

## PREMIUM COLLECTION: MINIMIZING TRANSACTION COSTS AND MAXIMIZING CUSTOMER SERVICE

The low-income market that microinsurers target presents its own unique challenges to collecting premiums. Primary premium-collection mechanisms used by mainstream insurers – such as salary deductions from employers or debit orders from bank accounts – are often not an option for poor households.

### Modes of premium collection

The way premiums are collected has a direct bearing on per unit transaction costs. The five most common ways are: a) loan-linked, b) debit order, c) fixed deposit, d) link with another financial transaction, and e) door to door collection.

Collection at the point of **loan disbursement or repayment** is attractive since the premium is “piggy-backed” on top of another financial transaction. Consequently, the marginal cost of premium collection is kept to a minimum. However, client satisfaction with this method of collection tends to vary. The biggest disadvantages with this mode are:

- **Lack of transparency** – clients may not be aware of the actual price that they are paying for the benefits.
- **Unaware of cover** – clients may not know that they have insurance, so they may not receive the benefits.
- **Protection limited to loan term** – clients can only receive insurance coverage when they have a loan. Therefore, a client must be in debt to get insurance benefits.

Organizations that link loans and insurance products have several choices in which way they collect:

1. **Deducting the premium from the loan amount** – this is the most common approach, but borrowers usually do not appreciate getting a smaller loan amount nor having to pay interest on the premium amount.
2. **Adding the premium to the loan amount** – in this way, the client receives the expected sum of his loan, but still pays interest on the premium amount.
3. **Building the premium into the loan interest rate** – organizations use the slightly increased interest rate to pay off the clients’ premiums. Although the simplest, this is also the least popular

method because it creates a less competitive interest rate and disguises the premium so that borrowers may not realize that they have insurance coverage.

4. **Paying the premium with each loan instalment** – this method seeks to make the premium more affordable by dividing it up into numerous instalments. However, the line between insurance and loan gets blurred and can create confusion for the client.
5. **Paying cash up front** – if borrowers pay the premium up front, they will be more aware that they have insurance. However, this option creates an additional transaction cost and increases vulnerability to fraud as cash changes hands.

The second option, a **debit order**, lowers transaction costs and minimizes insurers’ vulnerability to fraud. At the same time, over reliance on automation is discouraged because it runs the risk of alienating low-income clientele who do not have the funds to hold a savings account. As in all methods of collection, the microinsurer needs to clearly explain how it is collecting the premiums in order to avoid ignorance-inspired backlash.

One of the simplest modes of collection is the **fixed deposit approach** in which clients receive “semi-permanent” insurance coverage without additional transactions. The depositor never pays any premiums and still has access and ownership of their money. Insurers must closely monitor the interest rate environment with this method. If the interest rate decreases too much, the payments will no longer be sufficient to pay off the premiums and then insurers will have a difficult time collecting the rest of their premiums through other methods.

The fourth approach is for customers to pay their premium when they make **another financial transaction**, such as paying union dues or buying groceries. This linkage creates efficiencies and builds on existing cash collection infrastructure. However, the low-income market may have difficulty affording two payments and therefore the transactions may be competing against each other for the consumer’s limited purse. This problem can be overcome if the link is associated with an income source, such as collecting a payment from the dairy cooperative and having some of it deducted to pay the premium.

The last option is to **collect the premiums physically** by going door-to-door, or through group mechanism, or by requesting policyholders to come to a central location to pay their premiums. These collection methods require a separate, insurance-only transaction. Physical collection is most appropriate for a) organizations without other financial transactions such as community-based health insurance schemes and b) accumulating-value policies that are difficult to combine with other financial services.

The most apparent problem with physical collection is the large transaction costs to the insurer – employees charged with collection need to have significant monetary incentive to be efficient. In addition, people are naturally averse to spending extra time and money to make such a payment. As the number of people handling the premium increases so does the possibility of fraud. In general, it is very difficult for insurers to recover premiums when defrauded by their employees – consequently causing financial deficits.

A comparison of these five approaches has to consider cost-effectiveness of the mechanism in relation to the value that is provided to policyholders (e.g. ease of access). In general, it is best to stay away from physical collection if any alternative method is available.

## Collection frequency and timing

Periodic payments – monthly, quarterly, or annually – are popular because they are inherently more attuned to the limited purchasing power and liquidity of the market. The main disadvantage is the additional transaction cost to the insurer and the increased likelihood that the policyholder will choose to cancel coverage or temporarily lapse in payments. Timing is also a critical factor. Insurers should focus on policyholders' professions to gauge when they will have disposable income to pay their premiums. Furthermore, knowing from where clients are getting their income can be used to cut transactions costs by collecting en masse from that source. Still, flexibility with premium collection should be emphasized, but insurers must make sure that their flexibility does not skyrocket their transaction costs.

## Client considerations

To expand the outreach of microinsurance and make existing schemes more viable, providers should strive

The International Labour Organization (ILO) and the Munich Re Foundation recently published **Protecting the Poor: A Microinsurance Compendium** on behalf of the CGAP Working Group for Microinsurance. This authoritative book analyzes the experiences of more than 40 microinsurance providers and is based on the **Good and Bad Case Study Project** led by the Operation subgroup and funded by DFID, GTZ, the ILO and SIDA. The translations into French and Spanish are financed by ADA.

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to assist policyholders to finance their premiums. For example, microinsurers can work with savings associations to encourage clients to deposit slightly higher amounts into their savings – these additional savings then serve to pay for their premiums. However, separate loans for premium payments are generally discouraged and only create a greater financial burden for the clients.

When trying to balance efficiency and affordability for organizations, a useful rule of thumb can be applied – equate a premium payment (e.g. monthly payment) to a non-essential item (e.g. bottle of soda). Also, one cannot assume that the premium payment is the only expense for the clients. For example, if a client must travel to pay their premium, the opportunity costs of transportation and missing work can significantly increase the premium they are paying. On the other hand, organizations can charge extra fees for their increased costs arising from collecting more frequently or physically collecting the premiums.

Microinsurers should allow for a certain number of losses due to lapses or non-renewals, while at the same time be proactive in protecting themselves from the resulting problems. Focusing on incentives rather than penalties can also help ensure fewer lapses – simple incentives can encourage clients to pay their premiums in a timely fashion. For clients paying their premiums more frequently, lapses can be diminished by promotional work that encourages clients to keep their policies. Finally, the best strategy to retain low-income clients is to help boost their incomes by indirectly helping them access microfinance. For example, microenterprise loans can help to increase household incomes and consequently the affordability of premium payments.

## Premium collection controls

To minimize fraud and mistakes in premium collection, both **hierarchical** and **horizontal controls** need to be put in place. Hierarchical controls require at least a rudimentary structure within the organization to monitor the quality of the premium collection process. If insurers choose to outsource the process to other organizations, horizontal controls should be created. For example, by demanding some sort of collective security from the organization or structure to which the process is outsourced.