - Focused on Accounting treatment concerns, insurance definition concerns
  - Case became stronger as market has continued to develop, and
  - Motivation for insurance supervisors is ***consumer protection***.

# The scope / target of the paper

- **Focus on areas that aim to improve the situation for low income people.** IAIS has been working on a range of “inclusive insurance” issues since 2006. The longest of any of the Standard Setting Bodies.
- **A more inclusive insurance market.** Discusses micro, meso and macro schemes so aims at an insurance market that better serves the underserved (directly or indirectly)
- It is **usually weather or other catastrophe risks related to agriculture or to natural catastrophe resilience. It can be other indexes.** BUT excluding mortality and investment index products (largely for convenience).
  - Some comments suggested focusing on one or other particular type of index (for example, index based crop insurance) but this was not considered to be necessary.
- **Project Sponsors** are a defined group in the paper – people who are part of the team bringing the project to fruition including insurers but also other parties involved.

# Defining Micro, meso and macro allows different approaches



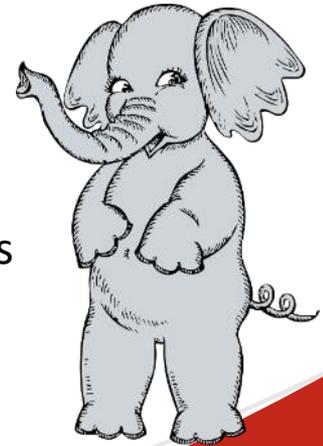
Our definitions might not be your definitions:

- **Micro** involves small policies for individuals or group schemes where individuals get coverage.
  - Consumer protection, basis risk, financial literacy all important considerations
- **Meso** insures the meso entity. They might communicate to members about their insurance but not insurance for individuals directly. No guarantee that things flow to one or other member of the meso organization.
  - Lower consumer protection and basis risk concerns can lead to less intrusive disclosure options
- **Macro** is sovereign coverage. No communication of individual policy linkage from government to public.
  - Can provide considerable relief from regulations but should consider some reporting

# Measuring and communicating basis risk

Whilst basis risk is an issue the paper makes the following observations:

1. Not all problems are basis risk problems even though it can be blamed for it.
2. Not all basis risk events are the same
  1. Adverse basis risk – “bad” things happen but no payout
  2. Perverse basis risk – payout happens but no “bad” thing
3. Not all clients are the same
4. Communication is important by product sponsors
  1. Be open with clients that basis risk is a possibility
  2. Use back testing results to illustrate products.
  3. Stochastic modelling might be useful for more sophisticated clients
  4. Share information with the insurance supervisor

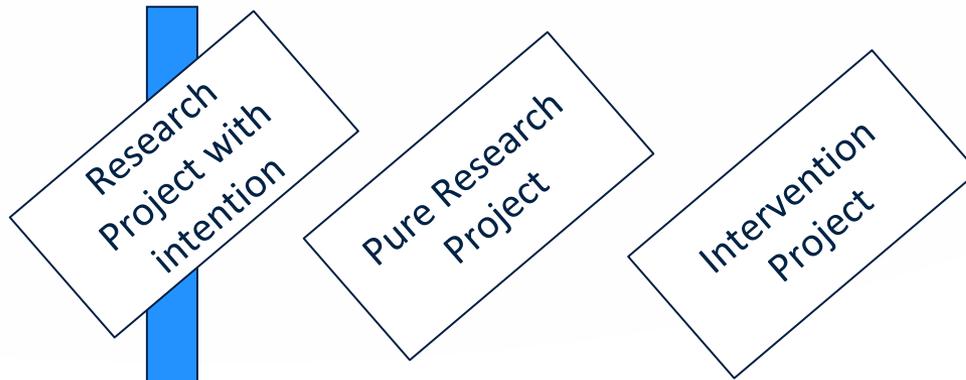


From the ideal world to the real world

**In the index based insurance area, there is a far greater preponderance of pilot projects.**



# Pilots and proportionality



**Gradually build to the final phase. Early pilot phases can get considerable proportionality relief whilst small**

“Proof of Concept” Pilot

**Testing, proving concepts, refining, adding different elements to the development (product, distribution, enhancing trust, education etc are examples of areas of focus at different times)**

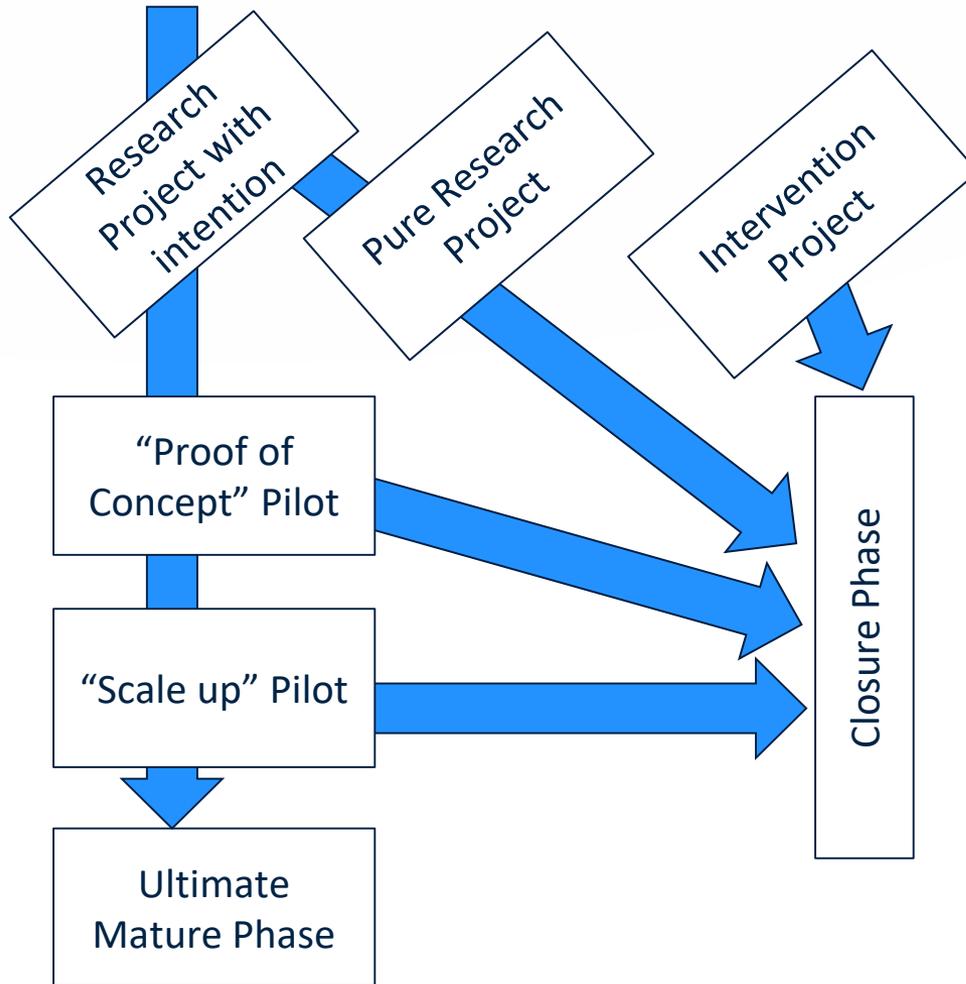
“Scale up” Pilot

**Continued refinement and improvements to delivery in an effort to grow size and enhance viability**

Ultimate Mature Phase

**Viable for providers and clients  
Sustainable  
Competitive  
Without problematic subsidies  
Formal, proportionately regulated and supervised**

# Pilots and proportionality



**Plan for both success and failure in a pilot.**

## Project not continuing

Clients and operations have to be closed out effectively.

- Any ongoing liabilities under insurance have to be considered.
- Any outstanding service delivery issues?
- Withdrawal of service for those that had taken it up might be an issue.

# Next Steps

1. December 2017 and January 2018: Public Consultation at twice standard length of time
  1. January 29<sup>th</sup> closing date is not flexible for this final consultation round.
  2. Consultation comments should be submitted through IAIS on-line system.
2. February 2018: Review and update paper
3. March 2018: Paper progresses through various committees to be adopted

# Presentation part 2

## Index Insurance: Status and Regulatory Challenges



Richard Carpenter  
International Legal and  
Regulatory Consultant  
(Financial Services)

# Overview



1. Background
2. What is index insurance?
3. Survey of supervisory approaches
4. The supervisor's problem
5. Legal and regulatory certainty
6. Insurable interest
7. Regulatory risks

# Background

- Significant increases in use of index insurance over last 20 years
- Promoted as effective method for insuring low-income farmers and households against weather and other natural disaster risk
- A number of advantages claimed, including:
  - Reduced transaction costs
  - Fast payment of claims
- Effectiveness remains to be proven
- Many supervisors looking for guidance on supervisory approaches

# What is Index Insurance

- Fundamental characteristics:
  - Obligation to make payment to policyholder triggered by pre-agreed index
  - Once payment triggered, amount of payment determined by value of index
- Unlike traditional indemnity insurance, no assessment of individual loss
- Hybrid products combine elements of index and traditional indemnity insurance
- Two types of index insurance may be:
  - Aggregate loss
  - Indirect loss

# A2ii Survey

- Objective – assist supervisors through stocktake of supervisory approaches
- On-line survey conducted first half of 2017
- Telephone follow-up
- Conclusions:
  - Index insurance offered in most responding jurisdictions
  - Primarily micro-level products providing protection against weather risks
  - None of the responding jurisdictions had formal regulatory framework for index insurance
  - Most jurisdictions are at an early stage in developing regulatory frameworks, although (two supervisors developed draft Regulations)

# The Insurance Supervisor's Problem

- Payment against index not unique to index insurance
- Weather derivatives designed to provide protection against weather loss
- Derivatives appropriate for sophisticated counterparties but not for sale as micro-level product:
  - Derivative issuers not supervised as insurers
  - Derivatives not supervised as insurance products
  - Subject to lighter prudential and market conduct requirements
- Problem faced by insurance supervisors to distinguish between derivatives (which have legitimate uses) and index products that should be supervised as insurance

# Providing Legal and Regulatory Certainty

- Legal and regulatory certainty critical for providers and their customers
- Maybe different definitions of insurance for different purposes:
  - Insurance contract law
  - International accounting standards (e.g., IFRS)
  - Regulation and supervision of insurance
- Primary concern to achieve supervisory objective - maintenance of a fair, safe and stable insurance sector for benefit and protection of policyholders
- Seek to ensure that index-based risk transfer products are brought within insurance supervisory framework, where appropriate

# Providing Legal and Regulatory Certainty



Approaches may include:

- A regulatory definition
- Restrictions on sale of index-based products to certain categories of customer, unless insurance
- Restrictions on on types on index products issued by licensed insurers
- Requirement for certain types of index product to be issued by insurers

# Insurable Interest

- Usually considered key requirement for insurance contract
- May be expressed differently (insured risk adverse to policyholder)
- Indemnity products pay against loss – if loss must usually be insurable interest
- Index insurance pay against index – as no requirement to establish loss, insurable interest cannot be assumed
- Establishing insurable interest an important consideration for insurance supervisors – when & how?

# Regulatory Risks



Survey identified number of key regulatory prudential and business conduct risks

Key prudential risks

- Underwriting risk
- Operational risk
- Legal and regulatory risk
- Reputational risk
- Credit risk

Most important to responding supervisors: legal and regulatory risk

Legal and regulatory risk seen as an obstacle to permitting index insurance by some supervisors

# Regulatory Risks

- Key business conduct risks
  - Basis risk
  - Policyholder value risk
  - Policyholder understanding risk
  - Mis-selling risk
- Most important business conduct risks were basis risk and policyholder value risk

# Thank you.

The Initiative is a partnership between:



BMZ



Federal Ministry  
for Economic Cooperation  
and Development



Ministry of Foreign Affairs of the  
Netherlands

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# Presentation part 3: country example



## Index Based Insurance - Kenyan Experience Regulation and Supervision



Joseph Owuor  
Senior Supervision Officer,  
Insurance Regulatory Authority  
of Kenya



# Introduction

## Regulatory framework

- Kenya's Draft Index-based Insurance Regulations discussed & agreed in a stakeholder workshop – awaiting enactment into law

## Supervisory approach and consumer protection

- Product approval: faster product approval process
- On-going monitoring

## Other supporting activities

- Consumer awareness/ education campaigns
- Facilitating PPPs – government and private insurance sector
- Advise the government on how to improve subsidised schemes (KLIP & KCIP)

## Facilitation of pilots -

- Products used on pilot basis have been given regulatory exemptions
  - Helps encourage market development of the product
  - Gives understanding of what works and what does not
- Pilot products may need to be redesigned once the formal regulations and product approval guidelines come into force. However most features of the current products would comply with these requirements

# Regulatory Issues/ Challenges

- Position on insurable interest for an index based insurance contract- when should it be determined?
- Is it insurance or derivative?
- What if it is a derivative and not insurance- how should it be regulated?
- Allow for a separate method of calculating the technical reserves
- Specify index based insurance specific capital requirements;
- Delay in enacting regulations to set the legal framework
- Data on pilot schemes – lack of statistical information on volumes covered, premiums collected and claims paid
- Lack of formal distribution channels

# Key Regulatory Considerations

- The product must offer fixed-sum instead of indemnity insurance
  - Allows for consequential losses and mitigation costs
  - The index can only serve as a proxy for the actual loss
  - The policy must not promise indemnity payment and IBI products must not be sold as indemnity contracts
- Insurable interest exist if there is prospect of adverse impact on the insured should the insured risk occur
  - Contract must state the risk against which insurance is provided. This is intended to distinguish under insurance from basis risk

# Proposed Product Approval Guidelines



Insurance  
Regulatory  
Authority  
*Bima Bora kwa Taifa*

## 1. Key Product Features:

- IBI products cannot be sold as indemnity insurance, and should be considered as a form of “fixed sum” or “agreed value” insurance,
- Maximum size of the possible total pay-out should be specified in the contract
- No waiting / grace period or cancellation to be allowed for IBI products,
- Sales & Cover windows , any exclusions, index to be used to calculate the pay-out and expected frequency of payouts must be clearly specified,
- Must specify the data sources and back-up sources or method to be used to approximate lost/inaccurate data
- Explain design features included to **minimize basis risk** in an **actuarial report**

# Proposed Product Approval Guidelines

## 2. Contract requirements

The index used to determine the pay-out should have the following features:

- Easily observable and measurable-specify how the data used to calculate the index will be observed and how the index values and resulting benefits will be determined
- Transparent, objective and independently verifiable
- A good predictor of the risk covered- the index should not trigger a payout unless the insured risk occurs
- Predictive variable -allow the index to be based on a predictive variable

# Proposed Product Approval Guidelines



## 3. Claims/ Consumer Protection requirements;

Marketing material should explain product and risks:

- Explain that pay-out depends on the value of the index and not the actual loss
- Explain which risks are covered and which will not be; what index is used to calculate the pay-out and expected frequency of payouts
- State eligibility criteria – determining insurable interest,
- Insurer must specify a complaints resolution process prior to product launch,
- Interested 3<sup>rd</sup> party/policyholder be allowed to receive data and calculate the pay-out themselves.

## Proposed Product Approval Guidelines

### 3. Claims/ Consumer Protection requirements;

- Policyholders do not need to lodge a claim – insurer must provide a notice,
  
- Pay-outs must be verified, communicated and paid within 30 days
  
- If an independent data validator is to be engaged, a SLA is needed with the independent body indicating;
  - how to resolve conflicts over the data, index values and benefits
  - the penalties the independent body is liable for if it makes mistakes

# Thank you

**Joseph Owuor**  
**Senior Supervision Officer,**  
**Insurance Regulatory Authority**  
**[www.ira.go.ke](http://www.ira.go.ke)**  
**[jowuor@ira.go.ke](mailto:jowuor@ira.go.ke)**  
**+254 719 047 249**