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Republic of Azerbaijan: Microfinance Sector Development (Microinsurance Component)

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This report is a product of the ADB technical assistance project (TA – 8621), which is managed by team leader Inmaculada Martinez, private sector development specialist at the Central and West Asia Regional Department, ADB.

Abbreviations

ADB	Asian Development Bank
AIA	Azerbaijan Insurers' Association
AMFA	Azerbaijan Microfinance Association
AZN	Azerbaijan Manat
CAGR	Compounded Annualized Growth Rate
CBA	Central Bank of Azerbaijan Republic
CBO	Community Based Organization
CIS	Commonwealth of Independent States
EUR	Euro
GDP	Gross Domestic Product
GSLI	Group Savings Linked Life insurance
GWP	Gross Written Premium
IAIS	International Association of Insurance Supervisors
IBNR	Incurred But Not Reported
ICT	Information and Communication Technology
ILO	International Labour Organization
IT	Information Technology
M&E	Monitoring and Evaluation
MBA	Mutual Benefit Association
MF	Microfinance
MFI	Microfinance Institution
MI	Microinsurance
MNO	Mobile Network Operator
MSME	Micro Small and Medium Enterprise
NBCI	Non-Bank Credit Institutions
NGO	Non-Government Organization
PPP	Public Private Partnership
RFID	Radio Frequency Identification Device
SISS	State Insurance Supervision Service
SME	Small and Medium Enterprise
SWOT	Strengths Weaknesses Opportunities Threats
TA	Technical Assistance
ToR	Terms of Reference
TSA	Targeted Social Assistance
USD	United States Dollar
VAT	Value Added Tax

EXECUTIVE SUMMARY

The objective of Microfinance Sector Development Project (the Project) is to enable the development of the microfinance sector in Azerbaijan with a view to increase access to financial services for the financially excluded or underserved sections of the population. The Project therefore recognizes microinsurance as an integral part of microfinance and one of the important instruments of diversifying the current portfolio of microfinance products being offered in Azerbaijan. Microinsurance is virtually non-existent in Azerbaijan and hence the challenge is to encourage stakeholders to make some small but right beginnings.

Rapid economic growth, a favourable balance of payments situation, sizable current account and fiscal surpluses and a stable currency have been some of the positive features of the Azerbaijan economy over the past few years. As a result, the government was able to substantially increase its spending on social sectors like health, education and social security. This has resulted in a sizable reduction in extreme poverty in the country. All of this has helped the country improve on the human development front where it is now categorized as an Upper Middle Income Country.

However regional imbalance of growth, income and wealth still persists in Azerbaijan. Moreover, the imminent stagnation of oil-GDP on account of declining oil production and falling global oil prices on one hand and slow growth of non-oil sectors on the other, is likely to result in a fiscal deficit in the near future. In order to counter this situation, the government is trying to focus on non-oil sectors and towards this has also issued a vision document aiming at broad-based development of various sectors.

The financial sector in Azerbaijan is dominated by banks, although the banking penetration is limited to urban areas. This gap left over by the mainstream banks has ostensibly helped the development of microfinance sector in the country. Currently non-banking credit institutions and credit unions function in this space but some banks are also moving in. However their product offerings are restricted mainly to credit only which is where the demand lies. Increasing competition in the sector may change this situation eventually.

Backed by rapid overall economic growth, the insurance sector in Azerbaijan has also witnessed steady growth over the past few years, as a result it is now the biggest non-banking financial sector in the country. However insurance penetration and density still remain low in Azerbaijan despite a significant improvement in the last five years. Azerbaijan follows a compliance as opposed to a risk-based regulatory framework. The Law on Insurance Activity is the apex legislation governing the insurance business in the country and the State insurance Supervision Service (SISS) is the supervisory authority. The insurance law contains elaborate provisions on licensing, supervision, market conduct and management of insurance companies. Provisions on consumer protection are contained in the Civil Code. The insurance law does not contain any provision on mutual, cooperative or takaful insurance.

Assessing demand for insurance has always been a challenge. A study undertaken in 2006 for Azerbaijan[1] revealed that insurance becomes unattractive for people when they do not get anything back at the end of a claim-free policy period. The low income segment in Azerbaijan was not seen to be proactive in planning for risks as they lacked long term outlook on financial exigencies arising out of loss-producing events. Respondents saw more value in life insurance when it was accompanied with a savings function although the monthly amount to be saved was considered to be too high by most of them. The size of low income market within the 'access frontier' was found to be quite limited thus leaving a large part of the market under the market development zone. Like in many markets certain behavioral anomalies like loss aversion, availability bias and cognitive dissonance often preclude people from buying insurance voluntarily. Consumer education with a strong focus on improving perceptions of people on risks and the concept of insurance therefore becomes an important factor in creating demand for insurance.

On the supply side, the insurance industry in Azerbaijan is fairly diversified with no single company enjoying a dominant market share. Business is also well-distributed between life and non-life insurance as well as voluntary and compulsory classes of insurance. The industry has grown at a healthy rate of 22% every year since 2010 although the same seems to be peaking-out of-late. Claims ratios for various classes of business have remained under 40% signifying decent profitability for the sector. Further analysis may be required to assess whether the same low claim ratios are having an adverse impact on client value and demand for insurance in the country. Like banking, the insurance offerings have also remained restricted to the middle and upper income brackets of the society.

In the current environment microinsurance is virtually non-existent in Azerbaijan. The supply side has concentrated mainly on business generation through 'wholesale' sources like corporate clients and banks. The demand side needs considerable inputs through consumer education to be able to appreciate the value of insurance. Diversified and developing insurance markets, strong presence of non-bank credit institutions (NBCIs), the absence of regulatory hurdles for microinsurance and absence of extreme poverty are some of the strengths and opportunities that can be capitalized upon. On the other hand challenges like low awareness, insurers' limited exposure to retail business and cultural differences between microfinance and microinsurance need to be addressed. The Market Study carried out in 2006[2] estimates that a significant portion of the population (50%-61%) lies in the market development zone, pointing out at the need to initiate market development initiatives like introduction of new products and distribution channels as well as consumer education and marketing strategies. Convergence with the microfinance sector could be an important

[1] Market for Microinsurance in Azerbaijan, Low Income Households' Needs and Market Development Projects, Microfinance Centre, 2006.

[2] This is the only formal study available on demand for microinsurance in Azerbaijan.

starting point in this regard. Credit, savings and insurance together form an ideal blend of financial services capable of addressing the entire range of risks faced by low income households. Adding microinsurance products of good value in their portfolio will therefore help the MFIs and banks to position themselves as total risk management solution providers for the low income masses. Apart from this, selling savings-linked insurance products can also largely overcome the limitation on acceptance of deposits faced by MFIs and can indirectly help in improving the profile of their overall credit portfolio. At some point, bigger MFIs can also think of becoming full-fledged life insurers themselves. Affirmative action on the part of insurers and MFIs can thus create a win-win situation for them as well as the low income clients of Azerbaijan.

Enabling regulation can play a pivotal role in developing microinsurance in nascent markets. Regulators around the world have adopted various regulatory approaches and tools to promote microinsurance within their respective jurisdictions. The public provision approach pre-supposes a larger and active role of the government in providing insurance to poor households through subsidized social insurance programmes. Agriculture insurance in China and health insurance in India are examples of this approach. Directive approach imposes mandates on commercial insurers to procure a certain portion of their total business from specified market segments. The approach is used where the insurance sector is reasonably capable of reaching out to low income masses. The market segment to be covered (for example rural population, women, etc.) as well as the targets to be achieved by each insurer are objectively defined and form part of the insurance regulation. Failure to comply with these targets attracts penalties and censure from the regulator. South Africa and India have adopted this approach in respect of specific market segments.

A concessionary approach aims at incentivizing the insurance industry to venture into a market segment that otherwise may not appear attractive to them. Incentives could include tax-breaks for business procured from specified market segments or through specified products designed for this market segment, relaxed norms for recruitment of intermediaries, etc. Jurisdictions like The Philippines have gone further by creating a separate concept of Mutual Benefit Associations (MBAs). These MBAs are 'micro-insurers' subject to relatively light regulatory norms for capital adequacy and compliance with prudential requirements. This approach can be used to attract market players offering informal insurance into the regulatory ambit. Nudge approach is another soft approach where instead of being 'hands-on' through explicit regulatory provisions, the insurance sector is nudged by the regulators to offer insurance products to the low income segment. This approach has been successfully adopted in Thailand where a Microinsurance Framework has been developed jointly by the insurance regulator and the industry. Still further, the long term market development approach adopts a 'wait and watch' policy towards microinsurance. The objective is to allow the market to grow organically before initiating proactive regulatory interventions for microinsurance development.

Several factors like macroeconomic outlook, a country's fiscal position, the overall business environment, the phase of development through which the local insurance industry is passing, poverty levels in the country, social security system, the country's overall policy on financial inclusion and the nation's governance ideology eventually shape the regulatory approaches to microinsurance. In all probability a mix of approaches are adopted. The key message is that a long term view has to be taken while adopting policy and regulatory approaches to microinsurance.

Since the demand for insurance among the low income segment of Azerbaijan is very low, specific long term interventions on the demand side may be necessary to create a pull. Consumer education becomes an integral part of any demand creation strategy. Decision making in uncertainty is fraught with many behavioral anomalies that ultimately prevent people from buying insurance and thereby retaining risks they cannot finance through their humble resources. A major role of consumer education for insurance is therefore to address these behavioral anomalies through effective communication tools and thereby bring in attitudinal change towards risks and insurance. Consumer education is often mistaken to be a process of information sharing only. Information should follow the creation of right risk perceptions and building of skills required to evaluate options. This being a voluminous task, all the stakeholders need to come together to develop a long term consumer education strategy and a structure that is capable of effectively implementing the same. Consumer education for insurance can also form part of a larger financial education initiative. In Azerbaijan the SISS has already developed some consumer education material which is being distributed to consumers. While this is a welcome effort from the regulator, there might be a strong case of scaling-up these efforts with concrete financial / insurance inclusion targets to be achieved in a particular time frame.

Similarly, engaging the insurance sector of Azerbaijan will also be equally important for microinsurance development. The industry lacks experience in microinsurance and hence it would be important to encourage insurers to develop products that best suit the needs of Azerbaijan's low income population keeping in view factors like affordability, access and of course behavioral issues. Pre-underwritten, parametric, packaged, long term and group products can be tried out in Azerbaijan. Savings-linked life insurance can also become an instrument for promoting savings besides insurance. Apart from products, developing distribution channels through MFIs and mobile network operators will also be required in order to access mass-markets in a cost-effective manner. As the mass markets develop, the need for easy and cost-effective access to reinsurance treaties for insurers may also arise.

The social insurance dimension also needs to be examined more closely for Azerbaijan. Globally, social insurance is shaping-up as a more sustainable alternative to conventional social security for health, agriculture, disability and pensions. Conventionally, social insurance is used to provide social protection to market segments that cannot afford to buy insurance. In addition, meticulously designed social insurance programmes can also offer a platform for developing voluntary insurance among the same market segment. Azerbaijan already has an agriculture insurance scheme supported by the government. Discussions around mandatory health insurance are also going on since few years. Hence this could be the right time to evolve a comprehensive strategy on social insurance for Azerbaijan. Several factors like potential partnerships with private sector, ensuring fiscal sustainability of social insurance programmes, ensuring impact through appropriate administrative structures and investment in technology platforms for smooth servicing can form part of this comprehensive strategy.

To sum up, the following recommendations can be considered for a multi-pronged microinsurance development in Azerbaijan:

- *Regulatory review* to develop a regulatory strategy on microinsurance as well as to incorporate various enabling provisions for the short as well as long term, keeping in view, various regulatory approaches and tools.
- *Market development* through better engagement with insurance and microfinance sector through support for product development, process design, marketing and business planning.
- *Formulation of a comprehensive strategy for consumer education*, either separately or in conjunction with financial education, including creating appropriate structures and financing mechanisms for its implementation.
- *Developing a long term national policy on social insurance* such that it creates impact and also supports voluntary microinsurance through effective public-private partnerships rather than competing with or crowding-out market based insurance.
- *Creating effective physical and virtual infrastructure* like technology platforms, depositories and payment systems for seamless service delivery.

I. INTRODUCTION

1. Project Overview

a. The larger objective of Microfinance Sector Development Project (the Project) is to enable the development of microfinance sector in Azerbaijan with a view to increase access to financial services for the financially excluded or underserved sections of the population. Towards this objective, the Central Bank of Azerbaijan will be supported in developing the necessary policy and regulatory framework for attaining financial inclusion. The key outputs of this project would be
   i. A Diagnostic Study on Financial Inclusion.
   ii. A National Strategy for Financial Inclusion in Azerbaijan and a roadmap for its implementation.
   iii. The assessment of capacity building needs of the Non-Bank Supervision Division of the CBA.

b. The Diagnostic Study on financial inclusion regulatory, demand and supply side analysis. Existing prudential as well as non-prudential norms for non-bank institutions as well as the policies and procedures on consumer protection and financial education shall be reviewed. The capacity building needs for enhanced monitoring and supervision shall also be identified. On the demand side, a household survey shall be carried out in order to analyze the demand for financial services among the low income segment as well as to identify the key constraints to financial inclusion. The supply side analysis will include a review of microfinance products like savings and credit as well as microinsurance and payment services.

c. This will be achieved through active consultations with the industry participants, regulators and the government. Another aspect of this Project is to enable the microfinance sector to diversify its product offering within the micro-credit basket as well as well as through other financial services like insurance and payments.

d. The Project therefore recognizes microinsurance as an integral part of microfinance and one of the important instruments of diversifying the current portfolio of microfinance products being offered in Azerbaijan. The Project also acknowledges the social aspect of microinsurance in terms of reducing the vulnerability of low income households to the risks of life, living and livelihoods. Microinsurance is virtually non-existent in Azerbaijan and hence the challenge is to encourage stakeholders to make some small but right beginnings. This will require the creation of the right environment on the regulatory, demand, supply and distribution fronts. This will be done through a review of policy, regulatory and supervisory framework for microinsurance, and analysis of secondary data. Based on international best practices, capacity needs of all stakeholders and critical success factors for sustainable microinsurance offerings will be identified in consultation with all stakeholders. Finally, an action plan that addresses the microinsurance regulatory and market development shall be developed and disseminated among the stakeholders. The detailed Terms of Reference (ToR) for the microinsurance insurance component of the Project is enclosed in Appendix 1.

e. This report is divided into four parts. The first part contains the introduction and project overview. The second part is an assessment of microinsurance market in Azerbaijan.

Section 1 of Part 2 discusses the broader macroeconomic context that bears direct as well as indirect relevance to the development of insurance and microinsurance markets. An assessment of the insurance sector in Azerbaijan is done in Section 2 covering the four important pillars of regulation, demand, supply and distribution. Section 3 goes on to describe the current status of microinsurance in Azerbaijan, an analysis of strengths, weaknesses, opportunities and challenges involved with microinsurance development in the country and the role microfinance sector can play in this direction. An assessment of the potential market for microinsurance in Azerbaijan is also made based on a review of past studies in this regard.

f. The third part of this report lays down short, medium and long term options for Azerbaijan in terms of microinsurance development in terms of regulation, demand creation and strengthening supply and distribution. The possible role of social insurance in protecting large sections of underserved population is also described. Recommendations and next steps suggest the concrete actions that can be thought of towards this end. Part four of the report contains Appendices.

II. ASSESSMENT OF MICROINSURANCE MARKET IN AZERBAIJAN

1. Macroeconomic Context

a. Azerbaijan witnessed an era of fast economic growth in early 2000s mainly on account of increased oil production and exports. The GDP growth (nominal) was as high as 34.5% in the year 2006. This resulted in a favourable balance of payments situation and a strong domestic currency. This also resulted in sizable current account as well as overall budgetary surplus. Such a healthy fiscal position enabled increased investment in social sectors like health, education and social security. The government spending on these three sectors increased almost five times from AZN 982.6 million in 2006 to AZN 4571.7 million in 2012. During this rapid growth phase inflation also remained relatively high with the consumer price index moving up to 20.8% in 2008 before coming down to 1.1% in 2012. Interest rates on savings have also seen some chequered movement and are still in double digits. All these years the currency had remained stable by and large, before a substantial devaluation of almost 34% in February 2015.[3] Rapid economic growth and increased government spending on social sectors has also positively impacted the poverty indicators. The percentage of population living below USD 5/day came down from 86% in 2002 to 39% in 2008. Extreme poverty also declined with people living below USD 2.50/day declining from 11.5% of the total population to 4.5% in 2008.[4] Poverty headcount ratio of people below the national poverty line stood at 5% in 2013.[5]

b. The overall trend of private sector development has also been positive. Almost 85% of country's GDP is contributed by the private sector.[6] Azerbaijan ranks 70th among 189 countries on ease of doing business.[7] The country scores high on indicators like starting a business and registering property (10th and 13th respectively) but doesn't do so well when it comes to construction permits, getting electricity connections and trading across borders.

c. Azerbaijan also figures well on the human development index. The country ranks 76th among 187 countries and territories and is classified as an Upper Middle Income Country.[8]

d. Despite the decent macro-economic performance, there have been concerns about the slow pace of non-oil GDP growth, concentrated development around urban areas and sharp inequalities of income and wealth among rural and urban populations. The GDP growth rate itself has been slipping down following a reduction in oil production and falling global oil prices. The nominal GDP growth may slow down to 3% and 2.8% respectively for the years 2015 and 2016.[9] The growth in non-oil sector is expected to be slower following a scheduled reduction in public investment. This is likely to adversely impact the

[3] All figures obtained from ADB Database.
[4] Azerbaijan Partnership Program Snapshot, World Bank Group October 2014.
[5] World Data Bank – Azerbaijan.
[6] Azerbaijan Partnership Program Snapshot, World Bank Group.
[7] Doing Business Report – 2014, World Bank.
[8] UN Human Development Report 2014.
[9] ADB Estimates.

current account surplus. As a result the country is likely to encounter its first fiscal deficit since 2005. In order to finance this gap the Government issued its first Eurobond in March 2014.[10] Similarly, regional imbalance of income and wealth has also arisen in the country since most of the economic activity and population are concentrated around Baku, the capital city. Agriculture in Azerbaijan employs 38% of the workforce but contributes only 7.5% towards country's GDP.[11] On the other hand, the oil sector that commands a 37% share of the country's GDP accounts for less than 1% of the total employment.[12]

e. As mentioned earlier, the high growth era has resulted in increased spending on social sectors like health, education and social security. As a result of this investment the country has been able to build good physical infrastructure for health. Over the past 10 years, more than 400 health institutions were built or refurbished, most of which are located in the regions and all the health institutions were provided with modern hardware and equipment.[13] The number of hospital beds available in the country is 7.5 per thousand capita. This number is 3.8 in Germany and 2.8 in Turkey. However the occupancy ratio of hospital beds in Azerbaijan is just 26.1% as against 89.5% in Germany and 61% in Turkey.[14] This indicates a significant under-utilization of health infrastructure. Even though the healthcare services provided at hospitals funded by the state budget are supposed to be free of cost, there seems to be a high prevalence of informal payments thus resulting in significant out of pocket expenditure for citizens.[15] A household survey undertaken in 2011 suggests that an additional 10% of Azeri households were poor as a result of out-of-pocket spending on health.[16] The country is in the process of revamping the healthcare financing systems through the introduction of compulsory health insurance. It is expected that once this system is in place, it will overcome the issue of informal payments, create a sustainable revenue model for public hospitals and increase their efficiency by generating a healthy competition among them.

f. Azerbaijan also has a Targeted Social Assistance (TSA) Program since 2006. The TSA program provides non-contributory cash transfer to low income households including social insurance. Almost 143,337 households (625,808 members) were covered under TSA in 2014. There is also a contributory social insurance program that provides benefits like pension, sick leave and unemployment benefits. While increased budgetary support to these programs has contributed significantly towards reduction of absolute poverty, implementation issues remain. As in the case of health, the problem of informal payments needs to be resolved and targeting needs to be improved. Moreover, there are emerging concerns about the fiscal sustainability of the pension system.[17]

g. Azerbaijan does not measure its financial inclusion performance formally but reports suggest that the banking penetration is quite humble with 29% of the total adult population

[10] Azerbaijan Partnership Program Snapshot, World Bank Group, 2014
[11] Poverty Analysis (Summary), ADB 2012
[12] Azerbaijan Partnership Program Snapshot, World Bank Group, 2014
[13] Azerbaijan 2020: Look into the future concept of development.
[14] Compulsory Medical Insurance System in Azerbaijan, Centre for Economic and Social Development, 2009.
[15] Ibid.
[16] Azerbaijan Partnership Program Snapshot, World Bank Group, 2014
[17] Ibid.

having a bank account and just 5% of the population saving through a formal institution.[18] In 2011, the ratio of financial sector assets to GDP in Azerbaijan was 30.6% which was less than some of its neighbours like Kazakhstan (62.5%), Turkey (105%) and Georgia (56.5%).[19] Banks hold about 95% of the assets of financial sector. The loan to deposit ratio (LDR) of the banking sector was 167.4% in 2013[20], which indicates that the sector is replete with liquidity from non-deposit sources. Although the banking sector seems to be quite robust, its exposure is limited to big businesses with a limited outreach for micro, small and medium enterprises. The growth of microfinance sector in Azerbaijan is perhaps a corollary of this gap left over by mainstream commercial banks. Non-bank credit institutions (NBCIs) and credit unions command a decent portfolio, especially in rural areas. Apart from 47 NBCIs and 107 credit unions, some banks have also become active in the microfinance space. The sector serves over 600,000 micro-credit clients across the country. Most NBCIs rely on capital investment from abroad as they are not allowed to accept deposits from clients. The recent devaluation of local currency has raised some concerns in the sector as many NBCIs had disbursed loans in US dollars, the repayment of which has now become more costly for the borrowers. The credit unions are even smaller with limited expertise and access to capital and hence are mostly localized. Most MFIs have chosen to restrict themselves to micro-lending only and have not diversified into other financial services like insurance.. Increasing competition in the microfinance space may change this situation eventually.

h. In December 2012, the Government of Azerbaijan adopted a strategy titled 'Azerbaijan 2020: Vision for Future Concept of Development'. This document analyses the achievements of the country and the challenges faced by it and lays down the strategy on a wide range of issues for the future. Among the issues dealt with in the paper, the following are of particular relevance to the Project
    i. Ensuring rapid development of the non-oil sector, increasing the effectiveness and competitiveness of the economy and securing progress based on innovation.
    ii. The expansion of opportunities for using Information and Communication Technology (ICT) and the total use of e-government services.
    iii. The formation of an economic model based on effective state regulation and mature market relations.
    iv. Measures to form a fair competitive environment and restrict monopolies in the economy, especially in the consumer market.
    v. Consolidation measures and structural reforms in the banking sector, stimulation of competition, improving the quality of banking-financial services including the improvement of infrastructure for electronic payment systems.
    vi. Ensuring balanced development of main segments of financial markets including non-banks and insurance.
    vii. Increasing capitalizations levels in the insurance industry, growing range of insurance products, expansion of life and medical insurance and promoting agriculture insurance through improved legislation.

[18] Global Findex Data 2014.
[19] Azerbaijan Financial Sector Assessment, ADB, 2012.
[20] Azerbaijan Partnership Program Snapshot, World Bank Group, 2014.

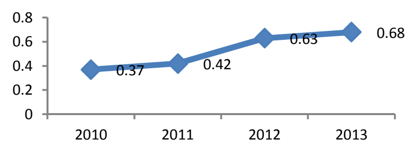
viii. Improving quality of healthcare, protecting patients' rights and improving control mechanisms through mandatory medical insurance.

i. This vision document may well form the basis of future policy, regulatory and market initiatives in Azerbaijan. The market players can take cues from this vision document to plan for their future business approach.

2. Insurance Sector Overview

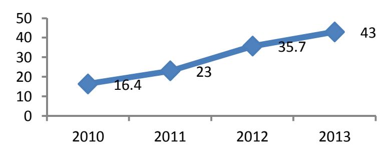
a. Insurance is a small but fast growing sector in Azerbaijan. As mentioned earlier, banking occupies predominance in the country's financial sector and insurance, private pension and capital markets are in different phases of development. However, insurance could still be the biggest industry among the non-banking financial sector industries. The key indicators of insurance penetration and density have grown significantly during the past few years, mostly on account of healthy economic growth (Figure 1 and 2). Insurance density has more than doubled between 2010 and 2013 while insurance penetration has almost doubled during this period. Despite this insurance penetration remains very low, as compared to developed insurance markets and quite lower than neighbours like Turkey (1.5%), Russia (1.3%) and Iran (2.7%) but almost equivalent to Kazakhstan (0.7%).[21] Insurance sector development has remained by and large slow in all CIS countries despite relatively rapid economic growth. On the positive side this indicates a huge untapped

Fig. 1: Insurance Penetration (% of GDP)



Source: Azerbaijan Insurance Profile June 2013, Xprimm

Fig. 2: Insurance Density (EUR/Capita)



Source: Azerbaijan Insurance Profile June 2013, Xprimm

potential to be covered in these countries. The insurance market in Azerbaijan comprises of one reinsurer, three life and 25 non-life companies. There are no mutual or Takaful insurers in Azerbaijan.

b. **Law and Regulation:** The Law of The Republic of Azerbaijan on Insurance Activity (Insurance Law) is the apex legislation governing the business of insurance in the country. In addition, the Civil Code, the Law on Compulsory Insurance and the Law on Deposit Insurance also contain relevant provisions. The Insurance Law is divided into 14 chapters containing substantive as well as procedural provisions on matters relating to licensing of insurers, governance and management, conduct of insurance business, maintenance of solvency, insurance intermediaries, insurance contract, accounts and audit of insurance companies and investment of funds by insurance companies. Various rules, guidelines and normative documents have been framed by the Ministry of Finance under the respective legislation. Azerbaijan follows a compliance based regulatory framework, as is the case with most of the developing insurance markets.

[21] Swiss Re Sigma 03/2014.

c. The State Insurance Supervision Service (SISS) has been entrusted with the function of supervision of the insurance industry in Azerbaijan under the Regulations prescribed by the Ministry of Finance in 2009. SISS deals with application for insurer licenses, renewal, cancellation and suspension of licenses, granting licenses to insurance intermediaries, receiving periodic returns from insurers, compiling and publishing industry level data, carrying out inspections of insurers and supervising insurance market conduct in the country. Insurers need to file their products with SISS before launching them in the market. Any change in the ownership or shareholding pattern of insurers needs to have a prior approval of the SISS. There are elaborate provisions in the law regarding the conduct of annual general meetings by insurance companies and the constitution of their Boards of Management. However, there seems to be no compulsion for insurance companies to appoint independent directors or women directors on the boards. The law lays down certain disqualifications for appointment of Board members.
d. The Insurance Law also lays down norms for investment of funds by insurers. Separate provisions are prescribed for investment of shareholders' funds and policyholders' funds. The investment norms are quite liberal and also allow investments in assets like real estate, non-state securities and equity capital of other legal entities. Insurers need to obtain prior permission of the supervision authority before acquiring a significant participating stake in other legal entities. However this permission is not required if the investment being made is less than 2% of the regulatory capital of the insurer concerned and the legal entity in which the investment is made is active in the financial sector. Thus the law seems to be consciously allowing cross-holdings among financial sector players subject to limits. The law also contains detailed provisions on insurer's financial dealings with their 'associated persons'.
e. There is a concept of 'required capital' and 'regulatory capital' for insurers. This seems to be in line with the regulatory concepts of 'required solvency margin' and 'available solvency margin'. The supervisory authority is authorized by the Insurance Law to specify the required capital as well as lay down rules for determining regulatory capital. The law also prescribes that the risks retained by an insurer under a single subject matter insured (property or interest) shall not exceed 10% and the same under a single insurance contract shall not exceed 30% of the regulatory capital. Hence while the law does not contain any provision for compulsory reinsurance cessions, it caps the retention levels of insurers under single risks. Any risk underwritten beyond this limit has to be reinsured. The current entry level capital requirement for obtaining an insurer's license is AZN 5 million. This relatively low capital requirement has facilitated the entry of many players in the insurance market. As per the current regulations, foreign insurers can enter the Azerbaijan insurance market through domestic companies. It is expected that the current cap of 30% foreign equity in insurance companies of Azerbaijan will be removed by the year 2017, thus paving the way for fully-owned subsidiaries of foreign insurers.
f. The Insurance Law also authorizes the supervision authority to prescribe periodic returns to be filed by insurers. Apparently these returns are currently being filed manually and there is no computerized or web-based system of filing of returns by the insurers. The SISS compiles industry data and posts the same on its website for public information. The insurers are also required to furnish their annual accounts duly audited to the supervision

authority. These annual accounts are required to be published in at least two newspapers. Apart from these, there are no other norms for public disclosures by insurers. The law also seems to be quite liberal in terms of reserving requirements for insurers. The law lays down general provisions for creation of reserves for unexpired risks and Incurred But Not Reported (IBNR) claims by life as well as non-life companies. The insurance supervision authority is authorized to frame rules in this regard. The supervision authority is also empowered to direct insurers to create additional reserves wherever deemed fit.

g. The insurance consumer is considered to be a 'participant' in the insurance activity of the country. Apart from this the Insurance Law does not contain any provisions on consumer protection. The Civil Code does contain some provisions on the process to be adopted by insurers in the event of claims, the time limit within which the claims need to be disposed and the penalty in the event of delayed settlement of claims. However there are no detailed provisions on consumer grievance redressal by insurers or independent fora like ombudsman.

h. **Demand:** Demand for insurance has always been a ticklish issue for practitioners and researchers around the world. As a concept, insurance offers protection against the financial impact arising out operation of uncertain as well as unforeseen events like sickness, untimely death, property damage due to natural disasters, etc. Insurance thrives on the theory that such risks are unpredictable at the individual level but can be reasonably quantified at the group level. As a result, the 'benefit' of insurance becomes contingent upon the happening or not happening of an insured event in the future. The benefit preposition in insurance is thus much different from other financial products. This aspect of insurance makes it largely unattractive for people, especially the low income segment with limited or no disposable incomes. Insurance is all the more needed for the low income segment on account of their higher vulnerability to the risks of life, living and livelihoods. For example, financial impact of adverse health episodes is known to push poor households further into the poverty chasm. In Azerbaijan itself, it was estimated that an additional 10% of the households were poor as a result of out-of-pocket expenditure on health.[22] Despite this the perceived value of insurance at the individual level tends to be quite low due to the unpredictability of the insured event and the uncertainty about its timing, whereas these should be the very reasons for buying insurance.

i. Decision making by humans is often far from rational, especially when they are made in uncertainty. The behavior actually demonstrated by humans in uncertainty is anomalous to the classical theory of expected utility. Empirical research now has sufficient explanations for these behavioral anomalies demonstrated by consumers in deciding whether or not to buy insurance. Some of those behavioral anomalies are discussed below.

    i. *Prospect theory and loss aversion*: Research shows that the mental pain caused by a 'loss' is almost double the pleasure a gain of equivalent amount would give. For most of us, paying a premium for indemnity products like health insurance and not having an occasion to claim is a 'loss' and not a 'cost'. Moreover, when it comes to choosing between prospective gains, we prefer certainty (risk-averse).

[22] Azerbaijan Partnership Program Snapshot, World Bank Group, 2014.

But the tendency changes substantially when it comes to 'bad' choices. Most of us would become risk-takers and choose a rare chance of a big loss rather than avoiding the same by bearing a small but certain loss (premium). This is why savings-linked life insurance is more often preferred over term insurance, despite the relatively high premium and low returns.

ii. *Availability bias*: As a general rule, we tend to overestimate low probabilities and underestimate high probabilities. However, we also tend to ignore very low probabilities. Since most insurance products cover low probability risks, people do not see enough value in buying insurance. We assess probabilities based on the ease with which instances of their occurrence can be recalled. This is why there is a big rush to buy insurance following a natural calamity like earthquake, despite the low probability of its immediate recurrence. Insurance is attractive only if it can be made 'affect-rich' for the consumer.

iii. *Mental accounting*: For most of us, maintaining a mental account of gains and losses – financial as well as non-financial – for every transaction we enter into is the easiest way to judge our success and failure. Under this format, paying premiums and not getting an opportunity to claim amounts to a 'loss' which is not acceptable. The resultant fortune of being loss-free is accounted for as 'luck' and not a well-earned 'gain'. On the other hand, being uninsured and having to face a loss can also be conveniently blamed on luck thus escaping a debit entry in our mental account. Fatalism limits the perceived utility of insurance.

iv. *Cognitive dissonance*: Lack of clarity or information on the core utility of a product after it has been purchased, often results in 'buyer's remorse'. One wants to get out of this uncomfortable situation quickly. Dropping-out becomes the easiest way to overcome cognitive dissonance towards insurance products. Low renewal rates (or high laps) could well be ascribed to this phenomenon.

v. Narrow-framing: The time frame in which we try to anticipate or plan things is often very small. As a result, small things round the corner assume higher importance than relatively big things lying at a distance. The tendency prevents financial planning and risk management. The poor households are more likely to suffer from this tendency on account of their precarious living conditions.

j. Creating demand for insurance involves active management of these behavioral anomalies through consumer education and marketing. Creating risk consciousness and an insurance culture among the population is often a long term and multi-pronged approach. Introducing compulsory insurance is one strategy some jurisdictions adopt for some types of risks. While this could be a good way to start, an over-reliance on compulsory insurance carries the risk of breeding inefficiency into the insurance market and may be counter-productive in the long term. Active insurance purchase takes place only when the consumer is confident about the concept, product and the service provider. Consumer education can provide concept clarity, marketing imparts product awareness and distribution channel generates confidence in service providers. Such a chain reaction only can generate sustainable demand for insurance.

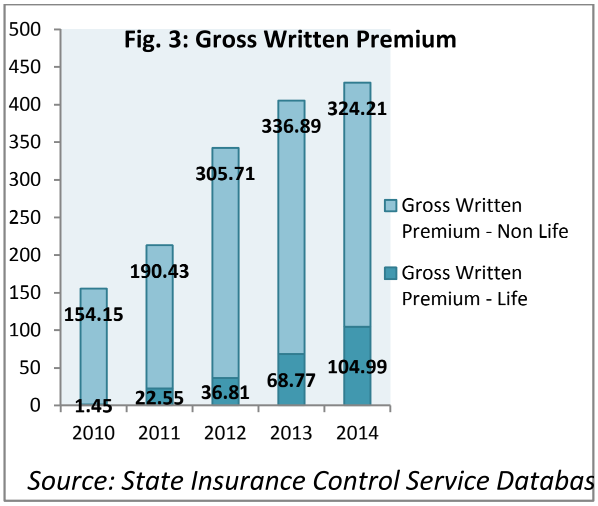
k. There have been no recent studies in Azerbaijan for needs or demand assessment of insurance, especially among the low income segment. The last such study that we are aware of was done in 2006.[23] This was a comprehensive study involving quantitative as well as qualitative research covering various aspects like how people cope with risks, what are their perceptions about risk and insurance, what has been their experience with insurance products and the possible approach to microinsurance development in the country. The main highlights of this study, especially the demand side conclusions are summarized below.

i. 'Most of the survey respondents rejected the generic insurance product offered to them because the premium was not returned after the policy period even where there was no loss during the policy period.' People want products with return of premium.
ii. 'Low income people differentiate in terms of trust between domestic and foreign insurance companies to the advantage of the latter.' This often happens in nascent markets.
iii. 'Azerbaijanis see some benefits of planning and saving but are not proactive in preparing for risks. It seems that they lack long term strategies and what is more important they are not aware of that factor in everyday life.' This is the narrow-framing tendency discussed above.
iv. 'There is a strong culture of collective support among Azeri society and it seems that this factor has positive influence on living conditions of many Azeri households.' Insurance by its very nature should be promoting solidarity. Mutual and takaful insurance can further strengthen the sense of solidarity and enable active insurance purchase.
v. 'Health and property insurance are among the most commonly used insurance products'. This could be partly because they are mandatory and/or subsidized.
vi. 'Respondents saw more value in life insurance when it was accompanied with savings function although the monthly amount to be saved was considered to be too high by most of them.' This conclusion re-confirms the loss aversion tendency discussed earlier.
vii. 'But the market which is within access now, provided that good products are developed, is only 5% of the total market. The rest of the market needs to be developed.' It is possible that things are slightly different now, but the fact remains that there is very little 'low hanging fruit' when it comes to microinsurance.

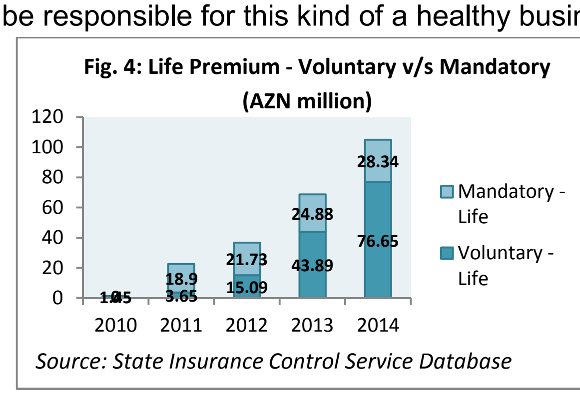
l. **Supply**: Azerbaijan's insurance market currently comprises of three life, 25 non-life and one reinsurance companies. Only one out of them is a state-owned insurer. Relatively low entry level capital requirement of AZN 5 million has facilitated the entry of many private sector insurers. Many big banks have their own insurance companies while others have some cross-holdings with banks. Some big industrial houses have also set their 'captive' insurers. Some foreign insurers are also active in the market but they mostly cater to their global clients present in Azerbaijan.
m. The gross written premium (GWP) of the sector for the year 2014 was AZN 429.2 million. While the insurance sector is dominated by the non-life insurance (mainly industrial and

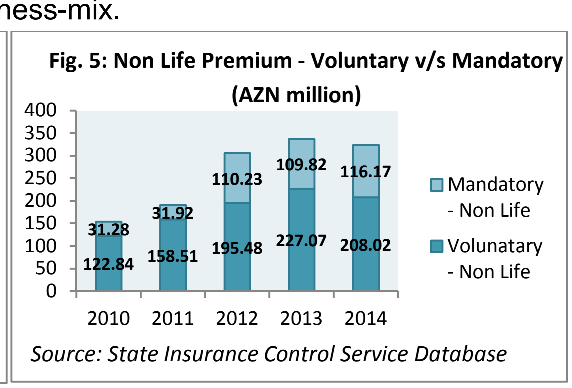
[23] Market for Microinsurance in Azerbaijan, Low Income Households' Needs and Market Development Projects, Microfinance Centre, 2006.

motor third party insurance), life insurance also enjoys a significant overall market share of almost 25% of total GWP. This is a departure from the trend observed in many other Central Asian markets where non-life segment heavily dominates the insurance sector. The growth in GWP has been significant for both the classes of insurance over the past few years. The industry's GWP has grown at a Compounded Annualized Growth Rate (CAGR) of more than 22% between 2010 and 2014 (Figure 3). Rapid economic growth, increase in car sales, small base and introduction of certain compulsory classes of insurance can be attributed to this phenomenal growth. Moreover, the premium growth appears to be plateauing off-late.



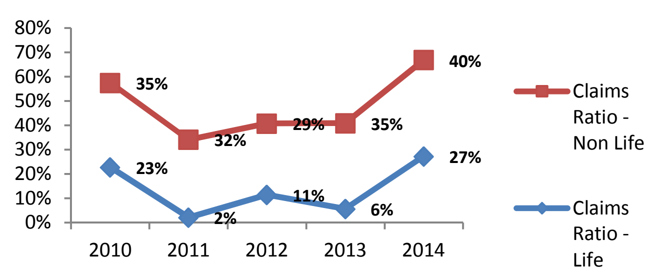
n. Another interesting feature of the business performance of the industry in Azerbaijan is the significant contribution of voluntary insurance to the total business. In most developing insurance markets, compulsory insurance classes constitute majority of the business transacted but Azerbaijan seems to be a pleasant exception. Voluntary insurance classes constitute 66% of the total GWP while the remaining is contributed by compulsory insurance classes like motor third party and compulsory insurance for industrial accidents. Within the voluntary classes of insurance, life insurance products generate 27% premium while non-life products contribute the remaining 73% (Figure 4 and 5). The dominant share of voluntary insurance has remained more or less constant over the years. Active support of banks and aggressive corporate tie-ups for all classes of insurance appear to be responsible for this kind of a healthy business-mix.





o. Insurance is a business of claims. And therefore the efficiency of any insurance industry should not just be judged based upon the premium it generates but also by comparing the claims payouts against the premium generated. For this purpose, claims ratio (proportion premium paid out as claims) is universally used as a primary measure. In the case of Azerbaijan, the industry level claims ratio for all products has remained in the range of 30% to 40% in case of non-life and 2% to 27% in case of life insurance (Figure 6). Individual life insurance contracts are most often long term policies with a savings element bundled with pure life insurance (endowment insurance). Hence in the case of life insurance, the claim payments include payouts arising out of death of the policyholders as well as on account of maturity of life insurance policies. Due to this it is difficult to make a judgement based only upon claims ratios in absence of data on maturing policies. However, in case of non-life insurance, where the policies are necessarily annual contracts, claims ratio offers a more clear assessment of the profitability of insurers and the utility value offered to consumers by the industry. While the low claims ratios, especially in case of non-life segment may indicate a high level of profitability for insurers depending on their expenses, on the other hand, they also tend to reduce the utility of insurance for policyholders.[24] Although the claims ratio is slowly rising over the past few years, they still leave a good scope for price correction, in general. As competition increases, claims ratios are likely to continue with their upward trend as a result of reduction in premium rates. Moreover, claim ratios need to be analyzed in the context of expense ratios of insurers and business acquisition cost ratio in order to get a more complete picture. In case of life insurance a more detailed segment-wise analysis may be required.

Fig. 6: Claims Ratio on Gross Premium



Source: Calculated from State Insurance Control Service Database

p. Like the banking sector, the insurance industry also has restricted itself to the middle and upper income brackets of the society. As a result, insurance penetration and density continue to remain low despite good business growth. The country has by and large carried forward the social security systems from its previous Soviet era. Azerbaijan has a Targeted Social Assistance (TSA) program which is administered by the Ministry of Labour and Social Protection. The TSA beneficiaries are provided with a life insurance

[24] Claim ratios are generally calculated on Net Earned Premium and not GWP. But when considered over a period of time, even claim ratios on GWP can provide a reasonably good picture.

cover, among other benefits. The issue of offering compulsory health insurance has also been under consideration since past few years. As a result of all these, market based insurance for the low income segment is largely under-developed – both from the demand as well as supply sides. Comprehensive social security systems often have a 'crowding-out' effect on market based insurance mechanisms for the poor. Going forward, this is something that may have to be dealt with at the policy level.

q. **Distribution:** Insurance is a distribution driven activity. Despite the increasing trend of online and direct sales of insurance products, distribution channels still command a majority share of insurance business around the world. As mentioned earlier, various behavioral anomalies make the consumer apprehensive about the concept as well as practice of insurance and hence there is very little latent demand for insurance. There is a big divide in terms of understanding, knowledge and perceptions regarding risk between insurance providers and consumers. Distributors are in the right position to bridge this gap on account of their proximity to the consumer. The importance of distribution channels is all the more prominent in case of microinsurance. In this case, the market segment to be dealt with has much lesser understanding of the concept and therefore is all the more reluctant to buy insurance. Poor households also face the issue of affordability and accommodating several other priorities within their limited income streams. They therefore need a strong sense of belief before they can see the value in buying insurance. Even after buying insurance, they need constant reassurance about the legitimacy of their decision in order to make them to renew insurance every year. This is where a strong distribution channel is required.

r. Individual agents and brokers have been the most conventional distribution channels for insurance. It has been observed that a 'human face' is very much important in insurance selling. Even among educated people, it is the 'word of mouth' from this human face that matters more to a consumer than the fine print of an insurance contract. Insurance agents provide that much needed human touch to insurance selling. Over the last few decades many alternative distribution channels have also developed. Bancassurance is one such alternative channel. It is of common knowledge that banks enjoy a special relationship with their consumers and hence are supposed to be more acceptable to them than any other institution. Over the past few years banking has gone much beyond its traditional products of savings and credit to other financial products like insurance, pension, payment services, investments, mortgages, leasing foreign exchange services, etc. A bank has today become a hub for total financial solutions. It also makes good business sense for banks to diversify their revenues through fee-based activities like insurance.

s. In the context of microinsurance MFIs are in a similar position as banks and can function as strong insurance intermediaries. The global experience by and large has however been that not many MFIs have been able to move beyond the sale of compulsory credit-linked insurance products. NGOs, cooperatives, retail shops, religious institutions, and post offices are some of the other alternative channels for microinsurance.

t. Mobile Network Operators (MNOs) have recently joined the list of microinsurance distributors in many countries in a big way. Here the insurance companies enter in to an arrangement with an MNO under which the consumer buying prepaid mobile airtime 'automatically' gets a small ticket accident or life insurance along with the airtime.

Depending upon the value of prepaid recharge the insurance is valid for a short period of time (generally one month). The strategy here is to bank upon the huge customer base of MNOs through a 'passive' insurance sale. This kind of a passive sale eliminates the costly process of underwriting, enrollment and insurance policy issuance to the individual consumer, thereby reducing the cost of insurance. The remaining cost of insurance is either factored into the mobile recharge price or is borne by the MNO. The MNO thus gets to pitch this as one of the value added offerings for its customers.

u. In Azerbaijan, distribution channels have not developed fully. Despite sizable voluntary insurance being sold in the country, there is hardly any retail sale of insurance products, apart from the compulsory motor and property insurance. As a result there are very few brokers and agents in the country. Some bigger companies are now trying to develop their retail business. As mentioned earlier, most of the insurance companies appear to be exploiting their captive business sources and seem to be fine with that. Developing retail business is slow, labour intensive and costly at least in the initial periods. However retail business once built can offer a strong top line as well as bottom line support. Microinsurance can only be sold through a strong distribution channel and hence unless the insurance sector realizes the value of retail sales, developing microinsurance will be a challenging task.

3. **Microinsurance Development in Azerbaijan**

a. **The Current Scenario**: Azerbaijan is almost a clean slate as far as microinsurance is concerned. The insurance regulation is largely silent on insurance for the low income segment but also does not contain any specific restrictions that can impede microinsurance development. Apart from a couple of instances, the insurance sector also has not tried to enter this market segment. In fact retail insurance selling itself is in a nascent stage and is restricted to compulsory classes of insurance only. While there is a general interest in knowing more about microinsurance, there is also some sense of skepticism around the same. The culture within the industry seems to be favouring business through captive channels instead of investing in open market competition. Limited competition in the market has made insurers settle in their own niche markets. A cultural shift may be required to shed such a circumspect approach. Macroeconomic factors also influence insurance sector activity. The rapid economic growth resulted in some kind of automatic growth due to factors like increasing sale of motor vehicles. As the economic growth rate stabilizes, the corresponding natural growth in insurance business will also stabilize. The reduced growth of insurance premiums in 2013-14 of 6% could be indicating the same phenomenon. This may give rise to the need for expanding the insurance market beyond its conventional horizons into territories like microinsurance.

b. To some extent, the insurance market is also affected by the phase in which other financial markets are in. For example, active debt and capital markets can enable innovative savings-linked life insurance products. Although the life insurance sector seems to be doing well, a further impetus in the form of active capital markets will certainly be a favourable development.

c. At some point of insurance sector development, access to reinsurance also makes a difference to the kind of products being made available in the market and the premium rates therefor. Difficulties in offloading a part of the risk to reinsurers especially through mechanisms like quota share and surplus reinsurance treaties can also hinder the seamless development of insurance markets. Insurance is a capital intensive business and as the insurance portfolio of insurers grows, it eventually becomes difficult and costly for insurers to keep infusing fresh capital in order to main their required solvency margins. Such a situation could squeeze out small players with limited capacity to raise additional capital. Easy and cost-effective access to reinsurance treaties allows insurers to expand their business without having to worry about infusing additional capital or increasing risk in their portfolio. It remains a subject of separate analysis as to how much of Azerbaijan's insurance portfolio is retained by the insurers and what is its impact on the need to raise capital but in general, access to reinsurance is critical for sound insurance sector development. A national or regional reinsurer with adequate reinsurance capacity and focus on supporting retail products is something that may be required in future.

d. Banks are already playing an important role in distributing insurance to their customers, although bancassurance has not yet been recognized as a formal distribution channel. In developed insurance markets, bancassurance channel contributes significantly to the overall insurance business. Formally, bancassurance can be operationalized through various models. A distribution arrangement between banks and insurance companies through partner-agent model is the first step towards bancassurance. Going further joint ventures may be formed with banks investing in a part of the equity of insurance companies. And the third model is full integration between a bank and an insurance company where the bank creates a subsidiary insurance company.[25] Azerbaijan already has the last two types of models. The creation of an enabling regulatory environment for a partner-agent model between banks and insurance companies could optimize the bancassurance scenario in Azerbaijan as this will open the floodgates for smaller banks and insurance companies for working together.

e. The situation is quite different when it comes to microfinance. Considering the decent development of microfinance sector in Azerbaijan, one would have expected a situation similar to mainstream bancassurance. Perhaps this is because of the fact that there are no cross-holdings between MFIs and insurance companies. There are no MFI-insurer tie-ups except for a couple of leading MFIs who have been doing credit life insurance. A more detailed assessment of opportunities of developing microinsurance through MFIs appears later in this report.

f. The demand side has had very little exposure to insurance so far. Apart from the compulsory classes of insurance, there is very little uptake of any other insurance product. Memories of the problems faced by the people regarding various financial services including insurance during the transition are still fresh in the minds of people thus making them apprehensive to any kind of futuristic financial product. While most of the people are more concerned about their day-to-day problems they do connect when prompted about long term risks they are exposed to. Apart from resorting to credit, they were not sure how these risks could be financed. Their level of information on insurance companies and products is quite limited as nobody seems to have approached them so far with voluntary

[25] Analysis of Bancassurance and its status around the world. Focus, October 2005.

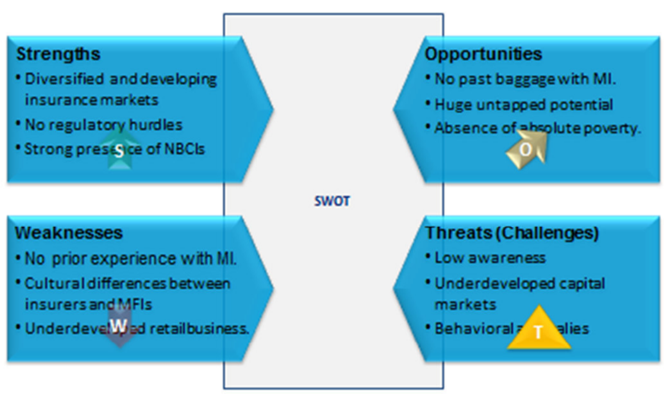
insurance products. Given a choice most of them would prefer savings-linked insurance products over pure indemnity policies[26]. All these tendencies are quite normal among the low income rural households across nationalities. Several behavioral anomalies mentioned earlier drive people into taking incorrect decisions on personal finance which is one reason behind their slow transition out of poverty[27]. And this is why it is said that insurance is always sold, never bought. On a different note, social security systems also play a role in shaping people's attitude towards risk and risk management. Comprehensive social security provided by governments tends to limit proactive risk attitude and may eventually have a 'crowding-out' effect on market based risk management tools like insurance.

g. **SWOT Analysis**: The current scenario of microinsurance in Azerbaijan throws open quite a few opportunities. The fact that microinsurance has to be started from almost scratch is an opportunity but also a weakness. A SWOT analysis for microinsurance development in Azerbaijan is given in Figure 10 below.

h. The strengths and weaknesses are specific to the country context. However there are no major roadblocks or limitations specific to Azerbaijan in the context of microinsurance development. The opportunities and challenges also are quite general and are present in all geographies. Overcoming the challenges and weaknesses and capitalizing on opportunities and strengths is therefore more of a management issue.

i. **The Potential Market for Microinsurance in Azerbaijan**: It is always difficult to do a *demand* assessment for microinsurance in any market, because of the diverse attitudes and perceptions about risk and insurance. It is relatively easier to estimate the *potential*

Fig. 7: SWOT Analysis



[26] Insights obtained from 3 Focus Group Discussions (1 rural and 2 urban) comprising of 8-10 clients each of bank / NBCOs.

[27] A detailed discussion on conceptual basis of microinsurance and global trends on microinsurance is provided in Appendix 3.

for microinsurance through a formal study. Such a formal study (the Market Study) was done in Azerbaijan in the year 2006.[28] This Market Study analyses people's attitude towards and their expectations from insurance. A segmentation of the low income market based on their attitudes towards insurance is done and based on this market segmentation, the potential demand for insurance among the low income households has been estimated. Accordingly, the market size for microinsurance in Azerbaijan was estimated to be 1.32 million households that add up to 61% of the low income population. The remaining portion of the low income population either cannot afford microinsurance (9%) or may not be eligible to get insurance because of limiting factors age, disability, etc.

j. Based on the quantitative research on attitude towards, the low income population was classified into three categories. In the first segment, the respondents were relatively educated, This market segment called the 'information seekers' was therefore most likely to buy insurance with some effort on consumer education and promotion. Unfortunately this was the smallest segment with just 20% households. The second market segment called the 'uneducated enthusiasts' was the most amicable of all as it carried a positive opinion about insurance. They were relatively less educated and hence were likely to be quickly disillusioned about insurance and may drop-out of insurance at a later stage. This segment was also the poorest among those interviewed and hence their lack of affordability was also likely to become a serious constraint. 'Skeptics' were found to be the largest group in the market with 44% households falling under this category. This segment carries a general distrust towards formal financial services due to the legacy of previous times and also perceives insurance as a luxury meant only for the rich. This could prove to be the most difficult market to reach out for microinsurance.

k. The Market Study also tried to assess the willingness to buy various insurance products. For this purpose some hypothetical and generic products were offered to the respondents. Not surprisingly, health insurance attracted the maximum number of respondents. However savings linked life insurance attracted the least number of respondents on account of the requirement to pay a fixed amount of premium at regular intervals. Overall 42% respondents said they could consider buying some or the other kind of insurance.

l. A projection of the current as well as future market for microinsurance in Azerbaijan has also been attempted by the Market Study using the access frontier approach. [29] Accordingly the market for microinsurance was divided into four segments – those who are either not eligible to buy insurance on account of limiting factors like age or do not require insurance (natural limit), those who may want to buy insurance but cannot afford the same (supra market – market re-distribution zone), those who are currently reluctant to buy insurance because of lack of knowledge, trust, etc. but may do so in future provided the right information and appropriate product is offered (within access frontier in the future – market development zone) and those who can and wish to buy the insurance products in their current form (within access frontier now – market enablement zone).

m. According to the Market Study, the market enablement zone turned out to be the smallest segment with just 4-5% of the low income population. This means that the 'easy market'

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[28] Market for Microinsurance in Azerbaijan, Low Income Households' Needs and Market Development Projections, Michal Matul, Justina Pytkowska and Martin Rasaj, Microfinance Centre, November 2006

[29] The access frontier as an approach and tool in making markets work for the poor, David Porteous, 2005

for microinsurance in Azerbaijan is quite small. A large portion of the market lies in the market development zone (50-61%). This market, although big enough, was not yet ‘ready’ for microinsurance at the time of survey and will need efforts on consumer education, marketing and product development before it can be converted into business. Both these segments put together, it was found that almost 54-87% of the low income population could benefit from microinsurance in Azerbaijan at the time.

n. The supra market that ranges between 7 to 9% of the population is also an important market segment. They are the ones who are enthusiastic about insurance but cannot afford to buy insurance and hence the commercial insurance market may never be able to reach them. In any country, the supra market often remains excluded from all risk management tools. Therefore this market segment becomes a strong case for social insurance.

o. In all probability, the socio-economic conditions in Azerbaijan would have changes substantially since this Market Study took place in 2006. However it still offers a good structural view of the market as it stood in 2006. This study can serve as a good baseline for any such future study. Moreover it can also provide good inputs for any microinsurance market development strategy for the future.

p. **Convergence with Microfinance**: Microfinance is perhaps the only sector in Azerbaijan that currently touches sizable volumes of low income population in the country. The physical and human infrastructure of NBCIs as well as credit unions can be easily harnessed to offer microinsurance products of good value to Azerbaijani population. MFIs in Azerbaijan who have hitherto chosen to focus only on micro-credit can add insurance products to their portfolio and thereby offer a borader range of financial products to their clients. Their insight of the low income customer of Azerbaijan will certainly help them in selling insurance more effectively. Goo business as well as social value can be attained by converging microinsurance and microfinance in Azerbaijan. A detailed note on how microinsurance and microfinance can be converged at the strategic as well as operational level is given in Appendix 4.

III. RECOMMENDATIONS AND ACTION PLAN FOR DEVELOPMENT OF MICROINSURANCE

1. Moving Forward

a. **Creating an Enabling Policy and Regulatory Environment**: Global experience has proved that regulation can play a vital role in market development. In nascent markets like Azerbaijan regulation has a bigger developmental role as compared to its supervisory function. Developing insurance for the low income segment needs nurturing from the demand as well as supply sides. Towards this regulators have to go much beyond their conventional roles of supervision of supply and distribution side players. Regulators around world have adopted various approaches to enable demand creation and promote effective supply of insurance to the low income households. Beyond insurance regulation, other financial service regulators as well as the larger policy making mechanisms of governments also tend to exercise influence on microinsurance development in the country. These approaches are implemented using various legislative, regulatory and policy level tools. A synthesis of various approaches and tools is given below.[30] A regulatory approach is defined as a specific combination of regulatory and supervisory tools designed to achieve a series policy goals via a specific level of state intervention within a defined product market or across a number of product markets to facilitate access to insurance**.**

   i. *Public Provision Approach:* This approach recognizes the inability of commercial markets to reach out to the poor segments of the society on account of which the state takes over the responsibility of providing insurance coverage to them. This approach may also adopted in combination with other approaches in order to cater to the ultra-poor sections of the society. Social insurance is often employed as a tool to implement this approach. Direct premium or claims subsidies, state entities getting actively engaged in carrying risk or even intermediation and automatic enrollment of population below the national poverty line are examples of this approach. Coordination issues among various ministries and departments involved, implementation problems, fiscal sustainability under-utilization of products due to lack of awareness and promotion and crowding-out of market based insurance are some of the issues to be dealt with under this approach. Agricultural insurance in China, national health insurance in India and PROAGRO-MAIS in Brazil are examples of this approach.

   ii. *Directive Approach:* This approach is generally adopted where commercial insurance markets have reasonably developed and have the financial as well as logistical capacities to reach out to the excluded segments of the society. Legislative or regulatory directives to market players to underwrite specific risks or specific market segments on a mandatory basis are an example of this approach. Obligations or targets are often fixed for market players to be attained in respect of a pre-defined group of customers or products. Normally these

[30] Adopted from Regulatory approaches to inclusive market development – Cross country synthesis paper 2', Jeremy Gray, Hennie Bester, Christine Hougard and Mia Thom, Access to Insurance Initiative, 2014.

targets are expressed in terms of minimum number of policies, lives to be covered or premium to be collected in respect of the target groups / products. The targets are often expressed as a percentage of total business underwritten by insurers. Failure to accomplish these obligations or targets may result in action like public censuring, penalties or even de-licensing. The insurance supervisors in such cases have to adopt off-site and on-site surveillance tools to implement this approach. Adequate checks and balances also need to be adopted to ensure that market players do not circumvent the obligations. In India this approach has been adopted through a system of Rural and Social Sector Obligation of Insurers. In South Africa the market players are made to sign a Financial Sector Charter to implement the Black Empowerment Policy

iii. *Concessionary Regime:* This happens to be one of the more sophisticated approaches towards microinsurance market development. It envisages creation of incentives for market players (as opposed to obligations) to enter into a relatively 'difficult' market segment through the adoption of the principle of proportional regulation. Incentives could range from creating a separate tier of insurers for microinsurance, allowing mutual and cooperatives to formally enter the insurance market with lower capital and solvency requirements, carving out a separate regulatory dispensation for microinsurance within the framework of apex insurance legislation for mainstream insurers and relaxing norms for qualifications of intermediaries for rural and social sector business. Tax incentives like exemption of defined category of microinsurance products from value-added tax (VAT) or similar indirect tax and / or exempting insurers from profit / income tax on the microinsurance business underwritten by them, can also be adopted. This approach is also adopted in markets that have a large number of informal players offering insurance or insurance like products and services. Relaxed prudential norms are used to attract such informal players to the regulatory fold. At some point the second tier insurers may graduate into full-fledged insurance companies subject to normal prudential requirements. The Philippines is a very good example of this approach where a large number of cooperatives were already offering risk coverage to poor households. They were allowed to form Mutual Benefit Associations (MBAs) subject to a separate set of regulations. Similarly South Africa is also ready to implement dedicated microinsurance regime with a view to regularize various burial societies offering funeral insurance.

iv. *Nudge Approach:* This is another soft approach towards microinsurance market development generally adopted in more mature markets. The underlying philosophy driving this approach is that hard approaches often distort the market and unless market players do microinsurance for its own sake without compulsion or concession, genuine market development will not take place. Regulators therefore adopt a relatively hands-off strategy under this approach and merely concentrate on creating macro level enablers rather than imposing stipulations or offering concrete concessions to the industry players. Here it is assumed that regulatory requirements are not too stringent to warrant concessions and the market players are mature enough to undertake responsible finance practices on their own. Being soft in nature this approach runs the risk of little impact in terms of mainstream insurers moving downstream and hence is usually adopted in combination with other approaches. Colombia has laid down policy contours for broader financial inclusion that includes insurance without imposing mandates on the industry through its Opportunity Banking Policy launched in 2005. Similarly in Thailand, a Microinsurance Framework was adopted in 2011 under the second Financial Sector Master Plan. This Framework was adopted in close consultation with the insurance industry which has voluntarily undertaken to promote products under this Framework.

v. *Long Term Market Development Approach:* This approach virtually adopts a 'wait and watch' policy and chooses to allow market and regulatory capacity to develop before looking at the more difficult low income market. The underlying rationale for this approach is that it would be unviable or unreasonable to expect insurers to venture into the low income market, either through incentives or mandates. Highly nascent markets like Mongolia and East Africa have adopted this kind of an approach.

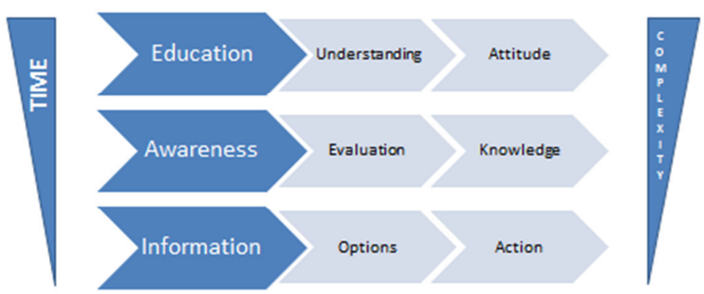
b. Regulatory approaches and tools can go a long way in shaping the future of microinsurance. Globally, regulators are rising to the occasion and coming out with solutions that best match their respective context. Macroeconomic outlook, country's fiscal position, overall business environment, the phase of development through which the local insurance industry is passing, poverty levels in the country, social security system, the country's overall policy on financial inclusion and the nation's governance ideology are some of the factors that determine regulatory approaches to microinsurance. The key message is that a long term view has to be taken while adopting policy and regulatory approaches to microinsurance.

c. **Demand Side Interventions**: Unlike the banking and microfinance sectors, the demand side and its perceptions on risk and insurance are quite critical to the development of the insurance sector. No matter how good or 'actuarially fair' a product is, it won't sell unless it matches the perception of clients. An insurance contract carries a promise of a guarantee (in case of term life insurance) or indemnity (in case of property and liability insurance) which is contingent upon the happening of an insured event that may or may not occur. This makes the acknowledgement of value for insurance very difficult in the eyes of the average consumer. A sizable portion of the insurance business in many markets, therefore, is comprised of mandatory covers such as motor third party insurance, credit life, etc... This reliance on mandatory insurance is the reason behind a lack of latent demand for insurance. In the context of Azerbaijan, the mandatory side of insurance market is already being accomplished through covers like motor third party and property insurance. There is also discussion to include health insurance as a mandatory cover going forward. Hence, from a strategic market development perspective, efforts need to be made towards increasing the share of voluntary insurance through consumer education and marketing.

d. Consumer education is defined as a process of developing and enhancing skills and knowledge to make informed and well-reasoned choices that take societal values and objectives into account[31]. The key concepts of consumer education include informed choice, developing value systems, recognition of responsibilities and rights and wise decision making. The purpose of consumer education is to equip the consumers with necessary skills, knowledge and tools so that they understand their needs and can choose the right products that address those needs. In the context of insurance, the purpose of consumer education is to educate the consumer as to why, what, where, when, how and how much to buy and how to use what they have bought. Due to poor risk perceptions people generally do not want to buy insurance (why), if they do perceive risks properly they do not know what kind of insurance products are available (what). Furthermore, they may not understand what is the right time to buy insurance(when), what are the options and what is the process to be followed (where, how and how much). Lastly, after buying insurance, they may not be able to file a claim, if the occasion arises, for want of information on claims processes (how to use).

e. Because of these factors, the consumer education process for insurance has to be much more scientific and comprehensive as compared to other products and services. Insurance consumer education would entail education, awareness and information. Education addresses the behavioural part that precludes people from buying insurance; awareness corrects the lack of knowledge about insurance products and insurers while information supports access to services (Figure 13). It is essential to understand the difference between education and literacy. While the former is aimed at changing the behaviour, the latter merely provides information. Many education campaigns on insurance as well as other financial services only emphasise on the literacy piece.

Fig. 8: Consumer Education Process



f. There is now enough academic evidence suggesting acute behavioural anomalies on the part of average consumers while making decisions in uncertainty. The prospect of buying insurance involves an evaluation and thereafter selection among 'bad choices'. The consumer has to evaluate the trade-off between a sure chance of losing a small amount of

[31] Consumer Education: Policy Recommendations of the OECD's Committee on Consumer Policy (www.oecd.org).

money (premium) and a rare chance of facing a big loss (the risk covered by insurance). When confronted with such bad choices, loss aversion induces status quo. Immediate losses loom larger than potential gains (or protection against losses). Absence of certainty about the 'benefit' of insurance prompts avoidance of purchase. Again, because of the endowment effect, the pain of paying the premium (real and immediate) is much more than the pleasure of protection against a potential loss (distant and contingent) that may never occur[32]. Thus people become risk-averse when it comes to choosing among good options (gains) but risk-takers when it comes to selection between bad choices (losses).

g. Effective consumer education can help in correcting these behavioural anomalies over a period of time. People have great difficulty evaluating low-probability risks, but they do a great job when the data are presented in the context of risks that they understand. Probability of loss is also easier to understand when a longer time frame is utilized to characterize the likelihood of the occurrence of event. Determining how to deliver this information is more of a challenge. People may not want to see more information if they have already decided that the risk is of low concern. So effectiveness of communication depends on whether people are motivated more by loss probabilities or by the consequence of a loss[33].

h. These complexities only enhance the need for a well-designed and sustained consumer education effort. Consumer education is a process and not a product and therefore has to be carried on for a longer term by all stakeholders in the sector in a coordinated manner. A lot of planning and investment may be required in the beginning. Different interventions may be required at the macro, meso and micro levels. An illustrative consumer education framework indicating objectives, types of stakeholders involved, activities, tools, monitoring mechanism and impact indicators is annexed herewith in Appendix 2. Such a framework will enable focused planning, implementation and review. Keeping in mind the nature and scale of the exercise and also the kind of investment involved, it may also be a good idea to integrate consumer education for insurance with overall financial education in varying proportions at all the three levels. Better synergy can be obtained this way. In the context of Azerbaijan, since the overall literacy levels are high, imparting financial / insurance education may be relatively easier and quicker with better chances of impact.

i. Apart from the sizable investment and number of stakeholders involved, cultural, linguistic, demographic, social and technological considerations also significantly influence the design and implantation of consumer education campaigns. An exercise involving such high stakes has to be strongly focused on impact. Towards this, an approach of undertaking baseline, mid-line and end-line studies and rollout through pilots can be adopted.

j. In Azerbaijan the SISS has already developed some consumer education material which is being distributed to consumers. While this is a welcome effort from the regulator, there might be a strong case of scaling-up these efforts with concrete financial / insurance inclusion targets to be achieved in a particular time frame.

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[32] Thinking Fast and Slow, Khaneman Daniel, Allen Lane, 2011, ISBN 978-1-846-14606-0

[33] McMorron, Insurance and Behavioral Economics, Improving Decisions in the Most Misunderstood Industry, Kunreuther, Pauly, Cambridge University Press, 2013, ISBN 978-0-521-60826-8.

k. **Engaging the Insurance Industry:** It will be difficult to develop microinsurance in Azerbaijan without the active involvement of risk carriers. As mentioned earlier a large part of the insurance industry has settled into a niche of their captive business sources. Only some insurers seem to be trying to develop retail channels of business. Developing the microinsurance business would require the presence of a retail culture within the insurance industry that can drive things like product development, process design and building diverse distribution channels that target retail business. SISS and AIA can play an important role in this direction by nudging the insurers in this direction.

l. Simplicity has to be the key feature of all microinsurance products. The list of exclusions and conditions should be kept at bare minimum so that the product can be easily explained by the distributors. The underwriting process should be short and simple. And above all the price should be affordable to the target population. Some of the product categories that can be developed with all these features in mind are discussed below.

   i. *Pre-underwritten products* are aimed at overcoming enrolment barriers that often prevent people from buying insurance. For such products the agents can carry pre-printed policy forms that can be given to the customers at the point of sale itself. Policies can also be issued online by selected agents and brokers through web portals connected to the servers of the concerned insurer. This way the hassle, costs as well as time involved in policy issuance can be reduced and more importantly, the customer gets the satisfaction of having a policy document instantly. Simple life insurance, personal accident insurance and household property insurance are some categories for which pre-underwritten products can be designed. Similarly, for simple risks like household dwellings, a first loss cover without the application of pro-rata average clause can also be designed.

   ii. *Long-term products* can be designed for motor third party, household property, mortgage and personal accident covers. Most of the non-life products are annual renewable policies. Long term policies where the nature of risk is not likely to alter over a period of time, offer assured annual renewals as they eliminate the chances of dropouts as a result of cognitive dissonance. Hassles and costs involved in chasing renewals every year are also saved. Moreover, since the premium is charged upfront for the entire policy duration, such policies can be relatively cheaper then annual policies. Single premium long term life policies are also preferred among the low income clients. Long term products enable the development of a long term outlook among the consumers which is so vital from a conceptual understanding point of view. Long term framing enable insurers to present the likelihood of a low-probability event occurring during the term of the policy. Individuals are then more likely to take into consideration what the consequences of such an event would be[34].

   iii. *Package or bundled policies*, again for simple risks offer coverage against multiple risks through a single contract. Individuals, households and enterprises are often exposed to multiple risks relating to human life, property and liability. Therefore it makes sense to offer a single policy covering all such risks as

[34] Ibid.

opposed to separate policies. On one hand it results in spreading of policy administration costs over multiple covers thus attaining price efficiency and on the other, it ensures diversification of risks for the insurer at the product level. The salespersons have more things to showcase to the consumer. In this case one approach could be to bundle more than one exposure in a single policy, like building, furniture, personal accident, personal liability, etc. Another approach is to cover a single exposure against multiple perils (all risks cover). A fusion of both these approaches can also be considered. Homeowners, shopkeepers, small enterprises, eateries and food joints are some market segments to be targeted for such products.

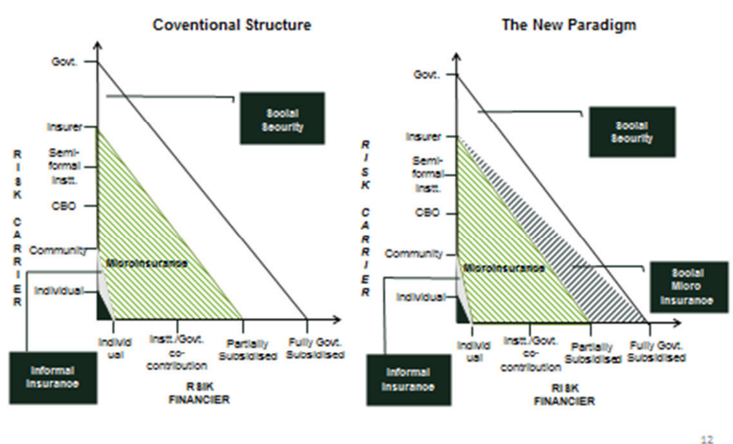
iv. *Group policies* carry similar advantages in terms of costs and pricing. Since they are generally sold to groups having homogenous risk profiles, they can be more accurately and fairly priced. They also promise big volumes. While most classes of group insurance are prevalent in Azerbaijan, group savings linked life insurance (GSLI) is an area that can be focused upon, especially for MFI clients. GSLI products can be offered to MSMEs, affinity and cultural groups. These products can be positioned as additional social security and in case of formal groups like employees, they can also be offered fully or partly as perquisites (perks) by their employers. Such products can also spur the formation of a long term savings outlook among masses that can then translate into purchase of individual long term life insurance. Group approach can also invoke insurance penetration among the low income segment as selling individual products to this segment is anyway challenging from a distribution perspective.

v. *Portfolio Insurance for Banks / MFIs* can be a type of group insurance product offered to banks and MFIs. A separate product can be designed for every credit line or product of the bank/MFI. For example life insurance coverage for personal loans, asset insurance cover for SME loans, cattle insurance cover livestock loans. Instead of issuing individual policies, a single group policy can be issued to the bank with a single sum insured that represents the loan portfolio of the bank. During the currency of the policy the sum insured can be adjusted periodically based on the fluctuations in the loan portfolio by charging / refunding premium on a pro-rata basis. The bank can either charge the client separately or factor the premium in the loan instalment.

m. Exploring alternative distribution channels has been one of the primary areas of focus for microinsurance development across the world. Tie-ups with MNOs under which any individual buying talk-time (prepaid recharge) gets an automatic personal accident cover, depending upon the value of recharge, is one of them. This way, the insurer gets access to thousands of customers at no effort and the same can then be converted to other product lines. The MNO gets a competitive advantage by offering a ‘value-addition’ to its core service of telecommunications. Since individual policies are not to be issued and regular volumes are assured, pricing can be done most efficiently. And there is no scope for adverse selection. Similarly, in another market a fertilizer manufacturer offers free personal accident insurance to farmers with every bag of fertilizer bought. Consumer durable goods manufacturers offer free insurance with sale of their goods. Many more such ideas can be explored and tried in the context of the local market conditions. It is possible that some such innovations may have been tried out in Azerbaijan but the point is that insurers need to keep striving for avenues that can serve as win-win situations for them as well as the potential partners.

n. **Identifying the Role of Social Insurance**[35]: Over the past few years, social insurance as a novel instrument of providing protection against various risks to the poor households, has gathered momentum with governments becoming active in this space in several emerging markets. Since most of the social insurance schemes carry substantial (if not full) premium subsidies and their enrollments are either automatic or supported actively through government structures, they have been able to achieve good scale in terms of people and property covered. In 2012, it was estimated that against 170.4 million lives/property covered under contributory or co-contributory microinsurance, almost 1.7 billion lives/property were covered under social insurance schemes across Asia.[36] This rapid growth of social insurance across Asia, Africa and Latin America has changed the face of microinsurance (Figure 14). A part of the space that was hitherto occupied fully by voluntary microinsurance is now taken over by social insurance.

Fig. 9: The Changing Face of Microinsurance



o. As against conventional social security schemes funded by the government, a social insurance framework adopts some kind of insurance mechanism under which the risks covered are well defined, they are actuarially priced and are carried by state-owned or private insurers. The premium is partly or fully subsidized by the government and the insurance coverage is standardized across the insured population. In some cases, the government also provides claims subsidies to insurers in order to keep the premiums down.

[35] An insurance program offering protection against well-defined risks to the desired segment of the population, which has a risk carrying arrangement either through licensed risk carriers or through a special risk fund created for this purpose and which is partly or fully funded by the government.

[36] The Landscape of Microinsurance in Asia and Oceania 2013, Premasis Mukherjee, Arman Oza and Rupalee Ruchismita, Munich Re Foundation and GIZ RFPI

p. The biggest benefit of social insurance is its potential to build huge volumes. The large risk pool built as a result of this scale helps in diversifying the risk resulting in lower premiums. The transaction costs are also relatively less since the enrollments are mostly automatic. The poor households are able to use the insurance mechanism at virtually no cost. Economies of scale also justify huge investments in technology like biometric cards for each insured family which can be used for efficient claims servicing. The insurance market can then aim at cross-selling their voluntary products to households covered through them under social insurance. Hence social insurance can also be used to expand outreach of voluntary insurance. Most social insurance schemes offer health and agriculture insurance.

q. Fiscal sustainability is a big factor to be considered while rolling-out social insurance schemes, as it becomes impossible to roll them back after introduction. In many cases, poor implementation and lack of coordination among government departments can result in under-utilization of benefits by the insured population thus resulting in a waste of public money. There is also a credible possibility of social insurance crowding-out market based insurance product from the low income segment since no voluntary insurance product will be able to compete with social insurance.

r. Hence, it will be important for Azerbaijan to outline a clear role for social insurance. Social insurance can be adopted as a part of public provision approach to microinsurance development. However in that case, clear definition of products as well as the market segment to be covered under this approach needs to be adopted. In other words, market segmentation between social and voluntary microinsurance has to be clearly laid down so that one does not encroach upon the other any time in future. Secondly clear ownership of one or the other government department needs to be fixed for the smooth and effective implementation of the scheme. Clear performance indicators for outreach and impact also need to be developed from the beginning. The same needs to be backed by an effective monitoring system,

s. More and more social insurance schemes across the world are now relying on effective public-private partnerships (PPPs) for effective service delivery and professional management the schemes. Private sector offers distinct advantages in terms of operational efficiency at a mass level. This can be harnessed effectively to achieve public policy goals in a more wholesome manner. Global experience on PPPs in social insurance indicates that the clear alignment of public policy goals and private sector objectives, laying down roles and responsibilities and developing an enabling legal and regulatory framework wherever necessary can go a long way in using insurance as an ally in achieving public policy objectives.[37] Hence for example, private sector expertise can be used in areas like product design, reinsurance, data management, claims servicing, consumer education and promotion, etc. At a larger level, a common technology platform can be created through a private enterprise that supports the information technology part of the social insurance program and also works as a national depository (database) for all insurance products that can be used for other purposes like social assistance payments and so on.

[37] Making Public-private Partnerships Work in Insurance, Miguel Solana, ILO's Impact Innovation Facility.

2. Recommendations

a. Short to Medium Term Initiatives

i. Better engagement between insurers and MFIs through active involvement of AIA and AMFA. This will increase the chances of tie-ups between them.
ii. The SISS can urge the insurers to develop some microinsurance products and test them in the market (nudge approach). This will induce some activity in the market.
iii. Regulators (SISS and CBA), industry associations (AMFA and AIA) and market players (insurers and NBCIs) can plan small events like workshops, road shows, etc. on concept of insurance. Mass-media coverage on the importance of insurance can also be increased. This will create some awareness among masses.
iv. Insurers and NBCIs can partner for some pilots on specific insurance products of their mutual choice. This will help them in gaining experience of an unexplored market.
v. A baseline research aimed at assessing the current attitudes to towards risk and insurance can be initiated. This will form basis of policy and regulatory review for future.
vi. Work can begin on a comprehensive regulatory review on creating an enabling environment for microinsurance. Various regulatory approaches discussed above can be considered to formulate a broad regulatory strategy.
vii. Work can also commence on framing a long term insurance education strategy which could be a part of the overall financial inclusion strategy. Strong focus on creating a multi-stakeholder structure and impact parameters to be maintained.
viii. Insurers can start investing in developing alternative distribution channels, especially through the MNO channel.
ix. A review of social insurance strategy at the national level covering the long terms policy on social insurance, performance of current social insurance programs, creating appropriate structures for future schemes, suitable engagement of private sector, creating legal and regulatory frameworks, etc.
x. Capacity building of regulators for an expanded developmental role and more effective supervision through IT platforms.
xi. Capacity building of market players on market development strategies, building cost-effective IT systems and overall management aspects of rating, product development, process design, sales, marketing and distribution channel development.

b. Long Term Initiatives

i. Based on the outcome of the regulatory review, make suitable amendments to insurance regulations that could include mandatory microinsurance quota (directive approach) and /or concessions for microinsurance (concessionary approach).
ii. The concept of a ‘micro-insurer’ can also be promoted by creating separate / relaxed regulatory norms for insurers exclusively involved in microinsurance. In

this connection the concepts of mutual, cooperative and takaful insurers can be included.

iii. Based on the outcome on insurance / financial education, begin implementation through a harmonized structure involving various stakeholders in line with the macro, meso and micro level consumer education framework. Monitor results and take corrective action through tools like regular M&E systems as well as midline and endline studies.
iv. Expanding the scope of consumer education on insurance by including appropriate curriculum on risk and insurance at school and college level.
v. Based upon the evolution of strategy on social insurance, creation of appropriate structures and entering into suitable partnerships with private sector.
vi. Creating social insurance as a base on which the mainstream insurance sector can build and expand their market base.
vii. Creation of common platforms like insurance repositories (depositories) and national payment systems that can serve the needs of social insurance, private insurance as well as other social schemes through active partnerships with private sector.
viii. Consider the creation of a national or even a regional reinsurer on PPP basis with a view to retain risks within the country / region as well as enable the development of cost-effective products.
ix. Focus on creating physical infrastructure to support cost-effective insurance service delivery like setting-up of rain-gauges across the country to gather weather data on a long term basis that will support products like index-based weather insurance, livestock health facilities for promoting livestock insurance, etc. Apart from insurance this kind of infrastructure could also support other businesses or activities. Again a suitable PPP model can be planned for this kind of infrastructure development.

Appendix 1
Terms of Reference

Contract : 119237-S84776
Project : TA-8621 AZE: Microfinance Sector Development (Microinsurance Specialist) (46536-001)
Expertise : Microinsurance Specialist
Source : International

Objective and Purpose of the Assignment

The technical assistance (TA) supports the Government of Azerbaijan enhance its understanding of inclusive financial services, and the need for a strategy for growth. A strategic approach for financial inclusion includes an assessment of existing services, needs and potential for new services such as microinsurance, remittances and payment services. The TA will support the preparation of a National Financial Inclusion Strategy and strengthen the regulatory practices that will facilitate responsible market growth and better outreach.

Scope of Work

The consultant will work with the insurance supervision authorities and other stakeholders (microfinance association, insurance companies) to improve the conditions for the development of pro-poor insurance. The consultant will assess the existing policy and regulatory environment and the current market environment (demand and supply) for microinsurance services. Microinsurance is understood as insurance that is accessed by low-income population, provided by a variety of entities and run in accordance with generally accepted insurance practices. The consultant will prepare an assessment report and will design, discuss and agree with the authorities on an action plan for the development of the sector.

Detailed Tasks and/or Expected Output

1. The consultant will carry out the following tasks, in close coordination with the financial inclusion specialist and team leader:
    a. Assess the policy, regulatory and supervisory framework for microinsurance products in Azerbaijan and identify gaps based on international good practices;
    b. review secondary data (including http://www.microinsurancecentre.org/resources/documents/market-development/market-for-microinsurance-in-azerbaijan-low-income-household-needs-and-market-development-projections.html) on the supply and demand of microinsurance products and services for low-income households in Azerbaijan, and related financial literacy needs, including results from the 2015 ADB-funded household survey;
    c. conduct interviews with key stakeholders;
    d. identify capacity needs of government regulators/supervisors and microinsurance providers in Azerbaijan;
    e. based on international good practices identify critical factors for the success of microinsurance products (including mechanisms to improve uptake) and how these would apply to Azerbaijan;
    f. Reflect findings from (i) to (iv) in a report including an action plan for addressing capacity needs, required resources, time line, and expected benefits and impact of the development of this product.
    g. Discuss findings and recommendations and proposed action plan with relevant stakeholders (including at least 3 focus groups with consumers, one with

providers and one with government officials) and agree with the insurance supervisor on key steps for priority actions;

   h. Finalize report and action plan to be used as an input in the financial inclusion strategy and as a stand-alone knowledge product.
   i. Identify potential follow up interventions for ADB.

2. The microinsurance specialist will submit the following deliverables:
   a. an inception report,
   b. an assessment of the microinsurance market in Azerbaijan to be published as a separate knowledge product,
   c. an action plan and (iv) a project concept note.
3. The assessment report should cover at a minimum:
   a. the policy and regulatory framework,
   b. description of the market, types of products, providers, distribution channels;
   c. critical factors for the development of microinsurance (including examples for international good practices); and
   d. recommendations for Azerbaijan.

Appendix 2

Specimen Framework for Consumer Education

LEVEL	OBJECTIVE	STAKEHOLDERS	ACTIVITIES	TOOLS	MONITORING	IMPACT
Macro	To create high level awareness among target population on insurance and risk managemen t. Deliver key messages	• National Governments • International Organizations • Regulators • Insurance Industry Associations • National Consumer Associations	• Formulating consumer education strategies • Developing frameworks for other stakeholders • Forming regulation to imbibe consumer education into core operations. • Promoting dialogue among stakeholders • Funding consumer education initiatives • Monitoring impact at the national level.	• Mass media • Workshops and Conferences • National level consumer helplines. • Interactive websites for stakeholders and consumers	• Creating a national repository of consumer education initiatives at various levels • Setting standards for consumer education for various stakeholders • Mandatory reporting for market players	• Increase in uptake of insurance. • Increase in persistency / renewals at the industry level. • Longitudinal studies on impact of consumer education initiatives at various levels. • Rating and rewarding consumer education initiatives of stakeholders.
Meso	To conceive and implement consumer education programmes within the geography and demography of the respective stakeholder.	• Insurers • Large Intermediaries • State and local-self governments,	• Integrate consumer education in their business processes. • Train intermediaries for imparting consumer education. • Undertake consumer education campaigns at the field as well as mass level. • Set-up multi-lingual helplines, websites and resource centres • Actively engage local print and electronic media for consumer education campaigns. • Conduct regular action research within their respective customer base. • Develop clear, simple and vernacular policy wordings. • Establish accessible, transparent and effective grievance handling	• Insured's need assessment tools to be made a part of the sales process. • Sales brochures, policy documents, correspondence with insureds to contain critical messages. • Use customer database to regularly feed consumer education messages.. • Periodic customer surveys. • Help desks at branch locals / service points. • Introduce customer counseling through dedicated staff.	• Develop mechanisms to verify whether standard processes are followed. • Handle instances of mis-selling sternly. • Assess intermediaries regularly for developing an informed customer base and reward them. • Analyze and report grievance statistics. • Analyze and report statistics from help-desks and customer counseling.	• Increased sales. • Trends in grievance reporting. • Renewal ratio. • Increased product uptake by existing customers. • Intermediary attrition. • Brand assessment. • Impact assessment through formal and independent surveys. • Claims rejection ratio. • Increased number of calls and walk-in queries at help lines and help desks.

			systems. • Focus is on capacity building			
Micro	To deliver and impart consumer education to the end-user.	• Grassroots level organizations engaged in financial literacy. • Savings and credit cooperatives. • Insurance intermediaries	• Implementing programmes conceived and developed at macro and meso levels. • Sharing information on resources like help lines etc. and helping consumers to access them. • Developing consumer consciousness among frontline sales force. • Provide feedback to upper levels on the tools that would fit best in the local socio-economic environment.	• Carry all the appropriate tools developed at the macro and meso levels. • Develop internal processes aligned with consumer education philosophy. • Regular training of front line sales force.	• Effective reporting system from the field. • Random confirmation from clients. • Grievance monitoring. • Process control • Regular reporting system for front line sales force. • Regular assessment of front line sales force.	• Sales figures • Renewal ratio • Reduction in number of grievances • Process deviations.

Appendix 3
Microinsurance – Conceptual Basis and Global Trends

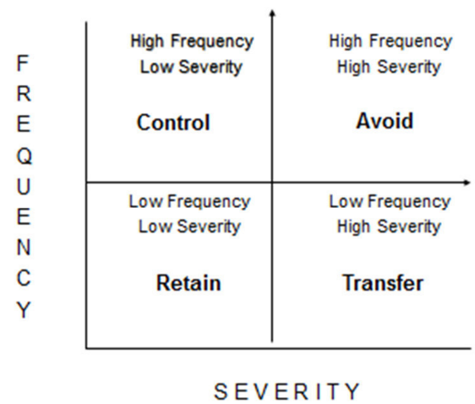
1. About Microinsurance

a. **Conceptual Basis of Microinsurance:** In simple terms, risk is the probability of a financial loss. Probability connotes the uncertain character of an eventuality to which human life property and activity is exposed. Financial loss depicts the severity of a loss-producing event. Thus every risk or loss producing event carries varying levels of probability and severity. Risk management involves identification of risks, quantifying them and adopting various risk handling techniques according to the different levels of probability and severity. Such an exercise could get complex depending upon the nature of risk exposure, but a sample classification of risks is given in Figure 7 for the sake of simplicity. Accordingly, risk retention is a better strategy for small risks that are low in frequency as well as severity. Risk reduction or control is a good strategy for risks that are high in frequency but low in severity. For risks that are high in frequency as well as severity, avoidance seems to be the best option. While financing of these risk handling techniques can be done through instruments like savings and credit, risk transfer through insurance is the only technique, aside from community risk-sharing, available for low frequency high severity risks. Insurance therefore is a risk management technique that finances risks that are rare in occurrence but carry a huge financial impact on the exposure unit.

b. The low income households, on account of their limited and often erratic income streams, become more vulnerable to all kinds of risks. Their capacity to save is low and as result their ability to borrow is also limited. As a result, quite often they end-up retaining all their risks by default. Since their risk retention capacity is also limited, even a small loss producing event can seriously disturb their finances and can even prove to be devastating. This is why the low income population needs insurance more than anybody else.

c. The economics of commercial insurance, however, operates at a different level. Commercial insurers strive to keep their claims and management costs to a minimum possible level so that they can generate maximum returns for their shareholders. This objective typically makes them design insurance products that are suitable for the middle and high income brackets of the society, to the total exclusion of the poor households. In addition, there are problems of affordability and awareness with the low income segment making access to insurance all the more difficult for them.

Fig. 10: The Risk Quadrant



d. Microinsurance as a concept, stems out of these constraints faced by the mainstream insurance sector and aims to develop credible solutions for these supply and demand side issues. The term 'microinsurance' was probably first coined in the late 1990s as it started attracting the attention of global development community. Since then its definition has kept evolving around the practice of microinsurance across the world. The International Association of Insurance Supervisors (IAIS) defines microinsurance as 'insurance that is accessed by low-income population, provided by a variety of different entities, but run in accordance with generally accepted insurance practises'. According to the Microinsurance Innovation Facility (now known as Impact Insurance Facility (www.impactinsurance.org)) microinsurance is a 'mechanism to protect poor people against risk (accident, illness, death in the family, natural disasters, etc.) in exchange for insurance premium payments tailored to their needs, income and level of risk'. In simple words microinsurance is insurance designed for the poor. This not only includes products that are affordable to the target segment and address the kind of risks they face, but also their access to these products through customized enrollment and claims processes.

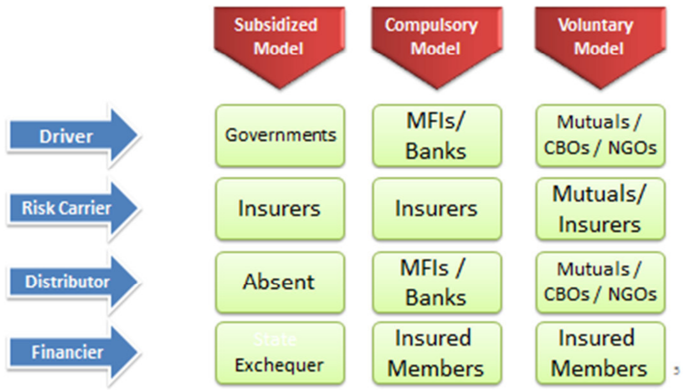
e. Inclusive insurance is a relatively new term that is often used interchangeably with microinsurance these days. Inclusive insurance refers to the market characteristics of affordable, sustainable, convenient and responsible delivery by licensed and regulated insurers and intermediaries of all parts of insurance products and services[38]. In essence microinsurance and inclusive insurance do not appear to be much different from each other. Microinsurance is a concept while inclusive insurance is an approach. Moreover, while microinsurance can include informal risk sharing / pooling mechanisms, inclusive insurance is about formal insurance supply. Some of the main distinctive features of microinsurance vis-à-vis commercial insurance are highlighted in Table 1

[38] Application Paper on Regulation and Supervision supporting Inclusive Insurance Markets, IAIS 2012

Table 1: Distinctive Features of Microinsurance		
Feature	Commercial insurance	Microinsurance
Approach	Supply-driven	Demand-driven
Strategy	Push strategy	Pull and push strategy
Revenue Model	Low volume high margins	High volume low margins
Marketing	Direct and distribution channels	Distribution channels only
Products	Specialized, flexible and complicated	Standardized, less flexible and simple
Coverage	Single risk, indemnity-based and comprehensive	Bundled, parametric complementary
Underwriting	May involve financial, medical and risk-specific underwriting	Pre-underwritten
Policy Administration	Individual, customized and centralized	Group, standardized and de-centralized
Claims Administration	Intensive, controlled and costly	Timely, delegated and cost-effective
Overall Consideration	High profitability	High outreach

f. **Microinsurance Models**: Microinsurance practice of almost one and a half decade across the developing world has tried many different approaches and models in terms of products, models, distribution channels, processes, use of technology as well as value added services like preventive healthcare. As a result of this hectic activity, largely supported by international donors, the sector now has some good insights on various microinsurance models that can be implemented along with their strengths and weaknesses. Broadly three models have emerged (Figure 8). The compulsory model emerged out of piggybacking of insurance with a fast moving micro-credit product. Mainly credit life and index based weather insurance products are offered under this model. The active involvement of governments in the social security space of the world's emerging markets has given birth to the subsidized model. Again this model comprises mainly of term life, health and agriculture insurance covers offered to the ultra-poor households. A substantial part of the premium (if not the full) is subsidized by the government. Lastly, the 'voluntary' model promotes microinsurance through hard-selling, much like the mainstream insurance and which currently commands only a modicum proportions in the sector.

Fig. 11: Microinsurance Models



g. The practice of all the three models has yielded its own set of strengths and challenges. All models have demonstrated varying levels of performance on various financial as well as social parameters (Table 2). Since the primary aim of compulsory model is to reduce the credit risk of the MFI / bank the benefits of insurance are not quite felt by the borrowers and hence such products often enjoy a low client value. To some extent, this also happens on account of lack of transparency and education. In order to overcome this criticism, many MFIs started offering 'credit life plus' covers where a part of the benefit also accrues to the nominee of the deceased borrower. Under this model, the product offerings have by and large restricted to credit life kind of products and the outreach has been mostly limited to micro-credit clientele. Despite these limitations this model has succeeded inoffering insurance to a large number of people globally. It has provided a good first-hand experience of insurance to the poor households.

h. The subsidized model has succeeded in other countries in attaining sizable outreach in a short span of time. However, big and quick volumes also come with their share of problems at the service delivery level. Lack of information and facilitation at the ground level and absence of effective monitoring mechanisms are some of the challenges this model is grappling with. It will be a while before such schemes settle down and demonstrate tangible impact on the risk profile of the target population. Moreover, the fundamental questions concerning their fiscal sustainability also remain.

Table 2: Overall Performance of Microinsurance Models

Parameter	Subsidized Model	Compulsory Model	Voluntary Model
Scale	High	High	Low
Client Value	Low	Low	High
Sustainability Potential	High	High	Low
Renewal Rates	Low	Low	High
Utilization	Erratic	Stable	Stable
Vulnerability to Adverse Selection	Low	Low	High

3

i. The sacrifice in insurance is real and immediate while the benefits are distant and contingent. While this makes voluntary microinsurance arduous, it also means that the positive impact of insurance on the society will be apparent only over a period of time. This is possible only if people continue to remain insured for longer periods. Voluntary model by its very nature contains an in-built imperative to promote sustained insurance purchase, thus offering better chances of having positive impact on vulnerable populations. Due to these features, voluntary microinsurance is likely to remain an area of interest in the years to come, notwithstanding its inherent problems of scalability, financial viability and mis-selling, besides the inability to offer inorganic growth. Expanding outreach among the low income populations beyond the captive catchments of compulsory and subsidized models will impel a persevered endeavour on the voluntary side.

j. **Global Trends**: Microinsurance as an activity started as an extension of microfinance with a primary goal of reducing the credit risk of the lending organization. The scope of microinsurance has since then, gone much beyond credit life coverage to diverse risks like health, agriculture, property, livestock and also savings-linked life insurance. Many innovations in terms of product design, distribution channels, payment mechanisms and claims processes have been tried and tested across the world. Essentially, factors like local socio-cultural context, interest shown by the insurance industry and regulatory environment have influenced these innovations and have been responsible behind the success or failure of these innovations and approaches. A high level synthesis of these global learning is given below.

    i. *Products*: Health insurance has been the centre of attraction in microinsurance circles globally. Health risks are more frequent as compared to life or property and hence are more perceptible in the eyes of consumers. Moreover, it has been established time and again that adverse health episodes are often responsible for pushing people into poverty. Hence apart from the conventional reimbursement products for hospitalization, many organizations have tried to include benefit (non-indemnity) covers for critical illnesses and fixed daily allowances in case of hospitalization. In some cases, coverage has also been granted for primary or outpatient which is generally one of the main exclusions of a standard health insurance product. While micro-health insurance carries a better social value, there have been problems with its sustainability. Handling adverse selection and moral hazard, high servicing costs, alignment with healthcare providers and over-utilization have been some of the challenges facing micro-health insurance. [39] In insurance, many times the customer's perception of value is much different from the real value a product offers. The same is reflected in the case of life microinsurance where people prefer conventional endowment type of products that offer lower returns against low risk, as against linked products that invest the corpus in capital markets that often generate higher returns in the long term. Studies suggest that even subtle 'de-biasing' through information messages is not enough to change this behavior.[40] Product design in microinsurance therefore has to match the 'preferences' more than the 'needs' of consumers, in order to be commercially successful.

ii. *Distribution*: The importance of distribution in microinsurance has already been highlighted earlier. In case of microinsurance where the ticket size (premium) is small and volumes limited, selling often becomes an unattractive preposition for the distributor. Sourcing the right distribution channel and developing the same has therefore been an important aspect. A better strategy here has been to ride on an existing channel like MFIs or banking correspondents for microinsurance distribution. An insurer in Brazil who also has a leading bank in its group has leveraged upon more than 47,000 banking correspondents of the bank to sell personal accident and funeral insurance.[41] The key factor here is the ability of insurers to understand the mindset of the existing channel and customize their products accordingly. On the other hand, passive selling has also been tried rigorously in some part of the world. Mobile phones have been extensively used not only to sell insurance but also for consumer education, payment of premium and claims servicing. Many MNOs offer insurance as a value added service to their customers along with every airtime recharge made by them.[42] Intermediaries are being core and used not just for selling insurance but also for offering other services like preventive healthcare, risk reduction services for agriculture, collecting population data and so on.[43]

iii. *Technology*: Rapid developments in information and communications technology have also been leveraged by the microinsurance sector. Livestock insurance is a relatively difficult product considering the high cost of identification of insured

[39] Making health microinsurance work: 10 recommendations for practitioners, ILO's Impact Insurance Facility.

[40] Can debiasing provided over the internet improve customer financial decisions? Evidence from experiments on life insurance decisions from India and the U.S. Santosh Anagol, Shawn Cole and Laura Litvine, ILO's Impact Insurance Facility

[41] Case Brief: Bradesco Seguros, Miguel Solana and Alice Mary, ILO's Impact Insurance Facility.

[42] Mobile phones and microinsurance, Pranac Prashad, David Saounders and Aparna Dalal, ILO's Impact Insurance Facility.

[43] Beyond sales – new frontiers in microinsurance distribution, Anja Smith, Herman Smith and Doubell Chamberlain, ILO's Impact Insurance Facility.

cattle as well as the claims processes. Instances of moral hazard in livestock insurance have resulted in product failures in many markets. An insurer in India started using radio frequency identification device (RFID) to tag the insured cattle, with a view to reduce the scope of moral hazard. It also uses mobile applications for enrollment and claims verification in order to reduce transaction costs. Moreover, RFIDs can also be enabled for other applications like monitoring cattle's health and prevention of diseases.[44] In health insurance the use of biometric smart cards, especially by some of the social insurance schemes has not only helped in identifying the insured population easily but has also enabled services like cashless hospitalization to the low income segment in an efficient manner and eliminating labour intensive manual processes. For products like savings-linked life insurance involving frequent premium collections, some organizations have developed mobile applications for their intermediaries that can register payments instantaneously and issue receipts to customers on a real time basis. Jurisdictions that allow payment through mobile phones have offered these applications to customers so that they can make premium payments directly.

iv. *Financial Viability*: Microinsurance often becomes a tight business model – both for the insurers as well as intermediaries. For insurers the challenge is to offer good value to the low income customers and keep the claims costs under control, at the same time. Experience has shown that if sufficient volumes are generated and distribution channels are used optimally, microinsurance can become profitable for insurers.[45] Similarly on the distribution side, it is easier for intermediaries taking-up microinsurance as an additional activity to become financially sustainable. For standalone microinsurance intermediaries, the model becomes tighter and financial viability will require calibrations on sales-mix, operational burden, keeping distribution costs under control and above all developing a sales culture within the organization.[46]

k. **Managing Scale Sustainability and Client Value**: The huge body of knowledge created as a result of microinsurance practice across Asia, Africa and Latin America clearly underlines the need for sustainability of microinsurance programs. Sustainability is an imperative for any business but it is more so for microinsurance because the social as well as financial benefits of microinsurance for policyholders, distributors as well as insurers are apparent only over a period of time. Insurance is anyway a long term business and hence can be done only if it is sustainable for long periods. Scale and client value are the two critical drivers of sustainability. On one side, scale can be attained only if sufficient client value is perceived by the buyers while on the other hand, client value can be built only if sufficient scale is available. However, it has also been observed that more often

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[44] A case for livestock insurance, Aparna Dalal, K. Gopinath, Sarfaraz Shah and Gourahari Panda, ILO's Impact Insurance Facility.

[45] Business case for microinsurance part II: Follow-up study on the profitability of microinsurance, Janice Angove, Aparna Dalal, ILO's Impact Insurance Facility

[46] VimoSEWA's resurgence: Increasing outreach and managing costs in a voluntary, standalone microinsurance programme, Arman Oza, Aparna Dalal, Jeanna Haltz, ILO's Impact Insurance Facility.

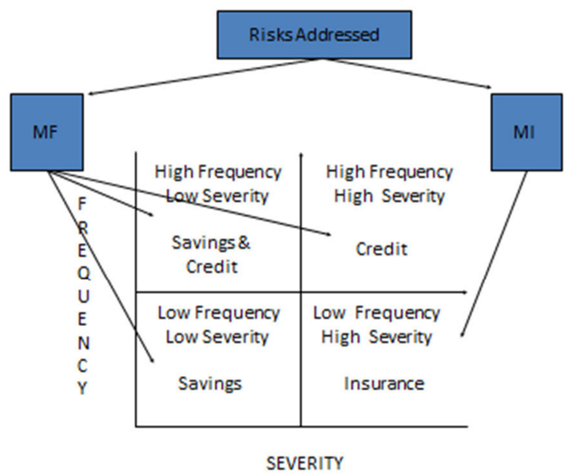
one comes at the cost of another. Focusing on client value through things like value added services, comprehensive coverage and active consumer education tends to compromise scale while targeting scale through compulsory or automatic enrollments ends-up in lower client value. Discovering the ‘right’ balance between these two financial and social goals is the key success factor for microinsurance (Figure 9). This is the foremost learning from microinsurance practice around the world.

Fig. 12: The Right Balance

Appendix 4
Convergence Between Microinsurance and Microfinance

a. Microfinance has seen an inorganic growth in most parts of the world over the last decade or so. Today, it is one of the sectors that have been able to offer sustainable and scalable social business models and hence has successfully demonstrated social as well as business value. Microinsurance as a financial service should have been an obvious extension to the savings and credit services offered by MFIs across the world. Conceptually, a proper convergence between microfinance and microinsurance could deliver better value to clients in terms of their improved risk profiles – both at the individual as well as community levels. Savings, credit and insurance clearly address different kinds of risks faced by poor households (Figure 11). As mentioned earlier, retention of low frequency low severity risks requires some cushion in the form of

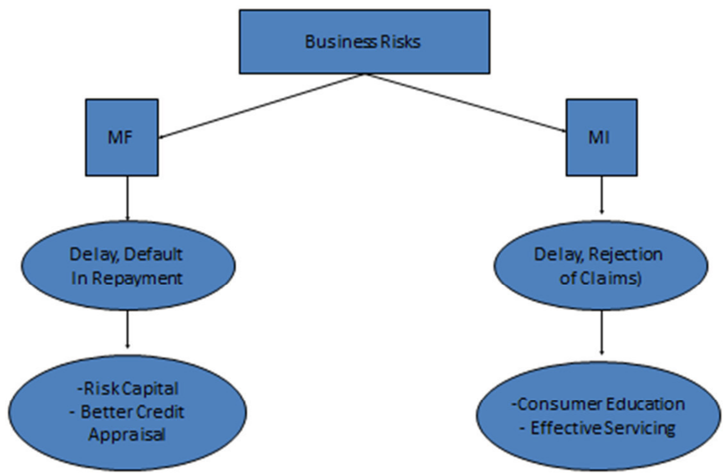
Fig. 13: Risks Addressed by MF and MI



savings. Risk reduction of high frequency low severity risks like outpatient care through preventive and healthcare is also best financed through savings. Avoiding high frequency high severity risks like those involved in activities like marginal farming need to be addressed through avoidance strategies like developing alternative livelihoods which can be financed through a mix of savings and credit. And the ideal instrument for handling low frequency high severity risks like sickness and natural disasters is insurance. It is only when all these categories of risks are effectively addressed that a poor household can hope to improve its risk profile and come out of poverty eventually. An improved risk profile of communities not only demonstrates good social impact but also carries a business value for service providers. As the risk profiles improve, people will be able to obtain bigger loans, will save more and may also buy higher value insurance products. Microfinance and microinsurance together can therefore deliver good value for customers as well as providers.

b. Alongside the areas of convergence, there are also certain striking areas of divergence between microfinance and microinsurance (Figure 12). Despite being a part of the same financial services sector, both are strategically as well as operationally different from each other. Credit is a fast-moving product with high demand and therefore requires very little marketing effort. As against this there is hardly any latent demand for insurance making it a hard-selling business. Moreover, the consumers' perception of credit and insurance could also be fundamentally different. In insurance, the sacrifice (premium to be paid) is real and immediate while the benefits (claims) are distant and contingent. The equation is exactly the opposite with credit, where the benefit (loan disbursement) precedes sacrifice (loan repayment). This is bound to create totally different expectations and impressions in the minds of consumers. This also creates a fundamental cultural difference on the supply side.

Fig. 14: Cultural Differences Between MF And MI



c. Coming to the business angle behind integrating microfinance and microinsurance, it is clear that this would offer the MFI to diversify its revenue model from a purely fund based activity to a fee based activity as well. The benefits of revenue diversification are too well known. Multiple revenue streams obviously limit the bottom line exposure of an organization to crisis like situations in one area, like the recent abrupt devaluation of local currency in Azerbaijan. Secondly, micro-credit is a capital intensive business and the business will most likely peak-out once the MFI has exhausted all its sources of capital. Microinsurance offers the MFI to expand its business and revenues horizontally without infusion of additional capital. Well-planned integration of microinsurance and microfinance will also create synergy in terms of optimization of transaction and human resource costs, thereby optimizing the net margins for the organizations. This could come in handy when the margins come under pressure on account of competition.
d. Apart from these general benefits to an MFI, distribution of savings-linked life insurance can offer certain specific advantage to MFIs. The basic objective of savings-linked life insurance products is to accumulate savings through regular premiums along with the coverage against natural or accidental death of the insured person. Long term savings-linked life insurance products therefore are widely used to fund known life-cycle commitments like children's higher education and marriage. During the currency of such policies, the policyholder can use it as collateral to obtain a loan by assigning that policy to

the lending entity to the extent of the corpus built under the policy (known as paid-up value of the policy). Thus an MFI can easily grant loans against such policies at no risk at all, thus reducing the share of unsecured loans in their portfolio. Savings linked life insurance policies distributed through MFIs can also work as informal checks against loan default thereby reducing the risk on the overall credit portfolio. This kind of strategy can effectively nullify the limitation of not being able to accept deposits, faced by MFIs. As has been pointed out earlier, selling savings-linked insurance is also relatively easier as compared to pure indemnity products.

e. On a larger scale, bigger MFIs can also aspire to become full-fledged life insurers through a subsidiary or a group company and thereby optimize their profits by retaining the insurance risks on their own as well as parking the client's savings within the group. This becomes a bigger and better way to mitigate the limitation of not being able to accept deposits in a compliant manner. Setting-up a life insurance company could be easier from a funding perspective as well, since the entry level capital requirement for insurance is much lower than that for banks.

f. In order to design an integrated business model for microfinance and microinsurance, it would be essential for market players to acknowledge these areas of divergence and work suitably to overcome them. To start with, there has to be a strategic understanding about the need to integrate both the businesses despite the fundamental differences in products and approaches. The social and business value of doing so has to be acknowledged and permeated across the organization. The plan could be to start distributing insurance to the existing credit clients but to eventually also aim at developing dedicated insurance clients. The market positioning of the MFI could thus become that of a total risk management solutions provider. At the operational level the plan should be to adequately train the field staff on the different mindset required for dealing with micro-credit and microinsurance. Balanced incentives and risk management system would have to be worked out so as to ensure that one activity does not subdue the other.

g. Similarly, aligning with MFIs will also accrue substantial benefits for the insurers. Apart from the top-line benefit of increased business and market share, microinsurance can also offer opportunities of up-selling and cross-selling to the MFI clients. Insurers can aim at reducing their operational cost by outsourcing some of their core functions like underwriting, premium collection, data entry, policy issuance and also claims servicing through the effective use of technology, depending upon the readiness and capacity of the partner MFIs. Volume based incentives to MFIs can encourage them to grow their insurance portfolio. Profit-sharing arrangements with partner MFIs for the particular portfolio of product(s) sold through them can also help in tackling the problems of adverse selection and moral hazard.[47]

h. To conclude, it is possible to create a win-win situation for the insurers, MFIs as well as clients by adopting a holistic approach as suggested above. Azerbaijan is a small market that can get saturated within a short period. It is therefore in the interest of all market players to start thinking of broadening their product offerings through convergence of

[47] Some regulatory jurisdictions prohibit payment of profit incentives or commissions to insurance intermediaries.

various products and businesses. Microinsurance and microfinance could become a case in point in this regard.