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# Microinsurance, Fraud, and Fraud Controls

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## Introduction—An Overview of Microinsurance

### *Micro Finance*

Micro finance has been defined as a development tool used to assist poor people in obtaining access to financial services at an affordable price (EY 2014a; Imhanlahimi & Idolor 2010). Micro finance is the provision of thrift, credit, and other financial services and products, usually in very small amounts, to the poor to give them an opportunity to raise their standard of living (Imhanlahimi & Idolor 2010; Eluhaiwe 2005; Nobel Prize.org 2006). Micro finance is largely associated with micro credit, or the provision of very small loans to low-income individuals who have little or no assets that can be used as collateral (Imhanlahimi & Idolor 2010; Ukeje 2005). This is an important socio-economic endeavor, as illustrated by the awarding of the Nobel Peace Prize in 2006 to Muhammad Yunus and Grameen Bank for their work to "create economic and social development" (Nobel Prize.org 2006). Yunus, the founder of Grameen Bank, stated that he regards micro credit as a human right and as an effective means of emerging from poverty. Grameen Bank's objective is to grant poor people small loans on easy terms (Nobel Prize.org 2006). More recently, Yunus noted that micro credit removes the collateral issue; it is banking based on trust (National Public Radio 2014).

Although, while micro credit has long dominated the micro finance market, recently other forms of financial services, such as the ability to save using deposit accounts and the opportunity to mitigate risk through insurance coverage, termed microinsurance, have been made available to the poor in some areas of the world (Giesbert et al., 2011).

### *The Need for Micro Insurance*

Micro insurance, which is more commonly referred to as "microinsurance," can be considered a subset of micro finance. The term "micro" means affordable to poor or low-income people[1] (IAIS 2007; Microinsurance Network 2012; Tom & Selvam 2010), and of course the term "insurance" means the pooling of risk through the purchase of insurance contracts (Hamid et al., 2011; Tom & Selvam 2010). As noted by Newhouse (1978, p. 19), "the purpose of any insurance policy is to convert an uncertain, but potentially large, loss into a certain, small loss."[2] More specific for microinsurance is the definition provided by the International Association of Insurance Supervisors (IAIS 2007, p. 9): "microinsurance—the protection of low-income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risk involved."

Ernst & Young (2014 b) note that financial inclusion, including access to insurance products, is critical to provide a safety net to low-income or "emerging" consumers. The "emerging consumer" of today will be the key to an expanding middle class in the future. It is estimated that the global middle class will expand by three billion people in the next two decades. This expansion will be needed to support global

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[1] The concept of low-income varies by jurisdiction, based on its state of development (IAIS 2007).

[2] The potentially large losses result from a catastrophe such as a fire, flood, death, etc., while the certain, small "losses" are the payments of insurance premiums.

economic growth. Thus, microinsurance plays a major role in the global economic growth of the future. West Africa and India are prime examples of rapidly growing populations that are benefitting from microsinsurance. India has the largest number of emerging consumers with insurance and many African nations such as Ghana, Kenya, South Africa, and Tanzania are not far behind (Ernst & Young 2014b). The promotion of microinsurance can only help with global economic stability for all. However, emerging consumers are not very trusting with regard to insurance products so it is imperative that fraud controls be in place to promote trust (Ernst & Young 2014b).

### *Microinsurance Frameworks*

In many areas, microinsurance is not considered a separate type of insurance, but rather is viewed as insurance available in small amounts. For instance, microinsurance can take the following forms:

- insurance with small benefits
- insurance involving low levels of premiums
- insurance for people working in an informal economy
- risk-pooling instruments for the protection of low-income households (IAIS 2007)

Microinsurance can be provided by "for profit" or "not-for-profit" entities which are privately or publicly funded and it may cover a variety of risks, including, but not limited to, illnesses, accidental injuries, death, and property loss (IAIS 2007). However, one of the most common forms of microinsurance is agricultural insurance where crops and/or livestock are insured. For instance, microinsurance policies may provide financial compensation for such uncontrollable adverse events as drought, crop pests or diseases, or death of livestock (ILO/STEP – GTZ 2006). The importance of such asset-backed insurance continues to grow in emerging economies (Ernst & Young 2014 b).

The insurance can be offered as a single product or bundled with other products, such as a loan. The most common microinsurance product is credit life insurance; if the insured dies, the life policy covers the outstanding loan balance, and in some instances may include funeral benefits for the policyholder. Microinsurance coverage can be provided on an individual or group basis (IAIS 2007).

> "While microcredit helps people to grow economically and to move out of poverty, microinsurance helps to make this growth sustainable and prevents people from falling back into poverty. Because of this fundamental link, microinsurance is often sold by microcredit organizations, and often offered in combination with loans. Some microfinance institutions sell insurance as an additional service. Others make insurance compulsory for their clients, for reasons ranging from reduced credit risk to building an insurance culture" (Lloyd's, 2009, p. 7).

### *Delivery Channels for Microinsurance*

Intermediaries may be used to promote microinsurance. Examples of such "channel partners" include microfinance institutions (MFIs), banks, credit unions, post offices, cell phone companies, funeral clubs, community leaders, etc., subjecting the microinsurance industry to fraud both by its customers and by its intermediaries (IAIS 2007). Further, in many areas of the world where there are emerging economies, both informal and formal community organizations may provide opportunities to introduce market insurance products to the community organization's constituents. However, when insurance is offered through community organizations, community leaders may commit fraudulent acts that insurance companies must guard against (Lloyd's 2009).

### *Fraud Issues Related to Microinsurance*

Since microinsurance is aimed at providing insurance coverage to low-income people, generally a relatively more "enabling" regulatory environment is required for the development and provision of microinsurance products (IAIS 2007). Further, for some types of insurance coverage, claims may be difficult to validate, and moral hazard[3] and fraud risks may be high (Kunzemann 2009; Lloyd's 2009). Accordingly, when a more relaxed regulatory environment for microinsurance is considered along with the inclusive nature of microinsurance, the opportunity for fraud in the microinsurance industry is rampant. Similar to threats of fraud in traditional insurance, fraud in the microinsurance industry can be committed by:

- Customers during the underwriting process or during claims assessment
- Agents or brokers
- Third parties
- Internal fraud by employees (IAIS 2007)

However, steps can be taken to prevent fraud in the microinsurance industry. For example, the IAIS (2007) contends that moral hazard and fraud can be limited by promoting *awareness of the issues* related to microinsurance, and *implementing controls* and perhaps incentive systems. We discuss specific opportunities for fraud in the microinsurance industry, such as providers not informing policyholders of their benefits, or policyholders faking disability claims. More importantly, we recommend controls to combat these examples of fraud and other fraudulent microinsurance practices.

### Importance to the Insurance Industry

Commercial insurers are discovering that offering insurance products to low-income households in emerging market jurisdictions is a new market segment (e.g., IAIS 2007; Kunzemann 2009; Lloyd's 2009). Lloyd's (2009) estimates the potential market for insurance in developing economies to be between 1.5 and three billion policies. It should be noted that in addition to the opportunity to increase profits by offering microinsurance coverage, insurers may reap other benefits, such as a larger and more diversified risk pool and boosts to the insurer's reputation. Further, market information gleaned from microinsurance activities and innovations may be able to be applied to other business activities (Lloyd's 2009).

However, insurers will likely need to adjust their control environment and tolerance for risk to appropriately match microinsurance risks. For example, most microinsurance products are simple compared to the more complex "traditional" insurance policies; further, microinsurance premiums are relatively lower than traditional insurance products (IAIS 2007; Lloyd's 2009). Accordingly, insurance companies may need to adapt their accounting and control policies to lower the costs associated with administering microinsurance policies (IAIS 2007). However, the potential benefits of relaxing controls to gain market share by the provision of microinsurance products need to be weighed against the potential for moral hazard. Biener and Eling (2012, p. 87) note that "the costs of strategies for addressing adverse selection, moral hazard and fraud relative to the small sums insured are higher in microinsurance markets, limiting the range of potential coping strategies." But finding ways to reduce the opportunities for fraud will help increase the profits to be realized through the sale of microinsurance products.

### Microinsurance Frauds and Ways to Combat Them

As previously noted, fraud in the microinsurance industry can be committed by: 1) customers during the underwriting process or during claims assessment, 2) agents or brokers, 3) third parties, and 4) insurance company employees (IAIS 2007). Further, a relatively more "enabling" regulatory environment for the development and provision of microinsurance products often results in increased instances of fraud (IAIS 2007). Specific opportunities for fraud and ways to combat such fraud in the microinsurance environment are discussed below.

[3] Moral hazard is a risk to an insurance company resulting from uncertainty about whether insured individuals may take unnecessary risks or not be vigilant in reducing risks after they are insured.

### *Customer Fraud—Agricultural Products*

Insurance for agricultural products is often in high demand because of the scarcity of food in many under-developed regions of the world. Insurance can lessen the impact of a loss of crops or livestock, thereby raising the standard of living in such areas. However, the risks of insurance coverage for small farmers can be substantial; claims are difficult to validate, making risks associated with moral hazard and fraud exceptionally high (Lloyd's 2009). Further, catastrophic losses of property and agricultural products are becoming more prevalent, a phenomenon many attribute to climate change (Lloyd's 2009).

Lloyd’s (2009) contends that index insurance is a potential solution to fraud problems in the agricultural sector, especially for catastrophic losses due to floods, earthquakes, and typhoons. Index insurance is viewed as a potential solution, because, under an index policy, payments do not depend on individual losses, but rather on an objective index, such as rainfall levels or the magnitude of an earthquake. Lloyd’s (2009, 16) states that “Once an index is calibrated and correlates well with actual losses, underwriting and claims verification costs for the insurer are minimal and moral hazard and fraud are virtually eliminated.” Roth and McCord (2008) concur with this assessment, noting that index insurance helps solve the most difficult challenges of agricultural insurance and significantly reduces the prospects of fraud. For example, moral hazard is virtually eliminated because the farmer cannot influence an index that is based on weather. Adverse selection will have no impact on the risk since the insurance payout is based on an index, such as level of rainfall. The costs of administering (adjusting) insurance claims are greatly reduced because it is not necessary for a loss adjustor to visit farms and calculate losses (Roth and McCord 2008).

Technology can also be useful to prevent fraudulent claims. IFFCO-TOKIO General Insurance Company is currently undertaking a project in India that identifies individual insured animals through RFID chips in the ears of the animals. Satisfaction with the program has been high thus far. Within six hours, a staff member working for the insurance company goes to the animal and reads the RFID tag. The information is directly transferred to the claims department and most claims are settled within a month versus six months for traditional claims methods (IFFCO-TOKIO General Insurance Company, 2009).

### *Fraud by Agents or Brokers*

People collecting insurance premiums may be fraudsters, pocketing amounts paid to them rather than remitting funds to insurance companies. In addition, records could be falsified. One suggestion to mitigate potential fraud is to encourage microinsurance providers to partner with non-governmental organizations, regulators, and financial institutions, as well as local self-help groups (Wharton 2013). These organizations have been participating in microlending and other services in developing nations for some time and they have the trust of the people. Accordingly, such organizations may have trusted individuals in place who can help screen for dishonest individuals.

A strong, yet flexible, regulatory environment is necessary for adequate consumer protections, especially given the vulnerabilities of microinsurance clients. The role of the insurance supervisor is especially important in developing nations. The insurance supervisor must set the requirements for agent qualifications and sanctions. They must also control the content of insurance policies to limit or eliminate exclusions and to keep the language simple. Insurance supervisors can encourage flexible payment arrangements for premiums and alternative claim settlement arrangements (McCord et al., 2008). Through regulation, fraud by agents and brokers can be reduced.

### *Third Party Frauds*

A common microinsurance product is credit life insurance; if the insured dies, the life policy covers the outstanding loan balance, and in some instances may include funeral benefits for the policyholder. Unfortunately, however, a common microinsurance fraud scheme involving third parties is often associated with these “funeral societies” (IAIS 2007). For instance, the insurance company may just collect premiums and then refuse to pay for funeral expenses. And sometimes the "agent" who collects the premiums never submits them to the insurance company.

Another type of third party scheme involves health care facilities offering free or discounted services for healthcare but then failing to fulfill its promises. When a health care facility fails to deliver on insurance contracts or agreements, the holders of such policies may have few, if any, opportunities for recourse (IAIS 2007). Selecting trusted doctors and hospitals with proven track records should help mitigate this type of fraud (Kunzemann 2009).

Also, unscrupulous individuals may impersonate insurance agents, collect premiums, and then fail to fulfill the terms of the microinsurance contract (IAIS 2007). To counteract such frauds, communities could be empowered to manage their own funds, reducing fraud by individual members (Kunzemann 2009). Such financial groups are apparently very common in Ghana, where the group handles the collection of funds and acts as a mediator between a financial institution and the individual members of the group (Giesbert et al., 2011).

Yet another type of fraud involves instances where fake policies are issued by fraudsters who pose as authorized insurers or intermediaries, when in fact they are not (IAIS 2007). These fraudsters collect premiums but then fail to deliver any insurance benefits. To reduce the risk of fraud by intermediaries, managers of the principal insurance company may want to inspect the records of intermediaries. However, this control could be costly and difficult to implement in practice, especially in remote areas. Nevertheless, it is important to note that the prevention of microinsurance fraud by third parties, such as intermediaries, is important to help ensure that the reputation of the nascent microinsurance industry and activities is not endangered (IAIS 2007).

### *Fraud by Insurance Company Employees*

Reducing fraud committed by insurance company employees involves having strong hiring, supervisory, and termination human resource policies in place. For example, GRET is a French non-governmental organization that administers a health microinsurance program in Cambodia. GRET monitors employees through a hotline that consumers can call with questions as well as through surveys and information technology tracking. It assesses employees annually with regard to product knowledge and claims procedures. GRET provides extensive training to all employees and gives feedback on the quantity and quality of sales each month. They also spot check employees in the field (Guarnaschelli et al., 2012).

The CARE Foundation provides another example of proactive employee policies. They hire microinsurance employees based on nominations by community leaders. They also screen employees through their aptitude for daily tasks involved in the job. The CARE Foundation conducts training by having employees sell the product to each other (Guarnaschelli et al., 2012). Proactive employee practices can screen out dishonest employees as well as promote a stable, effective sales force.

A summary of possible frauds related to microinsurance and ways to combat such frauds are summarized below.

**Table 1: Microinsurance Frauds and Ways to Combat Them**

| Category | Potential Fraud | Ways to Combat Fraud |
|---|---|---|
| Customer Fraud - Agricultural Products | Moral Hazard and Adverse Selection | Use index policies where payouts are based on an objective index (such as rainfall) rather than on individual circumstances.<br>Use technology such as RFID tags to better track livestock. |
| Fraud by Agents or Brokers | Agents and Brokers may fraudulently pocket premiums | Partner with established non-governmental organizations, regulators, local self-help groups, and financial institutions engaging in microlending to detect and exclude dishonest individuals.<br>A strong, yet flexible regulatory environment with punishments for dishonest individuals is necessary. Regulations must exist to credential agents, control policy provisions and language, and to provide for quick and fair claims settlement. |
| Third Party Frauds | Health Care Facilities may fail to deliver promised services. Fake policies may be issued by fraudsters posing as intermediaries | Select hospitals with proven track records and trusted doctors. Empowering communities to manage their own funds often reduces fraud from individual members. |
| Fraud by Insurance Company Employees | Individuals employed by the insurance company may misrepresent the products, fail to process claims, or pocket premiums and claim settlements. | The insurer needs strong employee screening policies as well as intensive training and supervision. Policies for dismissing and prosecuting dishonest employees need to be in place. |

## Conclusion

When insurance companies reach out to low-income markets by offering microinsurance products, there may be an increased risk of fraud due to relaxed regulatory environments and other factors. However moral hazard and fraud can be limited by promoting awareness of the issues related to microinsurance and by implementing controls appropriate for the microinsurance environment when considering the costs and benefits of such controls (IAIS 2007).

Some suggested controls are indexed policies and technology to cut down on fraudulent customer claims as well as a strong, but flexible, regulatory environment to provide customer protections against dishonest agents and brokers. Strong community affiliations can help to screen out unscrupulous third parties and proactive hiring, training, supervising, and termination human resource policies can reduce fraud by insurance company employees.

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