

# Insurance industry

## Challenges, reforms and realignment



Confederation of Indian Industry

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# Foreword

After a decade of strong growth, the Indian insurance industry is currently facing severe headwinds, grappling with slowing growth, rising costs, deteriorating distribution structure and stalled reforms. For the first time, since the industry was liberalized and opened to private and foreign insurers, the life insurance segment witnessed a year-on-year decline (around 10%) in the first year premium collected. The non-life segment is still struggling with underwriting losses, while health insurance is facing high claims ratio and inefficiencies in policy administration.

However, the picture is not all gloomy, while in the short run the industry may be undergoing a catharsis, the long-term picture is still compelling and a stronger and better founded insurance industry is likely to emerge from this challenging situation. The industry needs to offer appropriate product designs, which enable customized solutions for evolving customer needs in a professional and transparent manner, build and maintain trust among existing and potential customers, effectively deliver the product benefits to the customers and adopt a professional code of conduct. At the same time, the regulator needs to create a favorable environment for a competitive market

through constructive engagement and effective consultation with industry, emphasizing on proper market conduct, good governance, customer centricity and efficient distribution. With a density of US\$64 compared to US\$118 in developing countries and US\$3712 in advanced economies in 2010, the domestic insurance industry still has considerable scope for growth. However, a rethinking of the approach is required for the industry to achieve its potential. Innovation is the first casualty in tightly controlled markets leading to drying up of incentives for product manufacturers and decline in business activities. However, this is not to say that a free rein is recommended especially in financial services sector. A certain degree of freedom aligned with the market maturity may be desirable.

Perhaps after a heady period of growth and glowing projections of the future, it is time for the key stakeholders, i.e., the industry, regulator and the government to make a concerted effort for the orderly development and sustained growth of the industry.

The Confederation of Indian Industry (CII) and Ernst & Young have co-authored this report to outline the current issues and challenges faced by the insurance industry and steps that could be taken to ensure that the industry achieves its potential.



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# Executive summary

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The Indian insurance industry seems to be in a state of flux. While there has been a perceptible change in the market dynamics since liberalization and economic reforms, a considerable amount needs to be done for future growth and development of the market in an orderly and sustained manner. Notwithstanding the strong improvement in penetration and density in the last 10 years, India largely remains an under-penetrated market. The market today is primarily dependent on push, tax incentives and mandatory buying for sales. There is very little customer pull, which will come from increasing financial awareness along with increasing savings and disposable income. Till then the stakeholders will have to strive for product simplification, increasing transparency of cost and pricing, effective distribution and improving customer servicing to drive sales. In the long run the insurance industry is still poised for a strong growth as the domestic economy is expected to grow steadily, leading to rise in per capita and disposable income, while savings are expected to be stable.

For the first time in 12 years, the life insurance industry witnessed a decline in the first year premium collected in FY12, which declined from INR1,258 billion in FY11 to INR1,142 billion, a drop of approximately 10%. There is a perceptible shift in the life insurance market as the sales of Unit Linked Insurance Plans (ULIP) products witnessed a drop in sales and customer move toward traditional products. The

business model for insurers has been changing continuously for the past couple of years on account of regulatory changes. While the regulatory changes were aimed at customer protection and increasing transparency in pricing and operations, it gave the industry very little time to adjust, leading to a lot of uncertainty in the market environment. In addition to challenges in growth, pricing and profitability, life insurers are also faced with Significant challenges on the distribution front with a reducing agency force and uncertainties in alternate channels such as Bancassurance. The cap on commission and expense ratios further imposes restriction on the competitiveness of insurers and limits the expansion of distribution channels.

The non-life premium underwritten grew by 23% in FY12, reaching INR530 billion from INR430 billion in FY11, but the segment is saddled with considerable underwriting losses and pricing issues in addition to high claims ratio exerting increasing pressure on profitability. Insurers need to strengthen their risk assessment and underwriting mechanisms. There is a requirement today for long-term assets, benefit and health policies to serve the people till the time insurance in India is considered as a household requirement than just a temporary risk-mitigating tool. Furthermore the pace of reforms needs to be increased especially in the areas of pricing and reinsurance.

The three standalone health insurers also performed well with a premium underwritten growth of 13% for FY12, reaching INR17.3 billion from INR15.4 billion in FY11. Health insurers need to balance their portfolio, which leans heavily towards group insurance and introduce more products covering individuals. The claims and fraud monitoring process also needs to be simplified, strengthened by stricter guidelines for third party administrators. Despite strong growth, the non-life segment also faces stiff challenges in distribution, pricing and claims management and these issues need to be addressed on a priority to sustain the growth.

The industry is at an inflexion point and despite the signs of stress there is a silver lining. The insurance industry stands at the threshold of moving toward a stable position, delivering "stable profitable growth." Most players will now look to reassess the entire business model from product, pricing, risk management, acquiring rural customers, distribution, claims and fraud management and a realistic pace of growth. The industry is also likely to witness consolidation as and when the regulator finalizes the guidelines for mergers and acquisitions. The stakeholders should work toward maintaining a favorable environment for stable growth, increasing the penetration of insurance to rural and underpenetrated areas and increasing the contribution to the economy.

Faced with a persistent high inflation over the last two years and consequently, a high interest rate regime, the economy seems to have lost some steam

# Introduction

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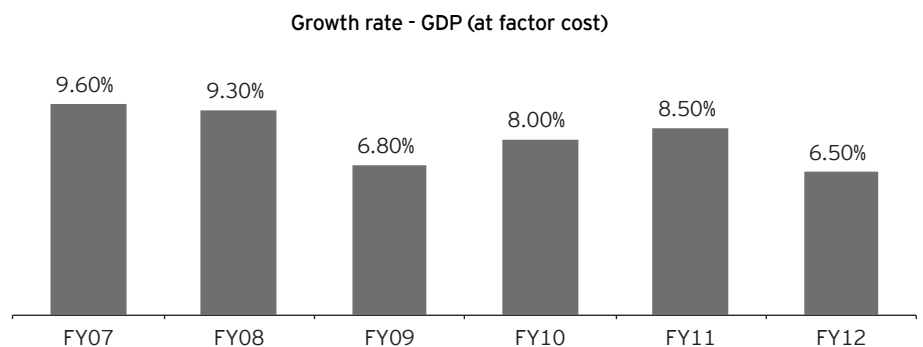


### Indian economy

India recorded a growth in the gross domestic product (GDP) of 6.5% for FY12, which was a sharp decline from the 8.5% witnessed in FY10. Faced with a persistent high inflation over the last two years and consequently, a high interest rate regime, the economy seems to have lost some steam. Although it can be primarily attributed to the global economic conditions and problems in the

Eurozone, the key indicators do not reflect a very strong picture. Growth forecasts for FY13 and FY14 are muted as well. Monetary measures seem to have had little effect on the inflation in the absence of fiscal tightening by the government. The prevalent high interest rate scenario has led to reduction in corporate activity and shrinking of margins.

**Exhibit 3.1. GDP growth rate**



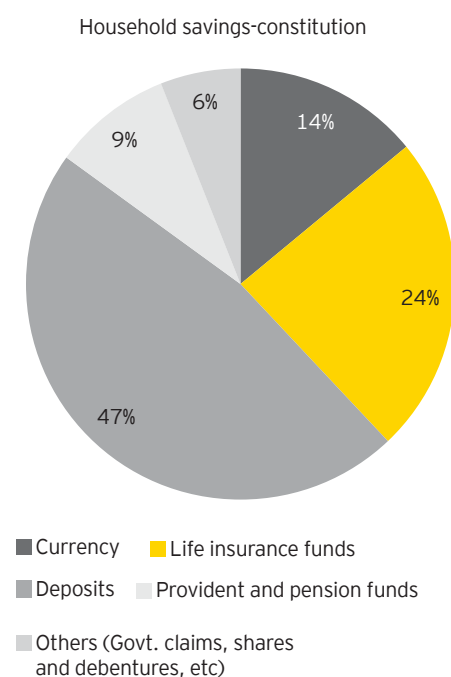
Source: RBI Annual Report, 2011



Global growth is projected to drop from around 4% in 2011 (year ending December) to around 3.5% in 2012 because of weak activity during 2H11 and 1H12 according the IMF World Economic Outlook released in April 2012. The July update indicates a further deterioration in the situation. However, the global growth has been maintained at 3.5% for 2012 and 3.9% for 2013. The growth for emerging economies has been revised downwards by 0.1% and 0.2% for FY12 and FY13 to 5.6% and 5.9% respectively. The positives for global as well as Indian economy is the cooling of commodity prices, especially oil; but the situation in the Eurozone will continue to weigh heavily on the global as well as the Indian economy.

The share of financial savings channeled to the insurance industry is approximately 24% and given the backdrop of moderating economic growth it might change a bit. However, it is not expected to vary drastically. The household savings in FY11 stood at INR10,439.77 billion, with the share of currency increasing to 13.3% (9.8% in FY10), deposits remaining largely at the same level at 47.3% (47.2% in FY10); life insurance funds increasing to 24.2% (22.0% in FY10) and provident and pension funds slipping to 9.1% (11.5% in FY10). The insurance industry, by offering long-term savings and protection products, can channelize a larger share of household savings and enhance the levels of financial protection currently deficient in the Indian economy.

**Exhibit 3.2. Constitution of household savings**



Source: RBI Annual Report, 2011

# Insurance industry landscape

## Premiums

According to Swiss Re, India's ranking in the world insurance market based on total premiums collected has dropped to number 15 in 2011 from number 11 in 2010. India's share of the world insurance markets has declined to 1.58% in 2011 from 1.8% in 2010, being displaced by countries such as Brazil, Spain and Taiwan, which now rank higher than India. Globally, total insurance premiums for calendar year 2011 contracted by 0.8%, with premiums contracting in advanced economies at -1.1% and those in emerging economies growing at 1.3%; with life insurance contributing 57% at US\$2,627 billion and non-life contributing the balance 43% at US\$1,912 billion.

## Players and market share

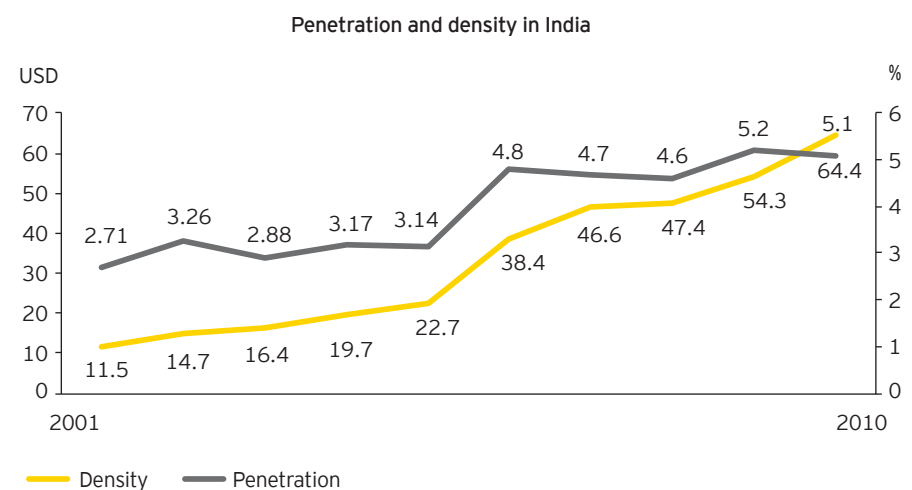
As at end-September 2011, the total number of insurance companies in India was 49; the life insurance industry consisted of 24 players, i.e., one public insurer and 23 private insurers, while the non-life insurance industry consisted of 25 players – 6 public insurers, 3 standalone health insurers, one reinsurer and 15 private insurers. Edelweiss Tokio Life Insurance Company Limited, which was granted registration in 2011 was the latest entrant in the life insurance sector. Religare Health Insurance Company Limited made a quiet entry in the health insurance sector in June 2012. Magma HDI General Insurance Company Limited and Liberty Videocon General Insurance Company, are the latest entrants in the non-life sector, and are due to start operations in 2012.

Based on total premium income, the Life Insurance Corporation (LIC) was the market leader in the life insurance sector with a market share of 69.78% in FY11. As at end-November 2011, ICICI Prudential Life insurance was the largest private sector player with a market share<sup>1</sup> of 6% followed by HDFC Standard Life Insurance at 4.6% and SBI Life Insurance at 3.5%. Based on total premium underwritten, the public sector non-life insurers held a market share<sup>2</sup> of 59.07% in FY11 – New India Assurance at 16.67%, United India Insurance at 14.98%, National Insurance at 14.61% and Oriental Insurance at 12.82%. As at end-March 2011, ICICI Lombard continued to be the private sector market leader with a market share of 9.99%.

## Penetration and density

Penetration moved from 2.71% in 2001, when the insurance sector was opened up to the private sector, to 5.1% in 2010. In the same period, insurance density increased from US\$ 11.5 to US\$64.4 per capita. Globally, the average density was an average of US\$3,712 per capita in advanced economies as against US\$118 per capita in emerging economies. Since economic growth exceeded growth in the insurance sector globally, overall insurance penetration in the world economy shrank further to 8.6%, even lower than a decade ago.

**Exhibit 3.3. Insurance penetration and density in India**



Source: IRDA Annual Report 2010-11

<sup>1</sup> Market share based on annualized new business premium

<sup>2</sup> Market share based on total premiums underwritten



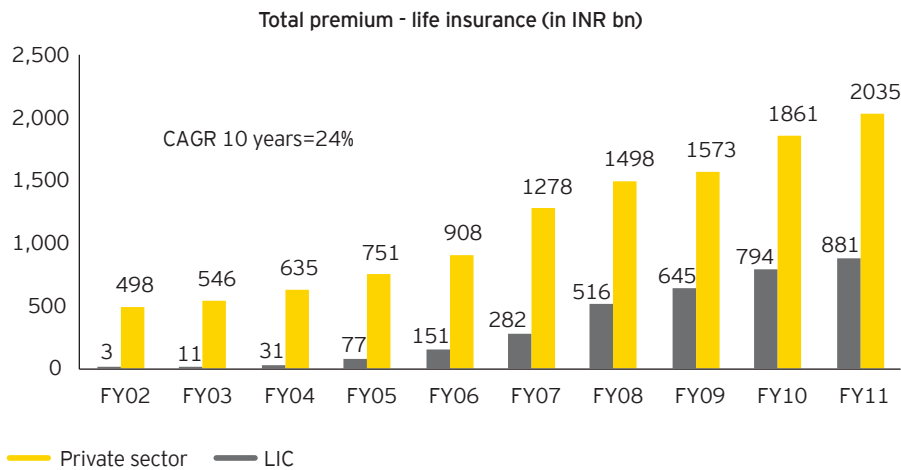
The life insurance penetration slipped in FY11 to 4.4% from 4.6% in FY10 while insurance density has grown from US\$9.1 in FY01 when the industry was opened to the private sector to US\$55.7 in FY11. In the non-life segment, penetration slipped in FY11 to 0.7% from 0.6% in FY10 while insurance density has grown from US\$2.3 in FY01 to US\$8.7 in FY11.

### Life insurance industry in India

According to Swiss Re, India's life insurance market was ranked at number 9 among 156 countries in terms of premium in FY11; India's total premium in life insurance grew by 4.2% (inflation adjusted) while the total global premium grew by 3.2%. The sector has grown at more than 24% CAGR over the last 10 years. The number of policies issued, declined at a rate of 22.61% to 48.2 million in FY11 from 53.2 million in FY10.

The total premium underwritten by the life insurance sector was INR2,916 billion in FY11 as compared to INR2,655 billion in FY10, exhibiting a growth of 9.85% down from the 19.69% growth in 2009-10. The first year premium, which is a measure of new business secured, underwritten by the life insurers during FY11 was INR1,264 billion as compared to INR1,098.94 billion in FY10 registering a lower growth of 15% in FY11 as compared to 25.84% in FY10. In terms of linked and non-linked business during the year 2010-11, 37.38% (as compared to 43.52% in FY10) of the total premium was underwritten in the linked segment while the balance 62.62% of the business was in the non-linked segment (as compared to 56.48% in FY10).

Exhibit 3.4. Total premium in life insurance



Source: IRDA website

### Exhibit 3.5. Total premiums in FY11

Total premium - split FY11							
Sector	Regular premium (previous yr)	Renewal premium (previous yr)	Total	Sector	Linked	Non-linked	Total
Private	36%	64%	100%	Private sector	79.20%	20.80%	100%
	(45%)	(54%)					
LIC	24%	76%	100%	LIC	19.30%	80.70%	100%
	(19%)	(81%)					

Source: IRDA website

ICICI Prudential Life Insurance is the largest private sector player (based on market share annualized new business premium) followed closely by HDFC Standard Life Insurance. The former has lost 4% market share over the last three years due to the emergence of stronger distribution ramp ups by other players and the new regulatory regime that impacted its ULIP-dominated business mix. ICICI Prudential Life, HDFC Standard Life, SBI Life, Bajaj Allianz and Max Life have managed to uphold their position in the top eight private insurers for the last five consecutive years. While Reliance and HDFC have been gaining market share, Bajaj Allianz has lost considerable share over the last three years. It can be observed that most of the top eight private life insurers have strong banking relationships. Further, the industry has seen the entry of four new bank-backed insurance players such as Canara

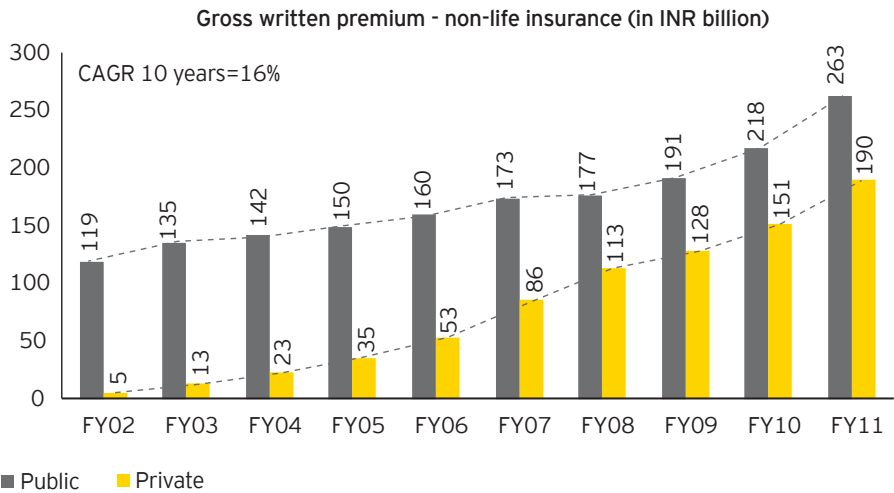
HSBC, Star Union Dai Ichi, IDBI Federal and India First Life Insurance. These insurers capitalize on the Bank's captive customer base and existing branch networks. Most of these players have a small or negligible agency presence.

### Non-life insurance industry in India

According to Swiss Re, India's non-life insurance market was ranked number 19 among 156 countries in terms of premium in FY11; India's total premium in non-life insurance grew by 8.1% (inflation adjusted) while the global total premium grew by 2.1%. The sector has grown at a CAGR of 16% over the last 10 years. The number of policies issued increased at a rate of 16.52% to 79.3 million in FY11 from 67.5 million in FY10. million in FY11 from 67.5 million in FY10.



Exhibit 3.6. Private and public sector non life insurers

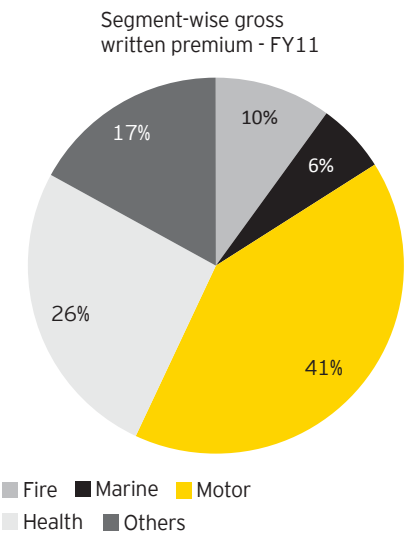


Source: IRDA website

The gross written premium underwritten by the non-life insurance sector in FY11 was INR453 billion up from INR369 billion in FY10, registering a significantly high growth of 23% over the previous year of 15.34%. In terms of segment-wise composition, major retail lines such as motor and health constitute more than 65% of the Gross Written Premiums in the market; the higher percentage is primarily on account of the mandatory

third party liability cover for vehicles and increasing importance of availing health insurance due to rising costs and increasing lifestyle diseases. Key commercial lines such as fire and marine constitute around 16% of total market premiums. Personal accident, liability, aviation, engineering and miscellaneous segments are all categorized under “others,” which constitutes around 17%.

Exhibit 3.7. Non-life insurance segments - FY10 and FY11



Source: IRDA Annual Report 2010-11





The demand for insurance products is likely to increase due to the exponential growth of household savings, purchasing power, the middle class and the country’s working population

# Underlying growth drivers for insurance in India



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Exhibit 4.1. Drivers for the industry

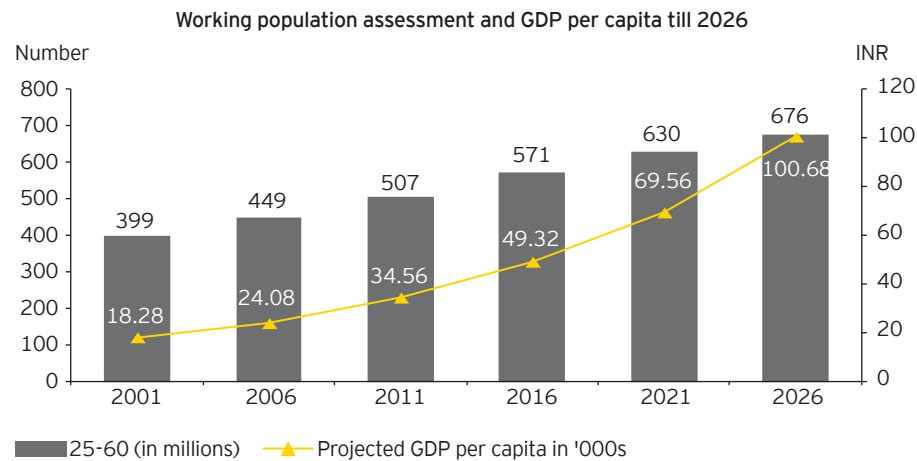
<ul style="list-style-type: none"><li>▸ Increase in the working population and higher disposable income</li><li>▸ Increase in awareness of various financial products including insurance</li></ul>	Growth of financial industry as a whole
<ul style="list-style-type: none"><li>▸ Need to invest for a secured future for self and for family</li><li>▸ Higher spends on consumer goods, travel, automobiles, facilities which are underlying drivers of various insurance lines</li></ul>	Growth of life and non-life industry
<ul style="list-style-type: none"><li>▸ Increasing universe of potential insurance takers - Individuals and Companies across industries, SMEs, MNCs</li><li>▸ Expansion of the universe of insurance takers driven by professionalization of companies</li></ul>	Promoting innovation and removing inefficiency
<ul style="list-style-type: none"><li>▸ Increasing number of providers offering a large range of covers at competitive prices and higher level of sophistication</li><li>▸ Regulations which are conducive for growth and expansion of industry</li></ul>	Competition and orderly growth
<ul style="list-style-type: none"><li>▸ Increasing focus on micro insurance under financial inclusion</li><li>▸ Increase in demand for motor insurance</li><li>▸ Increase in costs of healthcare and Govt. schemes on healthcare</li></ul>	Growth of specific insurance segments



# Growing economy and purchasing power

The demand for insurance products is likely to increase due to the exponential growth of household savings, purchasing power, the middle class and the country's working population. The working population (25-60 years) is expected to increase from 675.8 million in 2006 to 795.5 million in 2026. Increased incomes are expected to result in large disposable incomes, which can be tapped by the financial services sector in general and the insurance sector in particular.

**Exhibit 4.2. Working population and GDP comparison - estimation till 2026**



Source: CMIE, Census of India, 2001

## Rising focus on rural market

More than two-thirds of India's population lives in rural areas without proper access to insurance products. Micro insurance is seen as the most suitable channel to ensure coverage in these areas.

- ▶ Poor insurance literacy and awareness, high transaction costs and inadequate understanding of client needs and expectations has restricted the supply for micro-insurance products. As a result, the market remains significantly underserved, creating a vast opportunity to reach a considerable number of customers.
- ▶ From a modest beginning, micro insurance was able to grow to a respectable size with a total premium of INR15.43 billion collected under life and non-life micro insurance portfolios in 2011; life insurance premium contributed INR11.49 billion and non-life insurance premium contributed INR3.93 billion to the overall amount.
- ▶ In the life insurance sector, individuals generated new business premium worth INR1.30 billion under 3.6 million policies, the group business amounted to INR1.55 billion under 15.3 million lives. LIC contributed most of the business procured in this portfolio by garnering INR1.23 billion of individual premium from 2.95 million lives and INR1.38 billion of group premium under 13.3 million lives. There has been a steady growth in the design of products catering to the needs of the poor, with LIC leading the race.

IRDA has been endeavoring to improve penetration of micro insurance through multiple initiatives and believes that there is tremendous scope for growth.

According to the regulator, ways to increase penetration include the following:

- ▶ Insurers need to innovate to reduce per policy costs as ticket size is small. One way is to go for group schemes due to their low cost of distribution, low overhead costs, easy underwriting norms, and support of nodal agency in remittance of premiums and claims. This is easily accessible through community leadership.
- ▶ Insurers should use latest technological innovations such as mobile-based communications and internet to increase insurance penetration and reduce cost of operations.
- ▶ Currently, eligibility for micro-insurance agency is limited to MFIs, SHGs, NGOs. This needs to be expanded to grocery stores, embedded into various farm equipments etc. to bring in a variety of ways to distribute them as it besets the most.

## Rising demand for motor insurance

During FY03-FY10, the number of passenger cars has increased at a CAGR of 15.6%. This trend is likely to continue due to strong growth in the auto segment, resulting from an increase in consumer income levels due to which more than 28 million policies were sold in FY10. During FY11, motor insurance accounted for 42.7% of the non-life insurance segment reporting a growth of 28.2% over the previous year.

## Robust growth in health insurance

Evolving medical technology and increasing demand for better health care has resulted in a significant rise in the demand for health insurance. The Indian health insurance industry was valued at INR99.4 billion as of FY11. From the period FY03-FY10, the industry has grown at a CAGR of 32.59%. Share of health insurance was 26% of the total non-life insurance premium in FY11. Health insurance premiums are expected to increase to INR300 billion by 2015.

Under the social security schemes, the Government of India's Rashtriya Swasthya Bima Yojna (RSBY) launched in 2007 for families below poverty line in the unorganized sector has gained significance in the recent years. By bearing an expense of INR30, families are insured for INR30,000. With 75% funding coming from the Government of India, the scheme ensures cashless coverage of health services through smartcard and also provides a transport allowance with an upper limit of INR1,000. Public or private insurers, based on a bidding process, can opt for providing health insurance in the state for a particular district/set of districts. IRDA has also relaxed certain requirements with respect to solvency ratio of such insurers, in a view to promote health insurance in the country. As of end-July 2011, five states had implemented the scheme with 23.6 million cards being issued at a total expenditure of INR100 billion.



# Emerging trends

## Multi-distribution

To increase market penetration, insurance companies need to expand their distribution network. In the recent past, the industry has witnessed the emergence of alternate distribution channels. The typical distribution channels used by insurance companies now include bancassurance, direct selling agents, brokers, online distribution, corporate agents such as non-banking financial companies (NBFCs) and tie-ups of para-banking companies with local corporate agencies (for example NGOs) in remote areas. Agencies have been the most important and effective channel of distribution hitherto. According to the industry, the role of agents has started evolving from merely a prospecting and selling role to an advisory and service-related one.

Bancassurance in India has taken a different and perhaps an increased involvement in distributing insurance products with banks becoming joint venture partners of insurers. This makes them more committed to use their customer base and infrastructure.

A few alternative distribution channels have evolved in the recent years such as:

- **Online/internet:** The internet penetration in India has been on the rise, whereby increased number of people have access to internet both through computers as well as through mobile phones, including population in tier-2 and tier-3 cities.

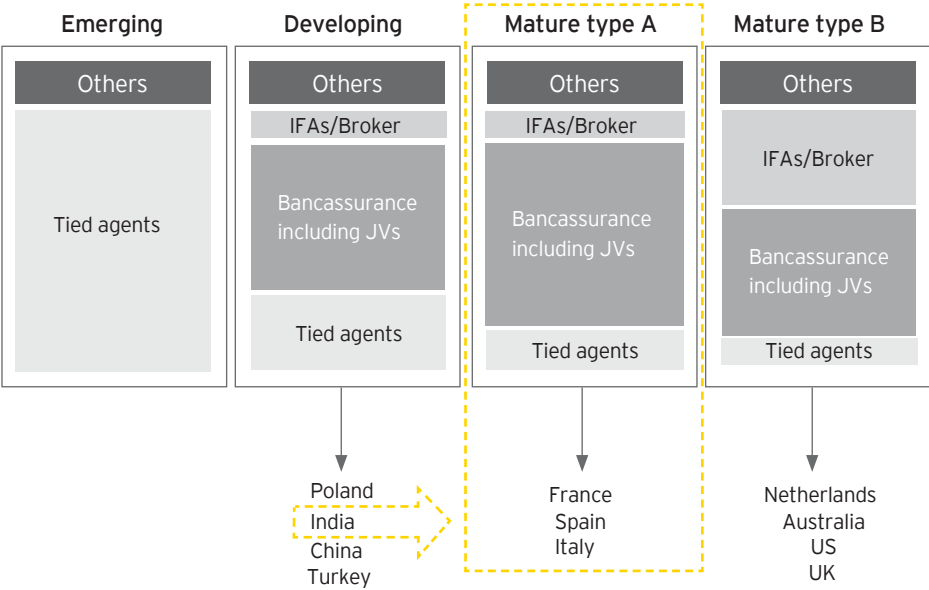
- **Direct Marketing and telemarketing:** With increasing telecom penetration in India, the use of direct marketing via database marketing is growing. Direct access to the customer and savings in intermediary cost make it an attractive option for the companies and is the key in development of the channel.
- **NGOs and affinity groups (SHGs):** With IRDA allowing NGOs/SHGs to distribute micro insurance, insurers can access the “untapped” areas at relatively lower costs using the existing relationships of such entities.

Globally, various insurance markets are at different stages of development, which is also reflected in their insurance distribution networks. Where insurance penetration is low, face-to-face interaction in the form of agents is required to educate customers. As the insurance penetration develops, other distribution channels such as independent financial advisors (IFAs), brokers, bancassurance and electronic channels come to the fore to supplement

the agency model. The following figure explains the evolution of the insurance distribution network across countries

For sustainable growth, various markets have developed alternative distribution channels, including extensions of the career and tied agency system such as brokerage, along with bancassurance, financial advisors and electronic channels. Among the alternative channels, bancassurance has grown rapidly in the past few years, especially in Asia. The global downturn has had insurers analyzing the profitability of their bancassurance business and taking a re-look at their organizational relationship with the bank. For insurers in strategic alliances with integrated models, the bancassurance business has been more successful compared to businesses where the bank is a pure product distributor. Concentrating on retaining and strengthening the tied agency system during these times of uncertainty is a focused strategy being adopted across various markets.

Exhibit 4.3: Maturity model of distribution



## Product innovation

With customers asking for increased levels of customization, product innovation is one of the best strategies for companies to increase their market share. This also creates increased efficiency as companies can maintain reduced unit costs, offer improved services, can increase flexibility to pay increased commissions and generate higher sales. Regulatory changes, especially those with respect to health insurance portability and micro insurance, offer considerable potential for insurance companies to be more innovative, while others such as product design guidelines is likely to stifle innovation, if not conceived and implemented in an appropriate manner. Micro insurance is important not only from social and economic perspective (prosperity and financial inclusion) but also from insurers' perspective for new avenues of sustainable profitable growth in future. Even the pension sector, due to its inadequate penetration (only 10% of the working population is covered), offers avenues for innovation.

## Claims management

Timely and efficient management of claims is crucial for performance in the industry. Delay in claim settlement generally results in higher claims cost. The incurred claims ratio, which measures the claims incurred to the premiums earned in the same period, stood at 97% for public insurers and 87% for private insurers in FY11 for the non-life insurance business.

In the life insurance business, LIC paid benefits constituting 55% of premiums underwritten while the figure for private insurers stood at 35%.

Some insurers have managed to limit the claims ratio by deploying in-house team of surveyors, engineers etc., stringent and sophisticated underwriting policy, geographical focus in certain segments and higher reinsurance cession especially for more complex lines of business.

## Profitable growth

In the period following the liberalization of the insurance sector (FY00-FY05), most insurers were heavily inclined to achieve growth at the cost of profitability. In the recent years, most players have shifted from the philosophy of "growth versus profitability" to "profitable growth" by focusing on expanding product range, developing innovative products and building robust distribution channels. Profitability continues to be a big concern and insurers have now shifted their focus on their bottom line to avoid exerting pressure on solvency and share capital. In the last two years, most private insurers have been reducing their operating expenses in a move toward profitability.

The life insurance industry reported a net profit of INR26.57 billion in FY11 against a loss of INR9.89 billion in FY10. At the same time the non-life insurance industry posted loss of INR10.18 billion in FY11 against a profit of INR12.04 billion in FY10.





There is enough potential for positive growth of the Indian insurance industry given the focused efforts of the regulator, government and players in the backdrop of rising demand for insurance. The industry does, however, face numerous challenges primarily on product designing, distribution and regulatory front. The following sections throw light on typical challenges faced by the life and non-life industry.

### Regulatory trends

The IRDA has mandated regulatory changes in order to promote a competitive environment in both the life and non-life insurance sectors.

With Health insurance portability being introduced, insured persons are likely to get credits for the covered term across the industry and will be limited to a specific insurance company. The regulator envisaged that this initiative will compel the insurance industry to act toward standardization of costs incurred on treatments, fix accountability and transparency about costs and push insurers to think about product innovations to survive competition.

The IRDA has recently dismantled the third-party liability pool in motor insurance and replaced it with the declined risk pool. While it is likely to have widespread implications on the size and loss ratio of the pool, the move is expected to drive the industry toward risk-based pricing.

Recent regulations pertaining to cap on ULIP charges and increase in the lock

in period, translated to reduction in overall distributor payouts, which in turn reduced the overall contribution of ULIPs to new business premium. With a cap on surrender charges, insurers showing profits due to release of lapse reserves will need to develop long-term efficiencies to be able to sustain the market.

Other recent regulatory developments include changes in the Finance Act 2012 impacting tax exemption of life insurance policies and service tax liability, proposed guidelines for the design of life insurance products, servicing of orphan policies and standardization of the proposal form, all of which have far reaching consequences for the industry.

There is enough potential for positive growth of the Indian insurance industry given the focused, synergistic efforts of the regulator, government and industry players in the backdrop of rising demand for insurance. The industry does, however, face numerous challenges primarily on the product designing, distribution and regulatory front. The following sections throw light on typical challenges faced by the life and non-life industry.



IRDA forecasted that the demand for pension schemes would increase with the rise in the working population and therefore required mandated a guaranteed return of 4.5% to protect policy holders

# Life Insurance: issues and challenges

## 5

### Products

#### Strategy and design

At a time when the highest NAV guaranteed ULIP were selling aggressively in the market, the IRDA banned the product in order to keep a tab on life insurers resorting to riskier fund management to conform to their commitment of guaranteed returns. Not only did these products attract an increased premium, but they also offer little protection to policyholders. According to IRDA officials, “in most of these products, customers are being lured with the promise of a decent maturity benefit, but in case of claims (in the event of death), the benefits or the amounts are sometimes lower than the premiums. The basic underlying principle of a life insurance policy is it should have sufficient life risk cover”. The regulator is keen to oversee the product design more closely to better protect policyholders falling prey to “low” or “insignificant” life risk covers. The challenge for insurers,

therefore, is to develop innovative products without crossing the boundaries of insurability.

Retirement planning is assuming importance in India considering the shift to nuclear families, increase in life expectancy, rise in health care costs, and the need for reasonable income post retirement; pension schemes are designed keeping in mind these objectives. IRDA forecasted that the demand for pension schemes is likely to increase with the rise in the working population and therefore required a guaranteed return of 4.5% to protect policy holders. However, it later withdrew the requirement for new products but mandated upfront disclosures at the time of sale with respect to assured benefits. While, longevity and interest rate risks continued to overhaul the pension schemes, the additional requirements made the products too risky for insurers. As insurers did not find the guidelines feasible, most of them withdrew their pension products from the market and at present only a few insurers including





LIC are offering pension products. This resulted in a sharp decline in the new business premium collected from individual pension plans slumped to INR11.39 billion in FY12 from INR192.57 billion in FY11. Given the recent spate of regulatory changes, product and provider restrictions, pension schemes seem to be drying up from the market.

While the changes in ULIP guidelines resulted in a significant decline in the product's share of industry sales and pension guidelines continue to be restrictive leading to a vacuum in this product line, the proposed changes in product design for life insurance products could further adversely impact the already declining fortunes of the sector in a considerable manner. The changes in product design being envisaged through these guidelines, if not implemented in an appropriate manner after conducting detailed impact assessments and establishing credible timelines, is likely to result in diminishing the scope for product innovation, increasing commoditization, as well as substantial product alterations/withdrawals resulting in increased lapsation.

## **Cost**

The Insurance Act, 1938, prescribes a ceiling on management expenses, which include administration expenses such as commissions, fund management fees, custodial fees, and expenses on marketing and advertising. The percentage varies from insurer to insurer and primarily depends on the new business premium garnered in a year and the age of the company. According to a recent amendment, this rule is applicable to only those companies that have been in operations for more than five years. The limit on expenses is set to protect the long-term interest of the policy holders and ensure that reckless expenditure by insurance companies might not hurt their profitability and long term sustainability. Due to significant expenses, most of the companies have accumulated losses running into millions of rupees.

Companies have to furnish details of expenses in the format, i.e., form 17D prescribed by the regulator for every financial year. The regulator tracks the expenses and cost structures, sends

warnings to the management teams and penalizes companies failing to adhere to guidelines. The challenge for most life insurers is to control these expenses and increase efficiencies with a view to achieve long-term profitable growth. While Rule 17D linked to premium tenure, drives commitment towards long-term super pension (LTSP), there is a need to further optimize monitoring and governance in this regard along with an overall review of reserving, accounting and capital adequacy requirements.

## **Taxation**

The insurance industry is facing challenges with respect to taxation on both the demand and supply side. On one hand, the service tax charged to insurance companies has been increased to 12% from the existing 10% – rate on life insurance policies where entire premium is not toward risk covered increased to 3% for the first year and maintained at 1.5% for subsequent years' policies at a time when mutual funds are exempt from such tax. On the other hand, the 2012 Budget mandated that

the sum assured be at least 10 times the premium (from the existing 5 times), compulsory service tax has been levied on all insurance. Further, with effect from 1 April 2012, benefits under the national pension schemes will not be clubbed under the one lakh benefit under section 80C making it an unfavourable avenue for long term savings. The age of senior citizens for the purpose of tax benefit on insurance premium or returns has been reduced from 65 years to 60 years. The new definition of sum assured has been modified to exclude the bonus amount received to claim tax deductions. The changes in the budget and taxation framework have made life insurance a relatively less attractive product while increasing the preference for mutual funds, public provident funds, non-convertible debentures, national pension schemes or tax free infra structure bonds. Changes in The Finance Act impacting the taxability of life insurance and the proposed changes under the draft Direct Tax Code is likely to significantly derail the prospects of the industry, which is dependent on the continuation of tax benefits, to have a viable business proposition.

## Distribution

The main distribution channels in life insurance are the traditional individual agency channel, corporate agency (banks and others), broking channel and direct selling (which includes online selling). From an industry perspective, it is an

agency-dominated business with 90% of the total premium being sourced from the agency channel. This trend is primarily a result of LIC's agency dominated (at 98% of business) business model. Private sector insurers have a more balanced channel distribution, with agencies contributing 47%, banks contributing 33%, corporate agents 9%, brokers 5% and direct sales 6%.

## Prospects and challenges of various channels

Life insurance, being a high involvement product, agency is the strongest channel for most product segments. Individual agents have been the dominant channel in acquiring business; however, their share has fallen from around 88% in FY2005 to 79% in FY11. The IRDA issued stringent licensing guidelines and new persistency norms in order to protect policyholders interests' in November 2010. This led to high turnover of individual agents and reduction of corporate agents of life insurers who suffered huge financial drain as a lot of money was spent on prospecting, appointing and training of these agents. At the same time, policies procured by these agents are rendered orphan on their termination due to lack of servicing support, leading to distress of policyholders. Insurers therefore, need to focus their efforts on reviving and strengthening the tied agency channel by optimizing recruitment, training, compensation and retention

of agents while constantly improving their productivity levels consistently in order to sustain the business. They also need to consider alternative channels of distribution such as bank-tie ups, which is a fee-based business with low investment as banks use their existing networks.

Bancassurance has rapidly emerged as a viable channel with a 10% share; it is expected to emerge as a very strong channel for private life insurance companies.

The use of internet to distribute life insurance products has only emerged recently, but has not made a significant impact so far, partly because of the substantial advisory component of most life insurance products.

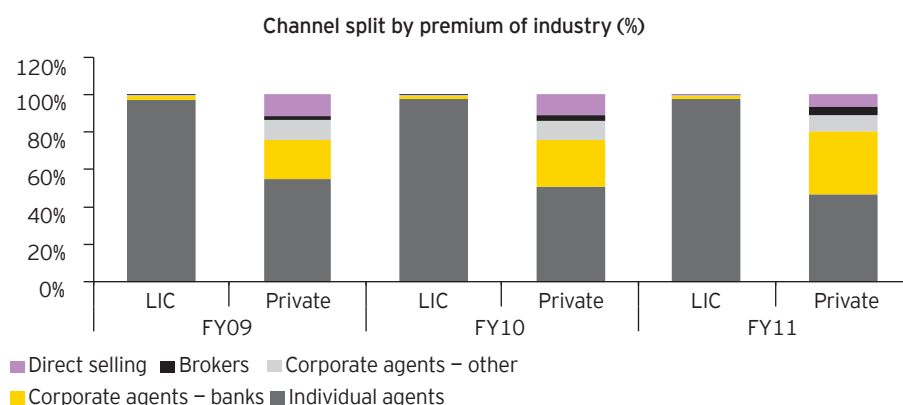
While most companies have adopted a multi-distribution approach, share of direct channel, brokers and other alternate channels remains low. Most companies are seen to be focusing on cost efficient channels; therefore, there has been an increased focus on these channels for select product classes, which are low involvement, e.g., protection covers and health insurance. While direct selling and other modes have remained steady, the growth in market share may be attributed to the universal banking model of selling savings and investment products under one umbrella and increased customer trust in the institutional form of selling.

## Compensation

The trend in operating expense ratio of life companies shows a marginal overall decrease. However, the actual cost for LIC has increased by 35% to INR122.45 billion in FY10 from INR90.64 billion in FY09; private companies have managed to slightly reduce costs. Overall the industry's total expense ratio has also decreased, which when looked at with the growth in premium indicates better cost management and improved productivity.

Commission as a percentage of total expenses has been on a downward trend falling from 48% in FY04 to 36% in FY11. This indicates improved

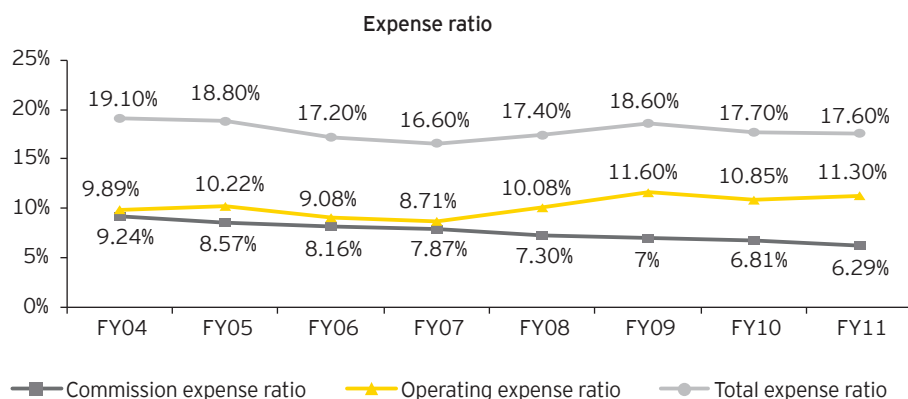
**Exhibit 5.1. Distribution channel-wise premium**



Source: IRDA website

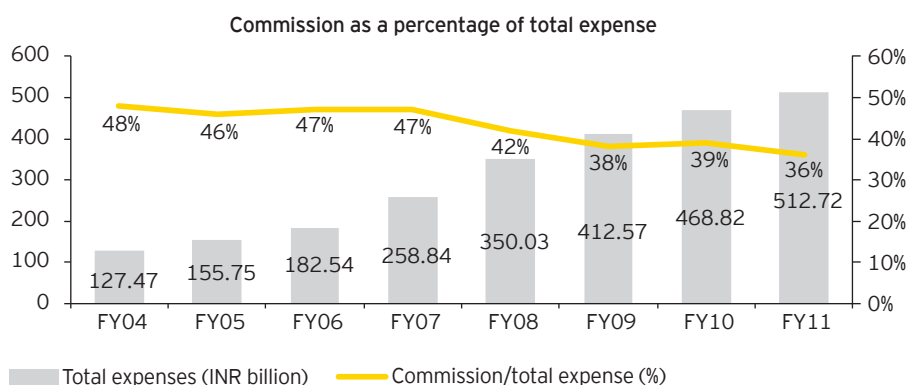


**Exhibit 5.2. Expense ratios**



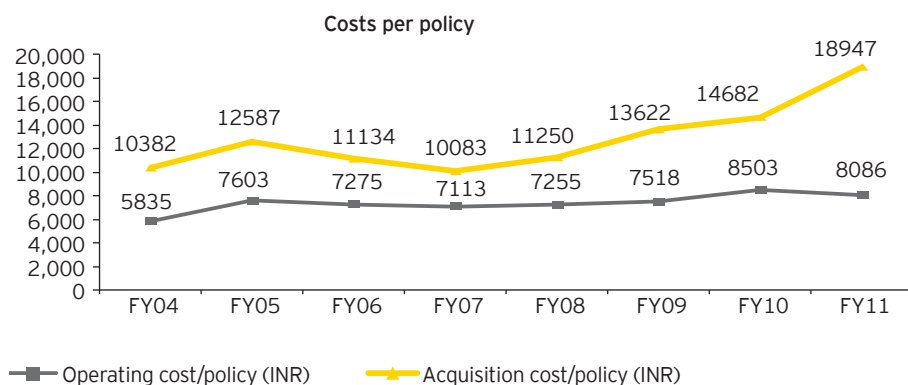
Source: IRDA Annual Report, 2010-11

**Exhibit 5.3. Commission costs and total expenses**



Source: IRDA website

**Exhibit 5.4. Operating and acquisition costs**



Source: IRDA website

competitiveness and hence squeezing of margins. Commissions however will continue to be the largest expense for insurers. The operating as well as the acquisition cost per policy of the insurers are on the uptrend, indicating higher cost of doing business, which means that the profitability of the insurers will be hit and they will take longer to breakeven. Acquisition costs have grown at a CAGR of 7%, while opex has grown at 6%. Being a push-based product, life insurers will continue to need to offer adequate compensation to distributors to increase penetration. There are numerous compensation-related challenges for insurers impacting the efficiency of their distribution models to deliver on objectives. Specific to tied agents, the compensation framework does not provide for treating a tenured and high-performing agent as different from others and allow payment of higher commission rates or support allowances to encourage such agents. Also, there is no mechanism, which allows compensation to an individual agent for any other services rendered by him to the insurer. Further, the regulatory compensation structure does not differentiate between a retail agent and an organized distributor such as a corporate agent or a broker. They are paid similar commissions. In addition the commission rate decreases after 10 years of existence of an insurer, which imposes further burdens. Corporate agents also help reduce the distribution expenses of an insurer through provision of infrastructure, manpower supply and assistance in marketing but are not permitted to be compensated beyond the stipulated commission structure.

Low penetration continues to be a critical hurdle for insurers. To increase the reach, insurers need to tap rural and semi-urban areas. As the cost of setting up operations in rural/semi-urban areas is far lower as compared to those in metros and urban areas, adopting suitable and cost-effective strategies to tap these areas will not only help increase penetration but also efficiently manage distribution.

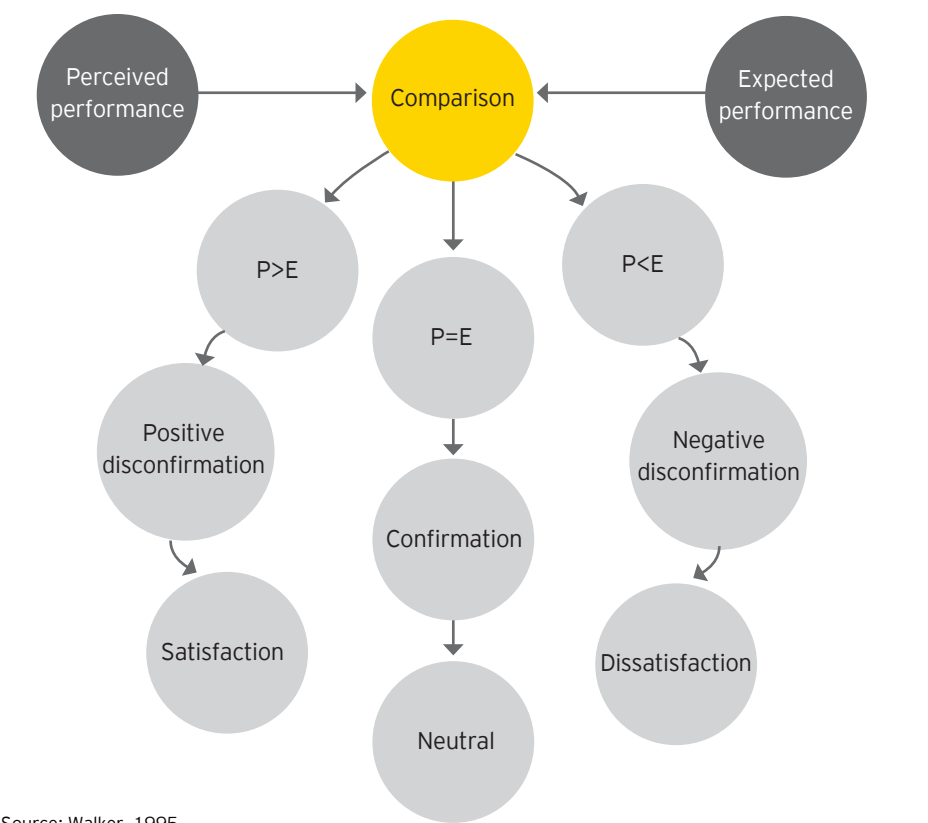
# Customer servicing

Customer service assumes primary importance in any industry, and insurance is not different. The regulator believes that in order that there is perceptible improvement in customer service, and therefore customer satisfaction. Insurers should identify areas, which are most vulnerable to frequent critical comments, analyze the reasons for such underperformance, and take steps to augment the resources sufficiently so that the trends of insufficient service delivery are arrested. If the Indian insurance industry is to make rapid strides of progress, efficient service delivery to the policyholder in its truest sense is the need of the hour.

## Key challenges in customer servicing

Service goes beyond delivery of policy document or processing customer requests; it involves the delivery of value and feeling of trust. The life insurer comes in contact with the customer at several points in time. Adequate, timely and good quality service is critical at each point. At the point of making a sale, it is imperative for the customer to understand the primary benefit of the policy and be convinced of that benefit. The life insurer needs to ensure that the guidelines and exclusions are adequately understood by the customer. Following on-boarding, life insurers should take due care to ensure that the customer has received his policy pack with photocopies of the policy as a part of the "welcome kit". At the time of premium payments, the life insurer should allow numerous payment options and employ adequate resources to facilitate smooth functioning of these options. In case of service requests from customers, they should be handled in a timely and efficient manner. The insurer should set turnaround times and ensure adherence to avoid

Exhibit 5.5. Perceived performance and expected performance



Source: Walker, 1995

delays. Claims settlement, traditionally, is regarded as one of the most painful areas of an insurance contract. The insurance company that handles its claims settlement process efficiently not only saves costs but also enjoys most popularity in the industry.

Mis-selling has grabbed the attention of the industry in recent times. Each distribution channel was faced with typical challenges in customer servicing. For instance in case of direct channel and

tied agents, product understanding along with customer handling is key. In case of bancassurance, the life insurer should ensure that the bank provides efficient services. The onus of the contract is with the insurance company; therefore, any incorrect details provided by the bank may land the life insurer in trouble with the regulator. It needs no emphasis to mention that an on-going training of all personnel that deal with direct consumer interface is vital for the continued success

Exhibit 5.6. Perceived performance and expected performance

Insurer	Outstanding as at 31 March 2010	Reported during the year	Resolved during the year	Outstanding as at 31 March 2011
LIC	150	2588	2672	66
Private	245	7068	7125	188
Total	395	9656	9797	254

Source: IRDA Annual Report, 2010-11

of the insurers. In the absence of personal touch in sales, as in the case of internet/online distribution, challenges involve providing complete details of the policy in a clear manner so that the customer is fully aware of the nuances.

There is a gap between the management’s perception of customer expectation and the actual customer expectation. Life insurers need to adequately understand what the customer really expects from his life insurance policy by obtaining regular feedback, conducting key client studies and tracking customer complaints to develop a product according to customer expectations. Next, insurers need to adequately empower their sales force to deliver an unforgettable customer experience.

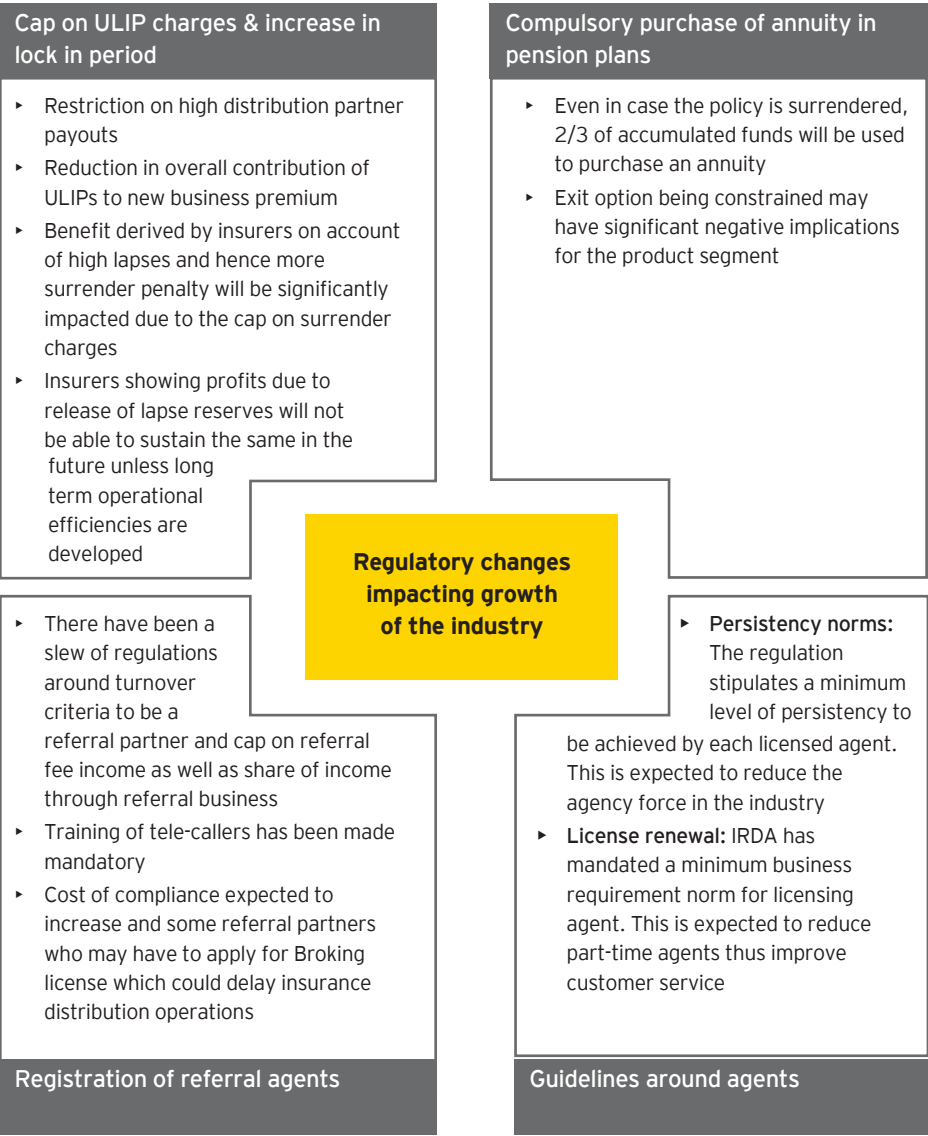
Customer grievance includes any dissatisfaction expressed by customers regarding service delivery, product expectations or any other aspect of business. The Grievances Cell of the Authority was set up by the regulator to receive grievances from the policyholders. In FY11, a total of 9,656 complaints were received; 27% from LIC and balance from private insurers.

Insurers should lay down a detailed customer grievance handling process, which includes efficient tracking, quality of resolution, timely tracking and accurate reporting. Complaints received should be analyzed to check adherence and effectiveness of the process laid down. Further, they need to be analyzed with the intention to bring about modifications to existing processes.

## Governance and regulatory issues

There are a number of regulatory changes and their likely implications on the growth of the life insurance industry.

**Exhibit 5.7. Regulatory changes in Life insurance**



Governance issues encountered by the life insurance industry include:

- A need for greater engagement and consultation with industry
- The regulatory approach may consider introducing changes through a process of discussion papers, regulatory impact assessment and phased implementation of changes

Despite the regulatory mandating changes in the life insurance industry with the intention to protect the interests of policy holders, the changes were too sudden for the industry to sustain, leading to de-growth. Changes related to ULIP and pension plans have caused a negative impact on the respective product segments. Similarly, the agency business has become unattractive due to the recent changes. The industry players need to incorporate numerous modifications to sustain the impact of the regulatory changes.



The non-life insurance industry has been growing in excess of 20% over the last two years however the penetration was as low as 0.7% of the GDP in FY10.

# Non-life Insurance: issues and challenges

## 6



### Products

The non-life insurance industry has been growing at a rate of more than 20% over the last two years. However, the penetration was as low as 0.7% of the GDP in FY10. The robust growth seen over the last couple of years is attributable to increasing affluence of the Indian middle class, expansion of Indian corporations and consistent efforts of the regulator to develop the market. The key factors for growth are discussed below:

### Pricing

Pricing in the insurance business is a meticulous task. One, various risk factors need to be assessed to arrive at the “right price” – a price that considers underwriting premium, withstands competition, generates operating surplus and performs in the highly volatile economic market. Two, the chief component of total cost, i.e., the cost of claims incurred is known only at a future date. Prior to de-tariffication,

price could not be varied, leading to a uniform trend in pricing devoid of any ambiguity. With de-tariffication, the regulator expected the “pricing” to be determined by competitive forces. However, post de-tariffication, insurers have been operating at extremely low prices, with certain players invariably depending on investment income to offset operational losses, thus increasing the loss ratios for the de-tariffied lines. Such price wars could prove fatal and eventually lead to quality taking a back seat. The key challenge for non-life insurance companies is balancing growth with profitability, with pricing playing an important role.

Price needs to be determined with a focus on long-term sustainability. According to some players in the industry, this is only possible when “price” is tagged to “return on equity”. Further, a risk-based pricing approach based on statistical models needs to be applied where the key focus is on solvency. This is only possible with a strong and proactive



actuarial practice that works in tandem with underwriters and risk management teams. A coordinated approach will not only help price a product better but also in adequately managing reserves.

## Innovation

Changing environment constantly forces insurers to reconsider their existing products and distribution channels to cover new classes of risk or manage their processes better. As pointed out by Swiss Re economist Darren Pain, “innovation” refers to the introduction of something new that improves on the status quo. Innovation may be radical in terms of developing newer products such as cyber insurance and supply chain disruption cover, or incremental such as amendments to existing policy terms and bundling or unbundling of risk protections.

Innovation primarily involves showcasing the unique value proposition to survive the competitive market. Regulatory restrictions, pressure of performance,

lack of maturity of markets and constant risk of mis-selling make innovation challenging in the Indian insurance industry. Ironically, however, with more or less all market players offering similar prices, innovation is the only differentiating factor.

The non-life insurance sector has seen little innovation – new product filings have been more in the nature of small incremental options available on existing products, more in the nature of riders than radical new innovative products. Some of this is partly because product wordings of some products such as fire, engineering and motor are still governed by tariff, which means that the coverage, exclusions and terms and conditions are defined by the IRDA. The relaxation provided to insurers is in terms of freedom to vary prices for the same product and introduce slight variations in the products through add-on covers. Another obstacle to innovation remains to be the stringent IRDA guidelines for both incremental and new products.

Some industry players cite instances of long delays observed in the approval of products by the regulator as a proof of the regulator’s resistance to innovation. However, the regulator has maintained that it is pro-innovation as long as it is in the interest of the public at large and backed by adequate market research.

Innovation in insurance is possible by way of capitalizing on the need of the hour. The “Directors and Officers liability” insurance has gained popularity given the fatal impact of corporate scams in the country. Policies that cover losses on account of natural and man-made catastrophes have shown a potential for growth. With natural and man-made catastrophes hindering the growth of the economy, there is a need to cover these unforeseen circumstances. Currently, the governments play the role of providing relief and managing disaster. Non-life insurers can develop simple policies to cover losses – ranging from loss of belongings, health expenditures for special treatments on account of

catastrophes, etc. Industry examples of product innovation in recent years include HDFC Life Sampoorna Samridhi Insurance Plan and Tata AIG's Private Client Group Home Secure Policy among others that have won accolades for product innovation.

### Simplicity

Majority of insurance products are sold through agents and insurance is seen as a “push” product by the customers. Products are sometimes pushed by intermediaries without adequately explaining the benefits and limitations of the policy, leading to a sense of dissatisfaction among the customers. There is an immediate need for simplicity in “wording” of contracts. Especially in the personal lines, insurers need to be meticulous in specifying exclusions, restrictive features, clauses for cancellation and renewability, etc., and simultaneously ensuring that the applicant fully understands the nuances. One way of simplifying would be to have a policy that reads “all risk policies” that covers all losses. Any exclusion to the risks will be specifically mentioned in the policy, thus putting the onus of exclusions on the insurer. The IRDA on its part has been trying to simplify products by way of key features document that provides main features, charges, payment modes and premium details clearly to customers.

Certain vanilla insurance products such as travel insurance, motor insurance and even health insurance, are being purchased off-the-shelf primarily because customers understand the product features. Simplicity and standardization of products reduce the advisory component and underwriting intervention required by some of the other complex insurance products. Some years back, ICICI Lombard tied up with a chain of retail stores to sell health insurance covers “off the shelf” to interested customers. The internet too has become

a popular medium for sales. The regulator, however, continues to strictly monitor such products as it believes that it is imperative for the insurer to disclose all the clauses of the policy as the onus lies on the insured to understand the policy features.

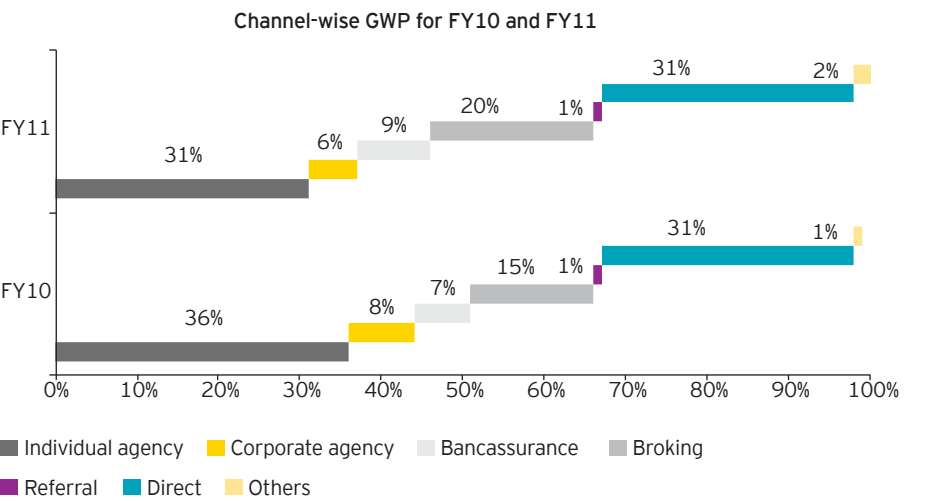
### Distribution

Traditionally tied agents have been and continue to be the primary channels for insurance distribution in the Indian insurance market. For non-life insurance individual agents are the biggest channel; however, their share at 31% in FY11 was not as significant as their presence in the life segment. Direct channel refers to selling through company-owned sales force, internet and telemarketing. Currently, certain inefficiencies including lower productivity besets this channel. However, global experience shows that this can be significant for Motor and Health. It accounted for a 31% share in FY11. Broking, a significant channel

for non-life globally, accounted for 20% of premium in FY11 comprising mainly corporate customers. Bancassurance, a relatively new channel in India accounting for 9% in FY11, has been gaining a lot of significance in the non-life insurance industry with their advantage of existing customer base and reach.

Advisory-based distribution channels and online channel for certain segments are likely to become significant going forward. With the industry already suffering from poor operational performance, less expensive channels such as online sales are increasingly being explored by insurers for simpler segments such as motor, travel, and health segments on account of new online technology. A number of websites providing comparisons of various insurance products and means for customers to compare and contrast prices, services and experiences among themselves are also gaining popularity.

Exhibit 6.1. Channel-wise gross written premium



Source: IRDA website



## Prospects and challenges of distribution channels

Channel	Prospects	Challenges
Agency	<ul style="list-style-type: none"> <li>▶ Retail and SME channels require advisory services of agents to understand the intricacies of the product.</li> <li>▶ The ability to penetrate the market due to familiarity with social and cultural norms makes it the primary channel, especially in B and C category towns.</li> </ul>	<ul style="list-style-type: none"> <li>▶ The channel need to adjust and compete with new business practices and products is a primary challenge.</li> <li>▶ It suffers from constraints of low yield, typical of the retail market.</li> </ul>
Direct channel	<ul style="list-style-type: none"> <li>▶ The in-house sales force understands the features of product and philosophy and the company, which give it an edge.</li> </ul>	<ul style="list-style-type: none"> <li>▶ It suffers from the inability to penetrate in rural areas where there is a need to push the product by understanding the social and cultural norms.</li> </ul>
Broking	<ul style="list-style-type: none"> <li>▶ Complex product offerings will help brokers to leverage their expertise further and their role is expected to evolve (in the retail space) from selling to client support and servicing.</li> <li>▶ With de-tariffing and complex product offerings, more brokers are expected to enter the space, and niche areas are expected to emerge among broking.</li> </ul>	<ul style="list-style-type: none"> <li>▶ For the brokers, penetration is largely restricted to commercial products, which is limited by the slow growth of the commercial segments.</li> <li>▶ For the brokers rise in virtual selling channels is a significant threat.</li> </ul>
Bancassurance	<ul style="list-style-type: none"> <li>▶ Bancassurance is customer friendly due to the ease of payment of premium and the facility of maturity/claim payments directly to the bank account.</li> <li>▶ With computerized bank branches covering the country, bancassurance's share is predicted to be around 40% by 2015.</li> <li>▶ The channel has developed on the back of the bank's need to focus on fee-based income</li> </ul>	<ul style="list-style-type: none"> <li>▶ Growth has been limited due to exclusivity rule. Exclusivity rule has also led to high fees demanded by the bank increasing "acquisition costs" for insurance companies.</li> <li>▶ Currently, banks are prohibited from offering commission to the bank employees for selling insurance products; hence, quality of service may be affected.</li> </ul>
Referral	<ul style="list-style-type: none"> <li>▶ Under this channel, quick reach and selling initiations are important for the insurance company to be profitable.</li> <li>▶ It enjoys the advantage of not requiring a license and the need to share databases.</li> <li>▶ The core proposition is in rendering marketing and administrative support to the insurance companies.</li> <li>▶ The channel is likely to be sought after as the industry becomes more developed and specialized.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Primary challenge is to get enough volume so as to break even in the cost involved.</li> </ul>

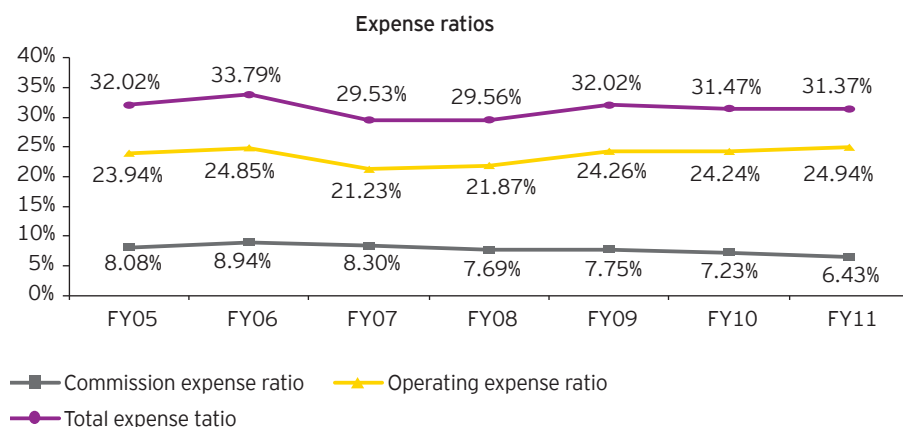
## Compensation

Since controlling expenses has become a challenge in the insurance business and most of these expenses are incurred on distribution, the issue of efficient cost management is strongly attached to effective distribution. With the new IRDA imposing restrictions on commission structure and mandating additional disclosures, distributors will earn lower commissions, going forward, and will have to adjust their business models accordingly.

Commission paid in sourcing business in FY11 stood at INR27 billion of which the private sector paid INR8 billion. The commission translates to 4.6% of total premium for private players and 7.7% of total premium for public players. The commission paid ratio was 6.43% for non-life insurance in FY11, down from 7.23% in FY10. The net commission paid ratio is close to zero for private players

(at 0.1%) but stood at 7% for public players in FY11. This is because of ceding commission being paid out by reinsurers, which is sufficient to cover commissions paid by private players; however, this is not true for public players due to higher retention and commission paid to source commercial business through brokers.

**Exhibit 6.2. Non-life insurers expense ratios**



Source: IRDA Annual Report, 2010-11

## Micro insurance in non-life to widen reach

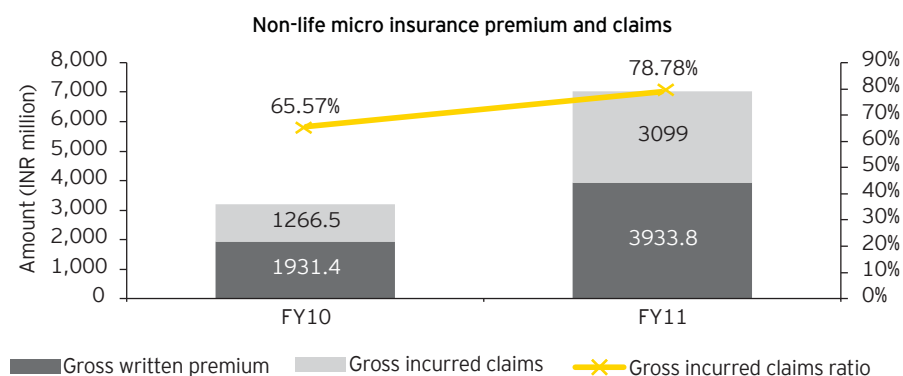
There are a number of products offered by all registered non-life insurance companies targeting the low income segment of the population – for example, Janata Personal Accident Policy, Gramin Personal Accident Policy, cattle/livestock insurance, etc. Further, there are a number of tailor-made/group micro insurance policies offered by private and public insurers for the benefit of these segments. Micro insurance, being a low price, high volume business, its success

and sustainability depends mainly on keeping the transaction costs down. This requirement is mandated by the IRDA in order to develop and promote micro insurance products in India. As on end-March 2011, non-life insurers had launched a total of 66 products under micro insurance.

Further, there is an increasing realization that social security schemes of the Government of India are better administered through insurers due to cost-efficiency, superior service delivery and better accountability. As such three

of the flagship social security schemes of the Government of India targeted at low-income/micro insurance segments namely Aam Aadmi Bima Yojana (AABY), Janashree Bima Yojana and Rashtriya Swasthya Bima Yojana (RSBY) have been handed over to insurers for administration. In FY11, the gross written premium increased 104% over the previous year to INR3,934 million and the gross incurred claims increased 145% over the previous year to INR3,099 million.

**Exhibit 6.3. Non-life micro insurance**

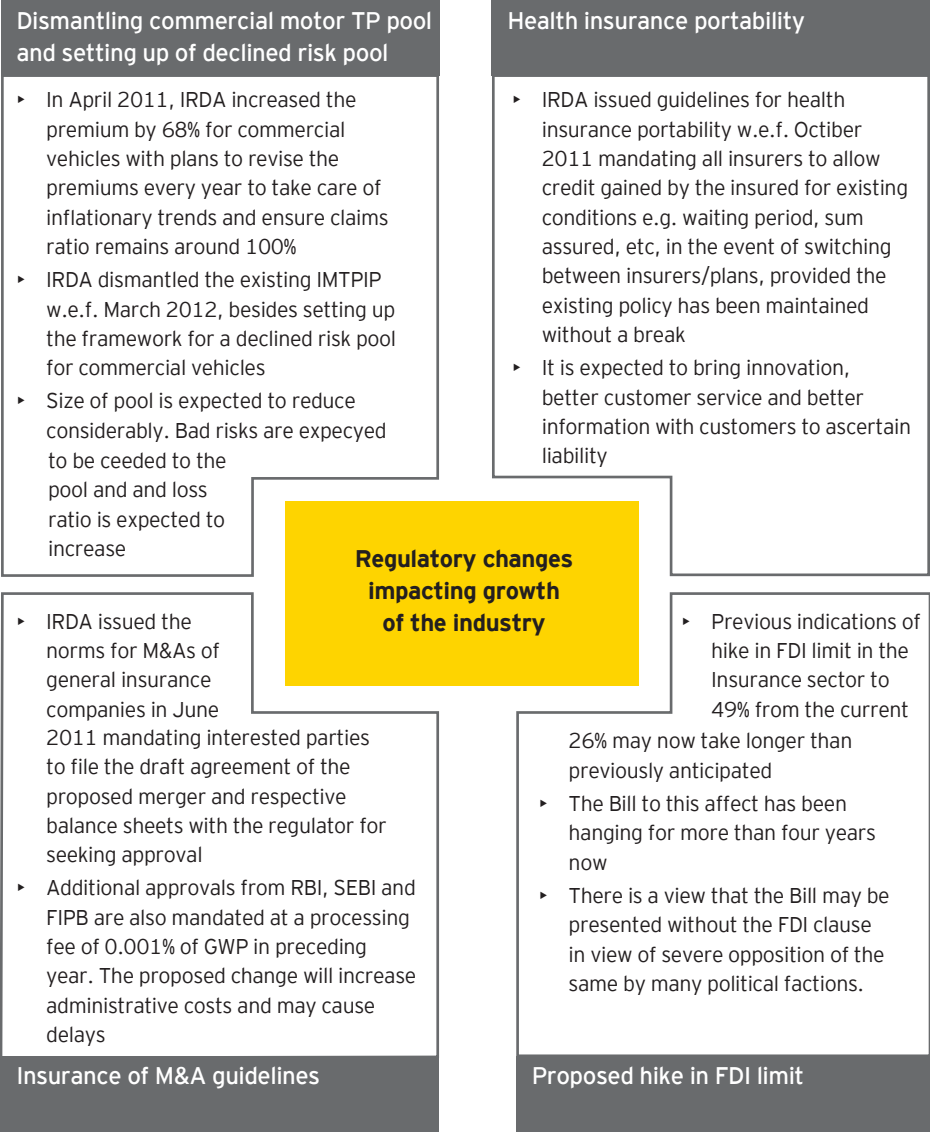


Source: IRDA Annual Report, 2010-11

# Governance and regulatory issues

There are a number of regulatory initiatives that are expected to impact the growth of the industry.

Exhibit 6.4. Regulatory changes in non-life industry



Regulatory changes in the non-life insurance industry are primarily aimed at reducing inefficiency and increasing competitiveness with the idea of bringing about product innovation. The regulator now needs to focus on increasing the penetration of the non-life insurance segment in the country.

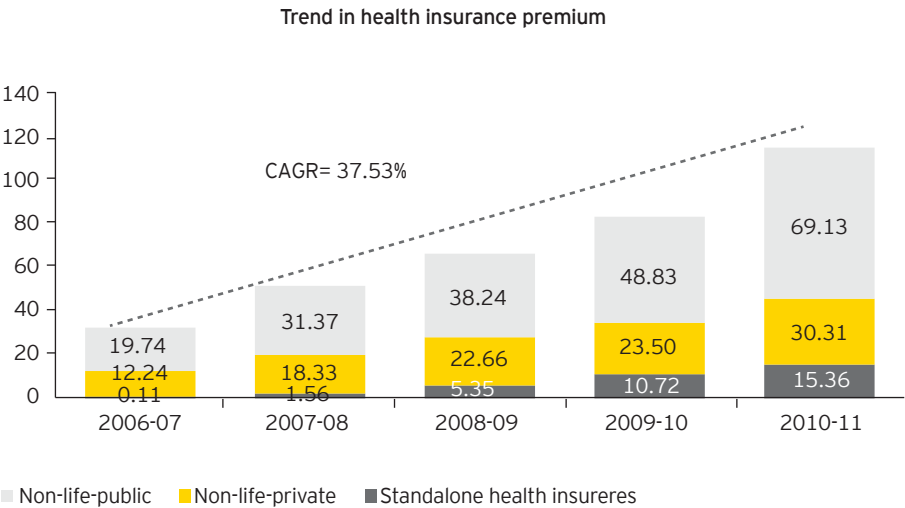
# Health insurance

Health insurance contributed to 26% of the non-life insurance premium at INR114.80 billion in FY11 growing at a rate of 38.22% from INR83.05 billion in 2009-10. The premium underwritten increased from INR10.72 billion in 2009-10 to INR15.36 billion in 2010-11. There are three standalone health insurers - Apollo Munich Health Insurance Co. Ltd., Star Health and Allied Insurance Co. Ltd. and Max Bupa Health Insurance Co. who contributed to 13% of the total premium underwritten for health insurance.





**Exhibit 6.5. Health insurance trend**



Source: IRDA Annual Report, 2010-11

Primary growth drivers for the industry include:

- ▶ Rising health care costs and growing lifestyle diseases have led to increased expenditure on health care, leading customers to go for insurance.
- ▶ Tax advantages of up to INR15,000 under Section 80 D (INR20,000 for senior citizens) make health insurance an attractive investment product.
- ▶ State and Central Government sponsored schemes such as Rashtriya Swasthya Bima Yojna, Arogyashree, Yeshasvini for population below the poverty line have offered fresh avenues for growth.

**Key challenges**

**Innovative products to counter increased competition**

The health segment has experienced high claims ratio historically and an obvious step for insurers was to raise premium rates. This led to customers preferring low premium policies from other insurers. However, customers were not able to carry forward their credits gained with one insurer in terms of waiting period of pre-existing diseases, no claims bonus, etc. to another insurer. Significant increase in customer complaints on account of this disadvantaged position laid the foundation for implementation of portability. The IRDA issued guidelines for portability in health insurance with effect from October 2011.

Concept	Implications
Portability means the right accorded to a policyholder (including family cover) to transfer the credit gained by him for pre-existing conditions and time bound exclusions if he chooses to switch from one insurer to another insurer or from one plan to another plan of the same insurer. This insures smooth transition from one insurance company to another with accrued benefits such as no-claim bonus and waiting period for pre-existing diseases.	<b>Customers</b> <ul style="list-style-type: none"> <li>▸ Flexibility to retain credits earned</li> <li>▸ Improvement in services</li> <li>▸ Employees will be allowed to carry forward insurance cover or converting to individual plan</li> </ul>
	<b>Insurers</b> <ul style="list-style-type: none"> <li>▸ Fuel more competition</li> <li>▸ Help in improving offerings, pricing and servicing</li> <li>▸ Increased costs due to data management systems etc.</li> <li>▸ May compel insurers to act towards standardization of costs as insurers cannot avoid transparency now</li> </ul>
	<b>Products</b> <ul style="list-style-type: none"> <li>▸ Product innovation is expected to take place in order to retain existing customers and gain new customers</li> </ul>
	<b>Intermediaries</b> <ul style="list-style-type: none"> <li>▸ Absence of renewal commission so no motivation to help customers</li> <li>▸ Limited role and portability might not be very effective due to this</li> </ul>

With customers being free to choose among various health insurers, the market has become highly competitive. “Innovation” is the solution to counter the competition. It could involve developing ideas into marketable products, i.e., product innovation or modifying the existing way of doing things or process innovation. Insurers are expected to have to innovate by introducing new/ differentiated products to attract new ones and reduce costs to retain existing customers. For instance, Apollo Munich launched a product where the sum insured is reinstated in full after a claim.

### Better controls to prevent frauds

According to the Ernst & Young survey on frauds in insurance, the Indian insurance sector incurs a loss of more than 8% of its total revenue collection in a fiscal year. Further, the study indicates that the average ticket size of a single fraud ranges between INR25, 000 and INR75,000. Increase in frauds indirectly drives up the premiums collected from policy holders as insurers ultimately recover the losses by increasing the prices.

According to a survey by Star Health Insurance Pvt. Ltd., the health insurance industry in India loses approximately 15% amounting to INR 6-8 billion per annum on account of fraudulent claims..

Fraudulent and dishonest claims are a major hazard not only for the insurance industry but also for the entire nation’s economy. Concrete proof as evidence including documentation, statements made by the customer and his family members and even neighbors are taken into consideration.

In order to reduce fraudulent claims, the IRDA has mandated sharing of claims data and even blacklisting “tainted” hospitals with a history of submitting inflated bills. Health insurers need to set up a detailed anti-fraud department to develop and implement a detailed program to combat frauds. Some insurers have put in place additional checks such as visiting the hospital during the insured’s stay or even his house to examine the case papers to prevent fraudulent claims. Insurers need to adopt a definite methodology to address and reduce risk of frauds within it.

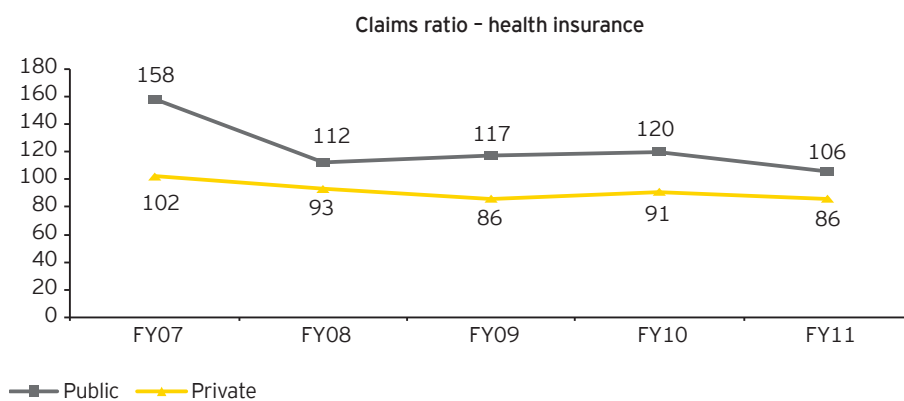


## Standardization to reduce claims loss

The Indian health insurance industry suffers from high claims ratio of more than 80% (observed in the last six years) in comparison to the international benchmark of 60%-70%. This is attributed to high frequency and high severity of claims. Health claims stood at 99% in FY11 as compared to 108% in FY10. High ratio during the year is attributed to:

- ▶ Low pricing of group health covers on account of high bargaining power of corporate organizations
- ▶ Non-standard rates of treatment due to absence of supplier management
- ▶ Frequent frauds

**Exhibit 6.6. Health insurance claims ratio**



Source: IRDA Annual Report, 2010-11

In case of group health cover, claims ratio decreased in FY11 mainly on account of revision of prices in the overall industry (16%-20%), reducing losses to around 100% from 120%. In case of individual cover, the loss ratio was around 80% in FY11 due to some revision in prices. For government schemes, the loss ratio

varied from state to state and was in the range of 60% to 120%. IRDA is expected to implement standardized rates for certain procedures and modify the claims management process for health insurance. This will help reduce the claims ratio further.





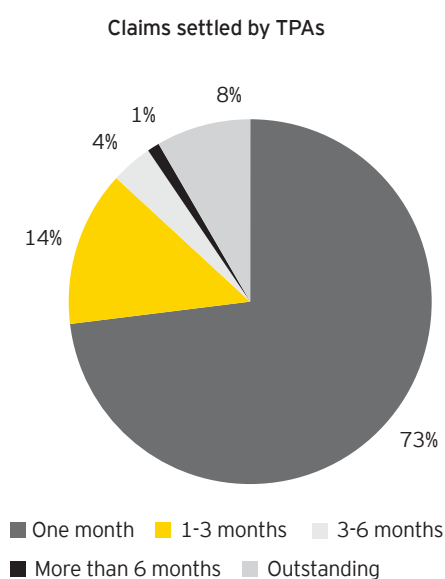
## Reduce inefficiencies by revisiting the third party administrator agreements

As at end-March 2011 there were 29 third party administrators (TPA) registered with the health insurer and IRDA to provide health services; license was renewed in two cases (Park Mediclaim TPA Private Ltd. and Rothshield Healthcare TPA Services Ltd.), and new license was granted in one case (Spurthi Meditech TPA Solutions Pvt. Ltd.)

More than 3.6 million claims were received during FY11 up from more than 3.3 million received in the previous year. Around 75% of claims are settled within one month and 15% in one to three months; performance of small players is not up to the mark as compared to big players regarding claims settlement.

The infrastructure of TPAs mainly consists of number of hospitals in the network and geographies serviced; other elements of infrastructure include number of branches opened and professional manpower. However, TPA claims administration involves a lot of inefficiencies including improper

**Exhibit 6.7. TPA claims data**



Source: IRDA Annual Report, 2010-11

dissemination of information, lack of motivation to control claims, minimal scrutiny of claims, and tying up with hospitals and service provider to inflate claims value. Recognizing the problems with respect to TPAs, the standalone health insurers who control around 60% of the health insurance market have abstained from availing the services of TPAs. The IRDA is proposing to implement a standardized format of service agreements to bring down inefficiencies. It is also considering banning services of TPAs from operating as intermediary for the government-sponsored health insurance schemes to ensure orderly growth of the industry.

Considering the inefficiencies in TPA services, fraudulent activities, increasing customer complaints against TPAs and regulatory stand against TPAs, insurers will likely need to revisit the service contracts with TPAs. In certain cases, there may be a need to reconsider their services to ensure high operational efficiency, fraud control and better customer service.

The Indian insurance market though facing challenging times is poised for strong growth in the long run.

# Way forward

## 7



### Significant latent market

The Indian insurance market, though facing challenging times, is poised for strong growth in the long run. The insurance density declined from US\$64.4 in 2010 to US\$60.6 in FY11 and is expected to decline further in FY12. However the insurance market has a considerable amount of latent potential, given the fact that the Indian economy is expected to do well in the coming decades leading to increase in per capita incomes and awareness.

### The industry

In meeting the significant potential, the industry has an increased role and responsibility. Three areas of focus could be – a) product innovation matching the risk profile of the policy holders b) reengineering the distribution and more significantly c) making sales and marketing more responsible and answerable.

### Distribution

Distribution channels evolved in response to market dynamics and changing consumer preferences. The alignment of economic incentives with distribution dynamics should be driven by market forces rather than regulatory intervention. Therefore, the questions that arise are – Is there a model that directly links incentives to investor interests? And what steps, if any, should



be taken to regulating distribution? What compensation models are likely to deliver the best results?

The answers lie in regulatory policies driving increasing efficiency of operations; product alignment to customer needs distribution effectiveness and overall customer centricity. If large numbers of consumers are aware of loads on the premium, they will influence the direction towards market acceptable levels. Restrictions on channel economics may significantly disrupt insurer distribution value chains, reducing sales and lowering profits. They may also increase the likelihood that intermediary remuneration will be driven into different forms, defeating the objective of the regulation and increasing the risk of reputational damage in future years.

## Regulation

Quick and frequent changes in regulations disrupt the business models of the insurers. The industry should be given time to adjust to regulatory changes in a phased manner aligned with a regulatory impact assessment. Regulations need to drive transparency and simplification of products and services. Insurance being a long-term product, customer servicing also becomes important as the individual claiming the benefits may be different from the individual buying the product.

The regulator also needs to drive financial education and awareness about insurance products to create a customer pull. Currently a majority of sales is accounted for by the tax incentives rather than any demand for insurance products. Increasing awareness and understanding the need and utility of insurance will drive growth in the industry in the long run.



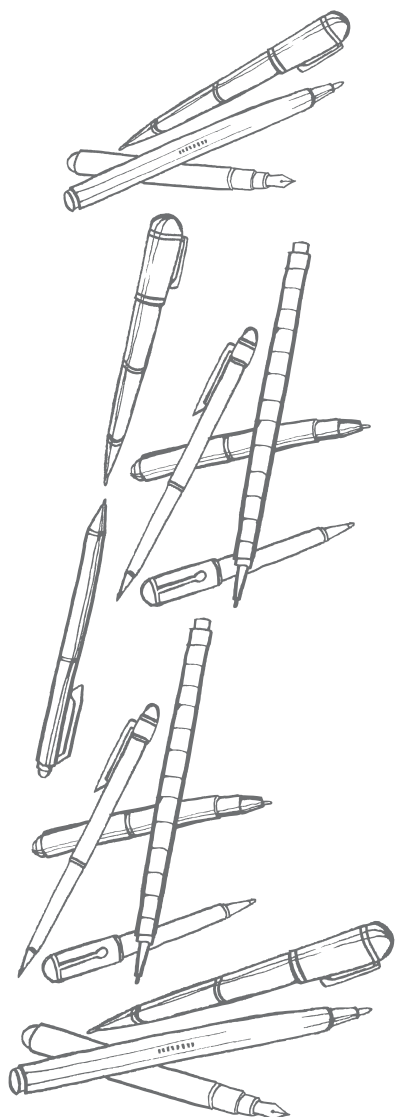


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CII is a non-government, not-for-profit, industry led and industry managed organisation, playing a proactive role in India's development process. Founded over 117 years ago, it is India's premier business association, with a direct membership of over 7000 organisations from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 90,000 companies from around 400 national and regional sectoral associations.

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