Market Review
March 14, 2011

Sector
Non-Life & Life

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India Market's Rapid Growth Poses Profitability Issues

The words "vibrant" and "colourful" are often used to describe India – adjectives that are also fitting of India's insurance market. In the past decade, private insurers have been allowed to enter a rapidly developing sector, and there are few signs of a slowdown in the pace of growth.

As the size of the insurance market has expanded sharply, the regulatory, underwriting and broking communities have needed to adapt quickly. While the full potential for growth in non-life and life insurance is far from being reached, the challenges to operating in a desirable though competitive market are mounting. A.M. Best notes:

- The global financial downturn has impacted India's insurance market to a far lesser degree than insurance markets in many other countries. India's economic prospects continue to offer great opportunities for non-life and life insurers.

- Despite low insurance penetration, the Indian insurance market is challenging. The influx of new entrants over the past few years has resulted in intense competition.

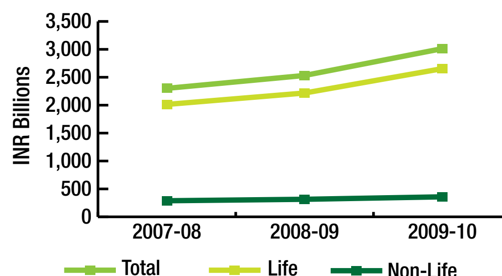
- Insurers appear to be taking steps to improve profitability, although A.M. Best believes underwriting results for non-life insurers are unlikely to turn positive in the foreseeable future. Non-life insurers have become dependent on investment return to compensate for poor underwriting results.

- New rules from the Insurance Regulatory and Development Authority (IRDA) on initial public offerings and mergers and acquisitions will be paramount in shaping the future of the industry. An increase in the foreign direct investment limit would transform the market further.

- After 10 years of market liberalisation, public sector insurers remain dominant. An increase in the stake of foreign players could help insurers raise additional capital, increase resources and bring in new management skills and knowledge.

- Given insurers' ability to adapt to the current challenging conditions, the Indian insurance market should be well positioned to grow further.

India Life & Non-Life – Premium Volume (2007-2010)



Source: Insurance Regulatory and Development Authority, annual reports 2005-06 to 2009-10.

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Executive Summary

India's insurance market has undergone significant change over the past decade since the liberalisation of the market in 2000. Further development appears inevitable as the attractions of operating in an emerging economy become more evident to international insurers and reinsurers.

A.M. Best, which rates a number of companies in India (see **Exhibit 1**), in this report, aims to identify some of the drivers creating opportunities for market participants, as well as discusses many of the market's challenges. It will look closely at the financial performance of insurers and the rationale behind underwriting trends. As the lure of India's insurance market is commonly compared to that of its neighbour China, comparisons will also be drawn between the two.

The reinsurance market is evolving and is vital to the development of insurance in India. Regulatory change is also paramount, particularly with respect to the life industry.

Growth and Challenges

India's insurance market has proved to be resilient throughout the recent global economic uncertainties, with total insurance premiums climbing 19% in the year through 31 March, 2010. Drivers include strong economic growth, which coincides with a growing middle class in the world's second-largest population. While most other countries have witnessed a slowdown in construction projects, in India, government spending is continuing.

India's export trade is fuelling marine cargo and aviation insurance, as well as creating opportunities for liability cover. The size of agricultural insurance is relatively small compared with commercial and motor business, although insurance to protect the country's enormous agricultural industry is available, particularly considering the range of natural hazards in India.

However, insurers and reinsurers in India face varied and immense challenges. Take-up of insurance is low because potential policyholders tend to feel there is little financial benefit from purchasing cover and a growing number of insurers are competing for a relatively small consumer base. Motor and health insurance, in particular, have been loss making.

Exhibit 1

India – A.M. Best Rated Companies

As of 2 March, 2011.

Company	FSR & (outlook)	ICR & (outlook)	Initial Rating Date
General Insurance Corporation of India	A- (stable)	a- (stable)	20/10/1999
The New India Assurance Company Ltd	A- (negative)	a- (negative)	25/1/1999
The Oriental Insurance Company	B++ (stable)	bbb+ (negative)	23/6/2006
United India Assurance Company Ltd	B++ (stable)	bbb+ (stable)	6/1/2011

Source: A.M. Best Co.

Key Observations

The non-life market has experienced strong growth over the past few years, but despite no major catastrophes affecting India since 2005, underwriting remains unprofitable. Public insurers rely on strong investment income, although high exposure to equities can create volatility.

Rates in certain lines are beginning to stabilise or rise as insurers move to more realistic pricing. Structural changes such as the creation of claims hubs are also being undertaken to improve underwriting losses.

Private insurers have grown at a faster pace than public sector undertakings (PSUs), although there has been a recent narrowing of premium growth rates between the two sectors. In general, private insurers tend to be more leveraged than PSUs.

Special Report

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Comparisons between India and China

Both India and China have large populations and economies that are growing rapidly, although China's total insurance premiums are more than double those of India. Life insurance penetration is higher in India than in China, reflecting the high savings elements in India's life products.

Motor insurance represents the biggest element of non-life insurance in both countries, however, it constitutes a larger market share in China. Although private Indian insurers are more highly leveraged than PSUs, these levels are much lower than for China's largest non-life insurers.

Brokers and Distribution Trends

The Internet is being increasingly used for personal lines insurance, although agents remain the key method of distribution. Brokers are playing a more important role in placing commercial risks, particularly reinsurance contracts.

Use of Reinsurance

PSUs take out less reinsurance than private insurers, as they are supported by historical reserves. International reinsurers are attempting to underwrite Indian risks as they seek risk diversification and growth, although business can be unprofitable.

Regulatory Change

The Insurance Regulatory and Development Authority issued a raft of new regulations over the course of 2010 and is expected to unveil new rules on mergers and acquisitions and initial public offerings in 2011.

Should the proposed Insurance Laws (Amendment) Bill 2008 finally be passed, the lifting of the Foreign Direct Investment limit to 49% from 26% would change the insurance landscape significantly.

Solvency requirements are expected to remain unchanged in the near future, although there is uncertainty with regard to the implications of new proposed accounting and tax rules.

India's Life Market

Growth for India's life insurance market has outstripped the non-life sector. However, life insurers are expected to face great challenges in the wake of a fundamental change in the way unit-linked insurance policies are structured. Capital strain is more of an issue for life companies than for non-life insurers. Consolidation among insurers is therefore anticipated, as companies – which are already cutting offices and staffing levels – seek ways to reduce expenses further and use capital more efficiently.

I. Market Conditions Pave Way for Further Growth

The Indian insurance market has experienced little direct impact from the global financial downturn. In the financial year leading up to 31 March, 2010, despite the troubles in the more developed insurance markets, total insurance premiums climbed almost 19% to approximately INR 3 trillion (USD 65.86 billion) – almost double the 10% growth posted the previous year (see **Exhibit 2**).

The insurance market has experienced growth for numerous reasons and is forecasted to continue expanding. India is the second most populous nation in the world with 1.2 billion inhabitants and a strong savings culture.

Economic prospects are deemed better in India than for many developing markets. Drivers include high growth in gross domestic product (GDP), which is estimated to have expanded by 9.7% in 2010. Statistics from the International Monetary Fund's October 2010 World Economic Outlook state that yearly GDP growth has averaged 8.3% from 2005 to 2010, despite the global recession. Increased wealth is resulting in higher discretionary spending and automobile sales, thereby creating heightened demand for motor insurance. These policies tend to be

Exhibit 2

India Non-Life & Life – Market Growth (2007-2010)

	Premium Volumes (INR billions)			Percentage Growth (%)		
Sector	**2007-08**	**2008-09**	**2009-10**	**2007-08**	**2008-09**	**2009-10**
Life	2,014	2,218	2,655	29.02	10.15	19.69
Non-Life	288	314	358	11.09	9.11	13.96
Total	**2,302**	**2,532**	**3,013**	**26.46**	**10.02**	**18.98**

Source: Insurance Regulatory and Development Authority, annual reports 2005-06 to 2009-10.

issued when vehicles are bought from dealers.

Other non-life lines of business are expected to grow. Construction and infrastructure initiatives are presenting greater opportunities for insurance and reinsurance. These include oil and energy risks, for example the building of thermal power plants in Maharashtra, in addition to the construction of dams, expressways, highways and multistory buildings. In February, finance minister Pranab Mukherjee said India would need USD 1 trillion for infrastructure projects by 2017.

There is a range of other product lines that non-life insurers hope will flourish as the economy grows. The exportation of software, petroleum products, and chemical and textile goods has created opportunities for marine cargo and aviation insurance.

Products liability represents a small segment of the non-life insurance market but has seen a pick-up in demand as trade partners include the United States, the United Arab Emirates and China. Directors and officers (D&O), professional indemnity (PI), errors and omissions (E&O) and products liability cover are becoming increasingly important for corporations.

Agriculture remains a key component of the economy, with various government incentives directed to the farming sector. Environmental risks, including crop failure, are covered by the state-owned Agriculture Insurance Company of India (AIC) and microinsurance initiatives.

Natural hazards, including droughts, flash floods from monsoon rains, severe thunderstorms and earthquakes, have attracted the attention of non-life insurers and reinsurers. The last major catastrophic floods took place in 2005, killing more than 1,000 across the state of Maharashtra.

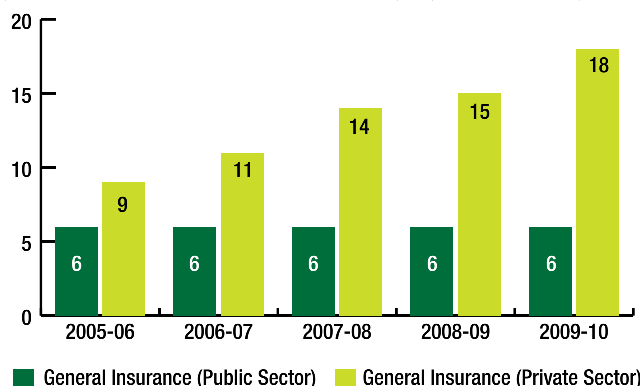
Terrorism remains a real threat in India, with the country having taken significant steps to prevent a repeat of the Mumbai attacks in November 2008 that killed more than 150 people. Since April 2002, India has operated a terrorism pool managed by the state reinsurer General Insurance Corporation of India (GIC Re), which successfully absorbed the Mumbai losses.

II. Challenges Facing Non-Life Insurers

While the size of the insurance market has grown strongly in recent years, total non-life insurance premium as a percentage of GDP remains low in India, at 0.6% in December 2009.

Insurance penetration is low and competition among insurers is high. There has been an influx of insurers since the liberalisation of the insurance market under the Insurance Regulatory and Development Authority Act of 1999. Under the act, public sector exclusivity was abandoned in favour of market-driven competition, resulting in the entry of international insurers through joint ventures.

Exhibit 3
India Non-Life – Registered Insurers (Public and Private Sectors) (2005-2010)



Source: Insurance Regulatory and Development Authority, annual reports 2005-06 to 2009-10.

The public sector undertakings (PSUs) – New India Assurance Co., United India Insurance Co., Oriental Insurance Co. and National Insurance Co. Ltd. – were created from the amalgamation and grouping of 107 insurers in 1973. Strong distribution networks have ensured that they remain the leaders by underwriting 60% of non-life insurance premiums. In addition, there are two public specialist insurers – Export Credit Guarantee Corporation of India and AIC.

As **Exhibit 3** demonstrates, the number of non-life insurers has increased significantly over the past few years, doubling to 18 currently from nine in 2005-2006. The insur-

ance regulator, the Insurance Regulatory and Development Authority (IRDA), would prefer private insurers to offer innovative products and good customer service to attract new customers, as opposed to competing for an existing client base.

In reality, price has been a key differentiator, particularly as the liberalisation of the insurance market was followed by certain rates being "de-tariffed" in stages from 2005. Premiums for property insurance, for instance, tumbled by 80% in some cases, and in recent years loss ratios have increased in many lines, including fire and engineering.

Motor, which is the largest line of business, representing 43% of total non-life premiums, has presented a particular problem for non-life insurers. In April 2007, the Indian Motor Third Party Insurance Pool (IMTPIP) was created for commercial vehicle third-party insurance business. Losses are distributed by the pool to all insurers according to their overall market share of all lines of business. Claims inflation has been an issue, and labour and spare parts costs have increased in recent years, leading to calls for the IMTPIP to be abolished and for insurers to return to market pricing.

To date, these demands have been resisted, and the IRDA is considering increasing third-party motor premiums. Insurers anticipate rates could rise between 10% and 100%, with the largest increases for commercial vehicles such as trucks. Nevertheless, rate rises may not be sufficient to turn around insurers' results completely. The IRDA will need to work with the government and balance pressure from haulage unions when setting out new rates, because industrial action from the unions could threaten to disrupt the Indian economy.

As is the case with motor insurance, health has also represented a hurdle to profitable underwriting. Health is the second biggest component and the fastest growing line of non-life insurance (constituting 21% of total non-life premiums) and has been largely loss making. Data has been insufficient or inaccurate on consumer profiles and disease patterns, and medical costs have escalated.

As with all rapidly growing insurance markets, talent can be an issue. The pool of professionals, which includes actuaries, underwriters and business managers, must continue to expand in line with the market's growth. This is particularly important as demands on professionals are increasing with heightened regulation. While there is good infrastructure for training with the existence of bodies such as the Insurance Institute of India, the Middle Eastern and African insurance markets threaten to draw talent overseas.

Other challenges facing insurers relate to the country's general economic stability. The Reserve Bank of India has raised interest rates seven times in the past year in an attempt to combat inflation and produce a soft landing. Inflation, particularly food inflation, is dampening consumer spending power.

III. Key Observations

Analysis of all non-life insurers in India reveals the non-life market has been growing strongly from 2006 to 2010, with aggregated gross premium written (GPW) rising by 11.5 % to 20.8% each year (see **Exhibit 4**). These data include premiums for health insurance and reinsurance premiums (excluding GIC Re), which are listed separately from total non-life premiums in the IRDA's annual reports.

While the top line is growing, underwriting has tended to be unprofitable. Combined ratios for the 23 non-life insurers operating for the whole of 2010 are high and have exceeded 110% over the five-year period. Despite no major natural catastrophes affecting India since 2005, over the subsequent five years, the best combined ratio occurred in 2007 – 110.4% – as third-party commercial motor premiums were lifted that year.

Net investment income ratios (net investment income as a percentage of net earned premium) have ranged from 16.4% in 2010 to as high as 20.3% in 2007, a particularly strong year as some insurers realized capital gains by selling some equity investments.

Liquidity is not a major concern for Indian insurers. Liquid assets, which include shares and cash, are high, representing 63.6% to 79.6% of investment portfolios from 2006 to 2010. The level of equity investment complies with the IRDA's guidelines, although high exposure to shares can create volatility, impact-

ing the stability of an insurer's risk-adjusted capitalisation and operating income.

As touched upon in the previous section on challenges, underwriting losses are common for non-life insurers. A.M. Best expects loss ratios to improve moderately, although underwriting losses are likely to remain in the immediate future.

The industry has begun to adjust to increased competition in the past year, and some premiums are stabilising or rising marginally. Property rates remain under pressure, although brokers and underwriters have indicated that in more recent months there has been some improvement for selected risks.

As the sole domestic reinsurer, GIC Re has influenced underwriting discipline and helped improve pricing. GIC Re tightened its renewal terms for companies in 2010-11 and altered its commission structure, which included the introduction of a profit commission.

In addition to raising some rates, insurers are also making structural changes to improve underwriting losses. They are employing professionals from the motor, medical and engineering industries to improve risk pricing. Claims control and management procedures have also been enhanced through the introduction of regional claims hubs, which have resulted in improved turnaround times in claims processing.

Public and Private Insurers

To a degree, aggregated data for the non-life sector are distorted by the six PSUs. A.M. Best currently rates three of the public sector insurers, which all enjoy strong risk-adjusted capitalisation. A.M. Best has Financial Strength Ratings (FSRs) on New India (rated A-) and Oriental and United India (both B++).

Unsurprisingly, since the insurance market was liberalised, the private insurers have grown at a faster pace than the already established PSUs. For instance, GPW for private insurers increased by 61% in 2007, compared with an 8.4% increase for public insurers. However, the recent narrowing of premium growth rates between the two sectors suggests that the market is stabilising; in 2010, both sectors grew by 17% (see **Exhibit 5**).

The IMTPIP is a key reason why private insurers are slowing their rate of growth. PSUs have tended to bear the brunt of the losses, but as the private insurers have underwritten more business, they have had to accept greater losses for compulsory third-party motor risks.

Private insurers tend to be significantly more leveraged than PSUs. Private companies' aggregate NPW to surplus was 157% in 2010 – considerably higher than PSUs, which had an aggregate NPW to surplus of 36% in 2010. PSUs' leverages tend to be lower in part because they have been able to build a larger capital base over a longer period. PSUs in general are well capitalised, despite their rapid growth and higher combined ratios, owing to strong performance in their investment portfolios.

Operating expense ratios are lower for private companies than for PSUs, as expenses are particularly high for PSUs operating large distribution

Exhibit 4
India Non-Life – Financial Trends (2006-2010)

	2006	2007	2008	2009	2010
Gross Premiums Written (INR Billions)	231.19	279.18	334.80	373.17	436.47
Change in GPW (%)	14.46	20.75	19.92	11.46	16.96
Capital & Surplus (INR billions)	438.22	434.12	536.94	385.57	611.69
Change in Capital & Surplus (%)	52.89	-0.94	23.69	-28.19	58.65
Loss Ratio (%)	87.07	80.09	82.44	85.48	87.06
Operating Expense Ratio (%)	35.64	30.31	31.46	33.38	33.00
Combined Ratio (%)	122.71	110.41	113.90	118.87	120.06
Net Investment Income Ratio (%)	19.24	20.26	19.27	18.15	16.37
Return on Premium (%)	15.08	24.25	19.19	5.12	5.45
Return on Assets (%)	2.54	4.41	3.18	0.88	1.14
Return on Capital & Surplus (%)	4.78	8.10	5.85	1.77	2.39
NPW to Surplus (%)	35.88	43.48	41.58	67.85	49.78
Net Technical Reserves to Surplus (%)	60.11	69.11	64.28	104.02	76.49
GPW to Surplus (%)	52.76	64.31	62.35	96.79	71.35
Liquid Assets to Surplus (%)	142.52	145.34	135.79	146.77	133.22
Liquid Assets (%)	79.60	77.23	75.30	63.59	67.88
Current Liquidity Ratio (%)	203.55	191.07	195.88	138.94	166.54

Source: A.M. Best Co., – Statement File Global.

Exhibit 5
India Non-Life – Financial Indicators for Public & Private Insurers (2010)

	Public Sector	Private Sector
Gross Premiums Written (INR billions)	271.36	165.11
Change in GPW (%)	16.94	17.00
Retention Ratio (%)	72.73	64.90
Loss Ratio (%)	90.36	80.77
Operating Expense Ratio (%)	33.75	31.63
Combined Ratio (%)	124.10	112.40
Net Investment Income Ratio (%)	19.33	10.72
Return on Capital & Surplus (%)	3.20	-3.80
NPW to Surplus (%)	36.32	157.02
Net Technical Reserves to Surplus (%)	61.49	195.92
GPW to Surplus (%)	49.93	241.92

Source: A.M. Best Co., – Statement File Global.

forces throughout the country. Higher loss ratios of PSUs partially reflect their historical third-party motor portfolio.

India's Country Risks

As part of A.M. Best's ratings analysis of companies, risks specific to the country where an insurer operates are examined. These risks are based on three categories – economic, political and financial system risk (which is further divided into insurance risk and non-insurance financial system risk) – and could compromise an insurer's ability to meet its financial obligations.

Under A.M. Best's country risk rating methodology, countries are placed into one of five tiers, ranging from "CRT-1" (Country Risk Tier 1), denoting a stable environment with the least amount of risk, to "CRT-5" (Country Risk Tier 5) for countries that pose the most risk. India is categorised as a CRT-4 country.

It is typical for insurance industries in CRT-4 countries to be less developed and, therefore, to have great potential for growth. This is indeed the case in India. As previously noted, India has great economic potential owing to its large labour force and rapidly growing middle class. Through the course of its development, GDP per capita is expected to grow, which will correlate with the demand for insurance products.

However, there is reason for caution when considering the market's short-term potential. India continues to suffer from great disparities in income and high unemployment. The labour market is still mainly rural, and there are high levels of poverty, with an estimated three-quarters of the population earning less than USD 2 per day. National security issues (namely terrorism) and a strained bilateral relationship with Pakistan also create high political risk. Lack of liquidity or depth in the financial markets creates challenges and an unpredictable investment environment for insurers.

IV. India vs. China

Brazil, Russia, India and China (the BRIC countries) are frequently cited as offering the best potential for investment opportunities. Comparisons are often drawn between the prospects presented by the Indian and Chinese insurance markets in particular, owing to their large populations and rapid pace of economic growth.

While the two countries share similar demographic characteristics and challenges, there are some key differences (see **Exhibit 6**). China's insurance penetration was 1.1% for non-life and 2.3% for life, while in India there is a significant gap between insurance penetration for non-life (0.6%) and life (4.6%). The considerably higher take-up of Indian life insurance in part reflects the strong savings culture in the country, and life products therefore have traditionally been designed as savings tools, with an element of protection. Savings levels are high in China, although the Chinese rely more on banking products for savings.

Although India's total insurance penetration of 5.2% is higher than China's 3.4%, China's total insurance premium in 2009 was two-and-a-half times the size of India's at USD 163 billion. Both countries' insurance markets have demonstrated resilience despite the global economic downturn, although China's grew at a faster pace from 31 December, 2007 until the end of 2009. During this period, China's premium volume increased 58.3%, reflecting in part stronger growth in GDP over this period. India's growth was lower at 31.9% over the same period, but compound annual growth from 1999 to 2009 has been 21% for both countries.

As discussed earlier, private Indian insurers have significantly higher leverages than PSUs, but not as high as some Chinese insurers. A.M. Best's report *China Life & Non-Life – Market Review* showed that on an aggregated basis, China's five largest non-life insurers had a NPW to surplus ratio of 437.6% in 2007, rising to 639.3% in 2008.

Compared with India, the portion of motor insurance is higher in China, making up 73% of non-life premiums in 2008. In terms of A.M. Best's country risk methodology, China is categorised as a CRT-3 country.

Exhibit 6
China vs. India – Insurance Market Statistics

Indicator	India	China
Population (millions)	1,199.1	1,334.7
Gross Domestic Product 2009 (USD billions)	1,310.2	4,985.5
Insurance Penetration – Life (%)	4.6	2.3
Insurance Penetration – Non-Life (%)	0.6	1.1
Insurance Penetration – Total (%)	5.2	3.4
Insurance Premium – Life (USD billions)	57.1	109.2
Insurance Premium – Non-life (USD billions)	8.0	53.9
Insurance Premium – Total (USD billions)	65.1	163.0
Change in Premium Volume 2007-2009 (%)	31.9	58.3

Sources: International Monetary Fund, World Bank, Sigma World Insurance in 2009.

V. Broker & Distribution Trends

Indian insurers are using the Internet to attract new policyholders and minimise expenses by selling personal lines products including motor, health and travel insurance, although Internet usage is varied throughout the country. Bancassurance partnerships are growing in importance, although agency forces remain the dominant method of distribution. The costs of face-to-face sales, however, are considerable (see VIII. Life Market in Evolution).

It is estimated that one-fifth of India's non-life premiums are placed through brokers. As is the case with insurers, brokers complain that the intermediary market is competitive. This reflects a growing number of registered brokers. **Exhibit 7** shows there were 303 licensed brokers operating throughout India in 2010, a 55% increase from 2005. Despite the challenge of finding domestic partners, international brokers such as Aon Benfield, Willis and Marsh have entered the Indian market to place treaty and facultative risks. Brokers state that capacity is not an issue for the market, which is also contributing to low commissions.

Exhibit 7
India Non-Life & Life – Number of Licensed Brokers (2004-2010)

2005	2006	2007	2008	2009	2010
195	222	258	281	296	303

Source: Insurance Regulatory and Development Authority, annual report 2009-10.

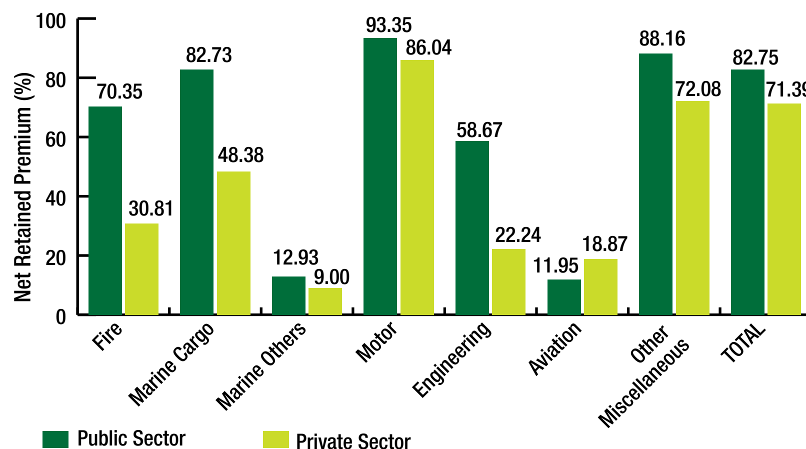
Governmental construction projects are tendered to both PSUs and private insurers and are generally offered to brokers, as well as advertised in the local media. Mandates for large risks are often tendered to more than one broker and placed with multiple insurers and reinsurers on a subscription-type basis. In addition to major building projects, intermediaries are utilised for specialist risks, such as D&O.

While some corporations are reportedly willing to pay higher premiums for broader cover, brokers complain that lower pricing remains the overriding factor in determining the placing of risk.

VI. Use of Reinsurance

The amount of reinsurance taken out by PSUs and private insurers is markedly different. **Exhibit 8** demonstrates that in 2010, PSUs' total net retained premiums on Indian business were 82.8%, compared with 71.4% for private insurers.

Exhibit 8
India Reinsurance – Net Retained Premium On Indian Business (2009-2010)
By class of business private/public sectors.



Source: Insurance Regulatory and Development Authority, annual report 2009-10.

PSUs retain more risk across every line of Indian business – with the exception of aviation. For instance, for fire and engineering risks, PSUs retain more than double the proportion of premium that private insurers do. For marine cargo, net retained premium for PSUs is 82.7%, versus 48.4% for the private sector.

The difference in reinsurance purchasing is related to PSUs being supported by historical reserves. In the absence of such reserves, private companies rely on risk transfer to a greater extent to minimise volatility and deliver relief on solvency margins.

Both PSUs and private insurers must cede at least 10% of their business with GIC Re, although obligatory cessions to the state reinsurer have been reduced in stages from 20% to 10% currently. The government-backed reinsurer, which has an A.M. Best FSR of A-, is

actively increasing its non-domestic book, in part as it seeks more profitable business.

In addition to GIC Re, reinsurance capacity is provided from Singapore, the Middle East, Bermuda, Europe and the London market. The IRDA requires that insurers seeking reinsurance overseas can only cede to companies with a satisfactory rating, as stipulated.

International reinsurers, including Swiss Re, Scor and Munich Re, are active in the Indian market but are not permitted to open branches in the country. This could change with the yet unpassed Insurance Laws (Amendment) Bill 2008, which would also result in Lloyd's being recognised as a branch of a foreign reinsurer.

International reinsurers are aware that unprofitable underwriting can be a cost of establishing themselves in the market. They are pursuing geographical diversification and attempting to build a presence and expertise in India, buying into the future growth of the Indian market.

However, reinsurers also exercise a degree of caution; despite India's potential, direct companies' loss ratios are high. Proportional business can be undesirable, particularly as there have been large losses in property and engineering risks.

Given the poor overall underwriting results, reinsurers are reluctant to share Indian insurers' underwriting experience. Reinsurers therefore view excess of loss treaties as more desirable, because this allows the reinsurers to "reprice" the excess layers on their own terms, separate from the underlying price. Excess of loss covers also provide reinsurers with certainty as to their exact liability. However, the end result might be that the direct insurers' net underwriting loss ratio deteriorates.

VII. New Regulations on the Agenda

The IRDA is increasingly scrutinising the insurance industry, recently overhauling the sale of certain life products (see VIII. Life Market in Evolution). In response to unexpected losses, all forms of credit insurance were banned last year, except for cover provided by Export Credit Guarantee Corp.

Insurance rules are changing and becoming more stringent, with policyholder protection paramount. The Indian insurance and reinsurance market is evolving quickly, and the regulator is holding numerous consultations. The IRDA is considering two elements, relating to mergers and acquisitions (M&A) and initial public offerings (IPOs), that could change the non-life market significantly.

Non-life PSUs tend to be well positioned to fund expansion as they are in general well capitalised, supported by large unrealised capital gains from historical equity holdings. The sustainability and viability of rapid premium growth for private insurers could be more challenging. Private insurers with short histories are more likely to have weaker capitalisation, as they have expanded rapidly in recent years.

Some private companies could consolidate to form bigger players. Reliance General Insurance Co. Ltd. is hoping to merge with Royal Sundaram Alliance Insurance Co. Ltd., a joint venture between the United Kingdom's RSA and India's Sundaram Finance Ltd. This would be the first such transaction in the non-life market, as only life companies are permitted to merge currently. The IRDA is examining merger rules for non-life insurers in conjunction with the Securities and Exchange Board of India (SEBI), the securities market regulator. The IRDA has emphasised deals should be in the interests of policyholders and enhance the value of the combined entity.

IPOs could be an alternative route to financing growth and may be attractive to shareholders planning to crystalise their investments. The IRDA is expected to publish IPO guidelines initially for life companies, followed by rules for non-life companies. An interest in ratings could derive from a company's need to raise capital, as well as its international ambitions.

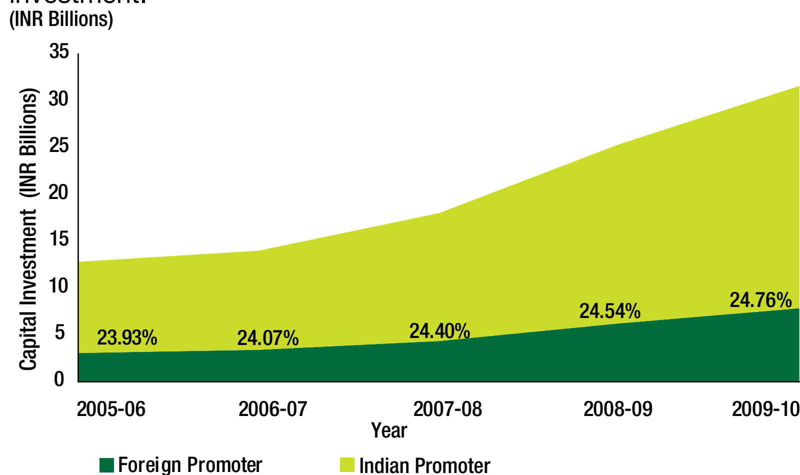
Raising the Foreign Direct Investment (FDI) limit from 26% to 49% would help provide additional funds to insurers

pursuing growth. However, this proposal in the Insurance Laws (Amendment) Bill 2008 is controversial and has faced strong political opposition.

International insurers state that in addition to providing funding, they can deliver technical knowledge and expertise to reduce expenses. This is arguably reflected in the lower loss, operating and combined ratios reported by private insurers compared with their public counterparts, as demonstrated in **Exhibit 5**.

Exhibit 9 shows that over the past few years, the aggregated investment of foreign companies has edged upward, reaching 24.8% in 2009-2010. This reflects the increased number of private insurers operating in the market and taking the maximum permitted investment stake in domestic insurers. Of the 18 private non-life insurers currently operating, 17 have international partners. Reliance General is the sole private insurer without a joint venture partner.

Exhibit 9
India Non-Life – Equity Share Capital of Private Sector Insurers (2005-2010)
Indian and foreign promoters with percentage of foreign direct investment.



Source: Insurance Regulatory and Development Authority

There is considerable scepticism, however, that the aforementioned 2008 insurance laws bill will be passed in its current form. In addition to political opposition, some domestic insurance industry participants claim there is no need for the FDI limit to be raised, as the non-life market is competitive and does not require additional capacity.

India's capital requirements for insurers are unlikely to change in the near future. The country operates a Solvency I-type model, with insurers required to have a working solvency ratio margin of 1.5 times, and there are no current plans to shift to a more risk-based capital approach. Enterprise risk management (ERM) is not high on insurers' current agendas, but it is of growing importance. The IRDA is asking life and non-life insurers for more information regarding ERM practices.

There are two proposed changes that could impact insurers in the next few years, although details are lacking at this stage. A roadmap has been published by the Ministry of Corporate Affairs to adopt International Financial Reporting Standards (IFRS). The Indian government, however, is facing pressure to delay the proposed phased transition, which would have resulted in some financial companies converting from April 2011. Currently, insurance companies are expected to adopt the new standard by April 2012.

International reinsurers could also be impacted by the Direct Taxes Code, which is set to replace the Income Tax Act of 1961 in April 2012. Again, details are still emerging, although there are concerns that premium in respect of insurance and reinsurance covering any risk in India could result in higher tax charges.

VIII. Life Market in Evolution

The life insurance market has grown at a significantly faster rate than the non-life sector, with life premium income rising 19.7% to INR 2.6 trillion during 2009-2010. Drivers similar to those found in the non-life market – especially increased economic spending – are helping to create a growing middle class with higher discretionary income.

The IRDA is attempting to improve awareness of insurance through its development role. The regulator published specific rules in November 2005 for micro-insurance, which is seen as a key means of broadening coverage. Insurance penetration is particularly low outside the urban centres, despite an estimated 70% of the population living in rural areas.

Life and non-life companies have rural and social sector obligations, with targets set by the IRDA on criteria such as percentage of premiums written and number of lives insured. As is the case with much of Asia, issues surround the cost of distribution, although some life companies regard these obligations to include the bottom of the pyramid as "the cost of doing business in India."

The biggest hurdle for the life market is changing regulation. Unit-linked insurance policies (ULIPs), which in 2009-2010 represented 85% of new business for private insurers, were completely overhauled in 2010 amid a territorial dispute between the IRDA and SEBI. This has resulted in considerable changes, with new rules on ULIPs issued in 2010, making products more focused on insurance protection as opposed to savings. This has included introducing caps on surrender charges and increased protection.

New business premiums have fallen as a consequence, and it is anticipated that there could now be a shift of product mix to traditional health and pension protection products, but these can be more capital intensive and result in heightened pressure on capitalisation. Consolidation is expected, with small to medium-sized companies thought to be particular targets.

Market competition is also a challenge, with the number of private registered insurers rising from 15 in 2005-06 to 22 in 2009-10. International insurers including Prudential, Allianz and Standard Life, have partnered with domestic companies to gain a foothold in the market.

Life Insurance Corporation of India (LIC), which was formed in 1956 from the nationalisation of 245 life companies, continues to dominate (commanding a 70% market share). LIC products are guaranteed by the government of India, and the company has maintained its market-leading position, supported by its distribution network and geographical presence through the country.

Private life insurers have failed to meet break-even targets indicated at the time of obtaining their licences, as they suffer from high procurement costs. Agency workforces are expensive in such a vast country, but face-to-face contact is required for the rural areas where there are low literacy levels, awareness and understanding of insurance offerings.

However, companies are focusing increasingly on operating expenses and cutting costs, given anticipated lower volumes following the introduction of the new ULIP rules. Private life insurers are reducing the number of offices and agents for the first time since the liberalisation of the insurance market in 2000.

Policyholders can lack confidence in the claims settlement system, and mis-selling has been a challenge, although the IRDA is increasingly addressing this. Among other measures, stricter rules making it more difficult for agents to market products aggressively are expected to contribute to a drop in product volumes. For instance, in February, the IRDA issued guidelines for individual agents on the persistency of life policies, stating that in the next three years at least 50% of both policies and premiums must be renewed, with this level rising to a minimum of 75% from the financial year 2014-15.

IX. Conclusions

Continued economic development is creating plenty of opportunities for India's non-life sector, although market participants face a vast range of challenges.

While insurers are attempting to improve underwriting losses, charging more realistic premiums for some classes of business, there is a heavy reliance on investment income to support losses. The lure of the Indian insurance and reinsurance market is continuing for international players, which may create greater capacity, fuel competition and ultimately make it more challenging to achieve underwriting profits in the near future.

Besides competition, the industry faces various challenges over the next 24 months. There is still some uncertainty regarding the planned adoption of IFRS and the new Direct Taxes Code, and whether the FDI limit will finally be lifted.

The life sector has already witnessed tremendous change. Life insurers are focusing on expenses to improve margins but must balance a rationalisation of structures with the need to retain staff to support growth. It will be challenging to grow, especially considering the high insurance penetration for life business in comparison with non-life insurance penetration.

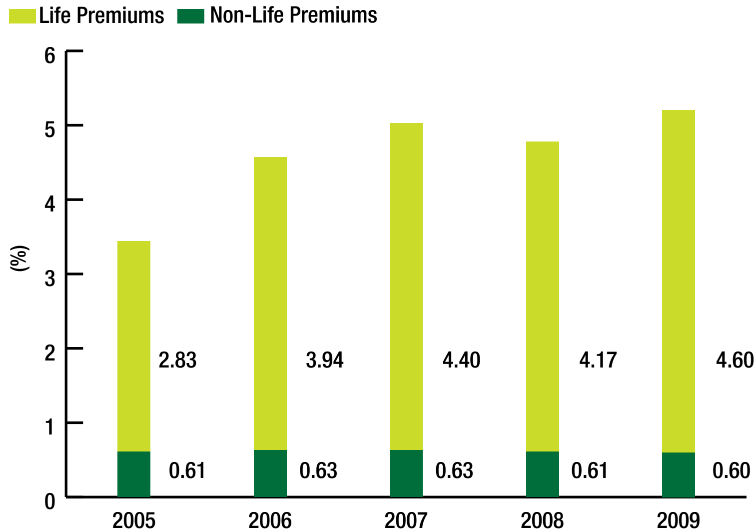
Both the life and non-life industries are evolving rapidly, although the IRDA's move toward international best practices is fundamental in shaping India's insurance market further.

Appendix

Exhibit 1A

India Non-Life & Life – Insurance Penetration As % of Gross Domestic Product (GDP)

Life insurance penetration is significantly higher than non-life insurance, reflecting life products' traditionally high savings

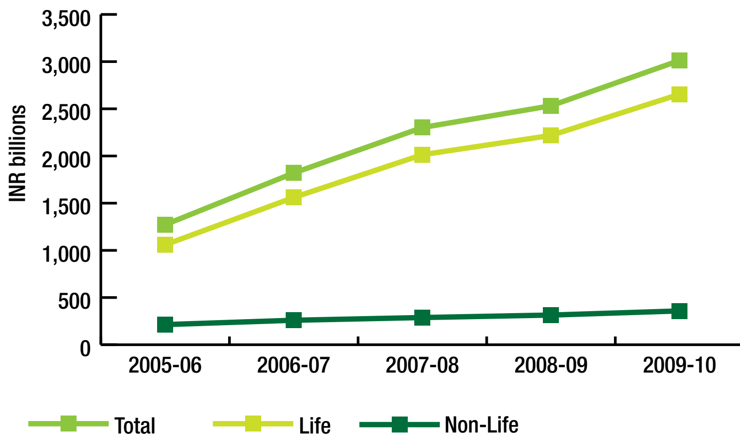


Source: Swiss Re, Sigma Insurance Reports, 2005 to 2009.

Exhibit 2A

India Non-Life & Life – Premium Volume (Fiscal Years 2005-2010)

Total insurance premium has risen sharply in recent years to INR 3,013 billion in 2009, driven by strong growth in the life sector.



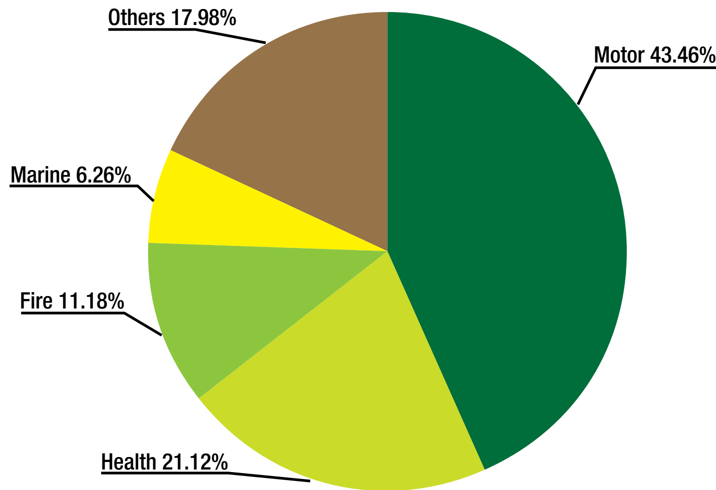
Source: Insurance Regulatory and Development Authority, annual reports 2005-06 to 2009-10.

Appendix *(continued)*

Exhibit 3A

India Non-Life – Sector Market Share by Premium Income (2010)

Motor continues to represent the largest line of business in terms of non-life premiums, followed by health insurance.

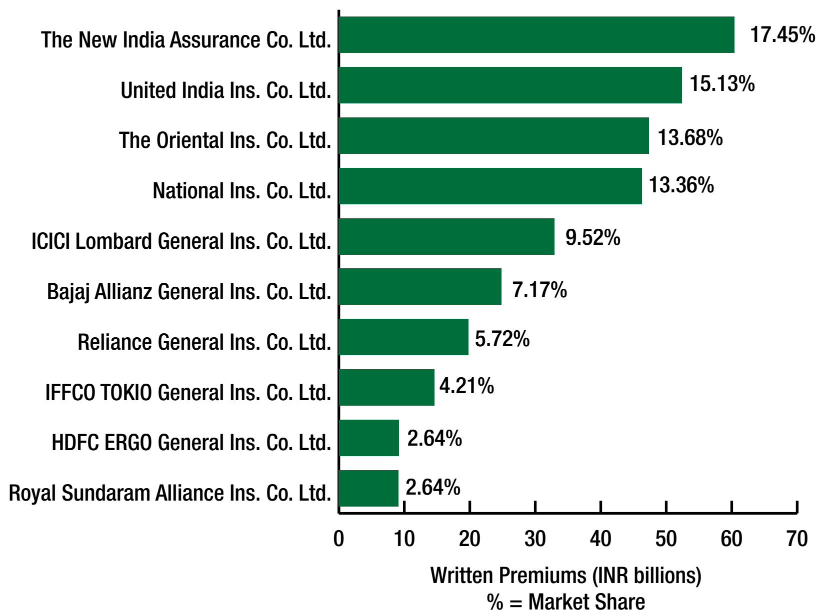


Source: Insurance Regulatory and Development Authority, annual report 2009-10.

Exhibit 4A

India Non-Life – Top 10 Companies by Written Premiums & Market Share (2009-2010)

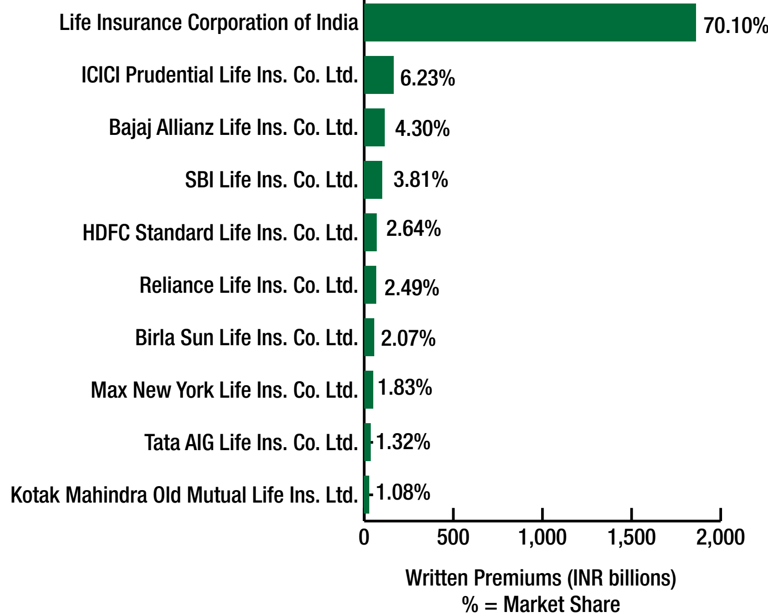
India's four public sector undertakings (PSUs) – The New India Assurance Co., United India Insurance Co., The Oriental Insurance Co. and National Insurance Co. – collectively control 60% of the non-life market.



Source: Insurance Regulatory and Development Authority, annual report 2009-10.

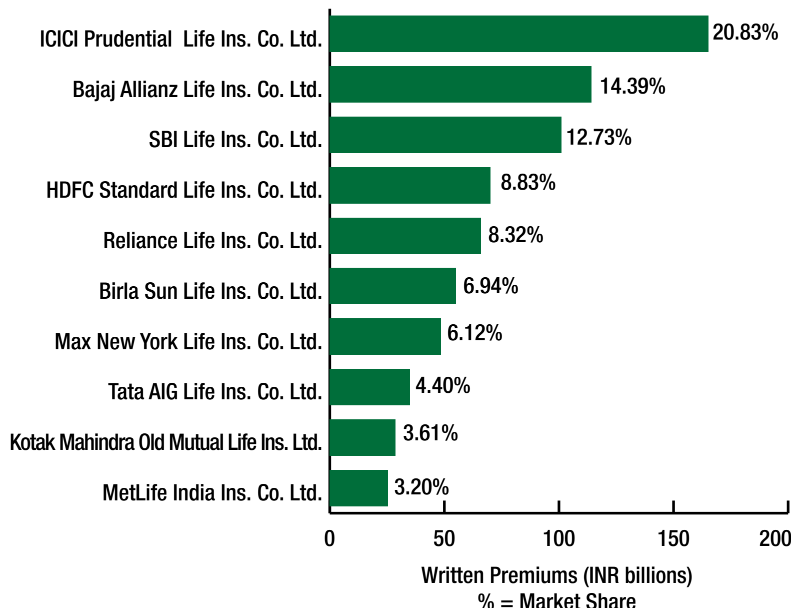
Appendix *(continued)*

Exhibit 5A
India Life – Top 10 Companies by Written Premiums & Market Share (2009-2010)
Life Insurance Corporation of India (LIC), the sole public life insurer, has continued to remain the dominant insurer in the sector, underwriting 70% of total life premiums.



Source: Insurance Regulatory and Development Authority, annual report 2009-10.

Exhibit 6A
India Life – Top 10 Private Sector Companies by Written Premiums & Market Share (2009-2010)
Among the private sector insurers, ICICI Prudential Insurance Co. underwrites one-fifth of the life premiums although the market remains fragmented and competitive.



Source: Insurance Regulatory and Development Authority, annual report 2009-10.

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