

Indian insurance sector

Building Growth,
Building Value

August 2015



Confederation of Indian Industry



Building a better
working world

Foreword

The insurance sector in India is overlooking an exciting period in its evolution. With the passage of the Insurance Laws (Amendment) Act 2015¹, the longtime demand of having greater access to foreign capital has been fulfilled. This one amendment can be a game changer as it will bring in significant fresh capital to re-energize the sector. However, insurance companies must tread with caution and carefully adopt changes to make the best possible use of the opportunities presented. The sector will have to partner with the regulator and other industry bodies to ensure that the current phase leads to a holistic long-term growth and successfully builds value for all the stakeholders involved.

The major gaps which the industry must plug in are around realizing a cost-effective distribution mix (primarily life), checking the ongoing slowdown in the non-life sector, getting a handle on claims (particularly in motor and health lines) and absence of a sizable presence in the pension space. To prepare for the next level of progression, the industry must have a strong focus on augmenting the value insurance brings to nation's economy, the society, its customers, the distributors, the shareholders and the insurance companies themselves.

The Confederation of Indian Industry (CII) and EY bring you this report on the Indian insurance industry where the key aspects on the evolution of the sector, the prevalent trends/challenges and the imperatives for the industry have been discussed. To bring in an external perspective, a separate section highlighting the issues faced in global markets is covered which identifies themes which may play a role in the Indian context in times to come. Finally we provide our view on the imperatives toward which the industry must work for a rewarding and engaging journey ahead.



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1. Press Information Bureau, Government of India, Ministry of Finance, 13 March 2015

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Executive summary

From its fundamental role of providing basic protection against losses, the insurance industry in India has come a long way over the last decade and a half. It has become an indispensable pillar to support India's ascent to economic prosperity and growth by accounting for risks, providing funds for nation building projects, steadying equity markets and driving social security. In the process, it continues to create significant value for all its stakeholders i.e. customers, distributors, shareholders and the insurance companies.

Indian insurance industry's growth story since liberalization has been dramatic. Both life and non-life sectors initially witnessed a long phase of sustained high volume growth. However, the life insurance sector's charge was halted by a much needed course correction initiated by the regulator in recent years, leading to a stagnation in growth and a question mark on the viability of the existing business models. Non-life insurance, on the other hand had a more consistent volume growth, but had its journey blemished by excessive claim related losses. In both these cases, much of the pain was unleashed by necessary, yet too frequent regulatory interventions, which prevented the industry from settling down.

Much like the Indian market, the global insurance scenario remains somber with persistent low interest rates (impacting margins), soft pricing conditions in the non-life sector and frequent regulatory reforms. Nevertheless, one major fact which differentiates the developed markets with the Indian market is India's unbeatable growth potential which in turn is derived from India's low insurance penetration (overall 3.3% - life 2.6%, non-life 0.7%), rising income levels, a high rate of economic growth and highly favorable demographic attributes.

For ensuring a future which is characterized by a well rounded industry growth and which maximizes value creation for all the stakeholders, the sector must work towards capitalizing on every opportunity. Some of the areas which it must pursue in this regard include:

- ▶ Chasing efficiency in distribution by finding synergy among channels, driving skill development at an industry level, optimizing the distribution network and achieving greater service integration between the insurer and the distributor
- ▶ Making the most of the Insurance Laws (Amendment) Act 2015 by effectively utilizing the incremental capital infusion to drive awareness, reaching out to underpenetrated segments and adopting global best practices in operational efficiency and service delivery
- ▶ Exploring possibilities in the pension space by developing relevant products and incentivizing stakeholders
- ▶ Furthermore penetrating the health insurance segment by engaging customers early, creating cost effective offerings (products with savings component, old-age health insurance) and by keeping a tab on frauds
- ▶ Solving the cost conundrum by a greater use of technology to streamline operations, to curb losses from claims and to prevent frauds
- ▶ Embracing digital whole heartedly to disrupt the traditional business structures while keeping risks in check by leveraging a resilient cyber security framework



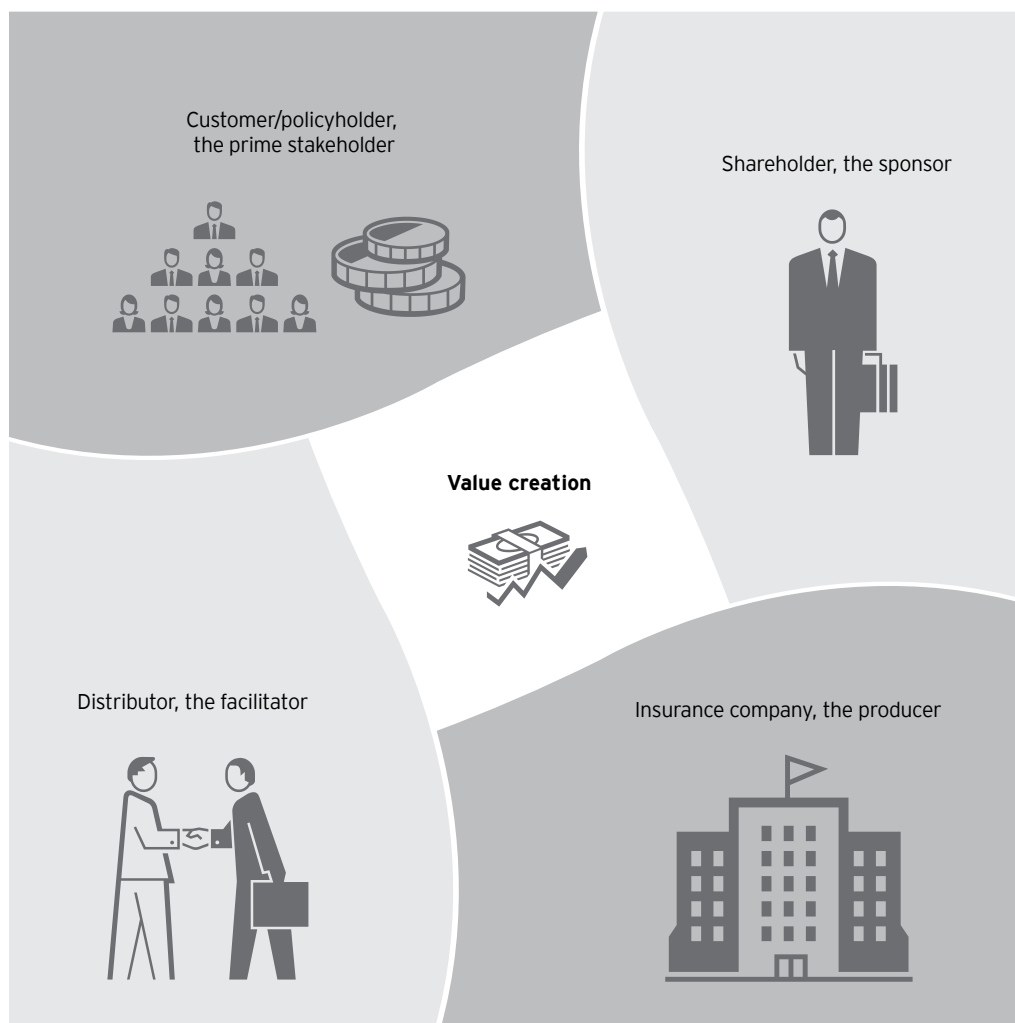
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**Overview: Driving
economic growth
while creating
stakeholder value**

a. Insurance industry - stakeholder value creation at its core

Insurance is an industry which has value creation at its core. It generates value for policyholders who lay their trust in an insurance product, for shareholders who back the business, for distributors who depend on it for their income and the insurance company itself which interlinks all the other stakeholders. It is this interlinking, which if done in a balanced manner while keeping the costs low, creates a long-term success story.

Exhibit 2.1: Stakeholder value creation



Source: EY Knowledge Analysis

Value creation for stakeholders takes the form of

- ▶ For a customer/policyholder: Selling need based insurance plans; fair payouts during claim, maturity or surrender
- ▶ For a distributor: Reasonable compensation for the time and effort involved in customer acquisition
- ▶ For a shareholder: Fair return on its investments over the long-term

- For the insurer: Creating a resilient business with a strong work culture, winning customers of its choice, attracting the right investors who believe in the long-term and drawing the best manpower who drive the business in an ethical manner

While the insurance industry in India has strived to maximize value for all, the emphasis on achieving a balance has been actively driven in the recent years by persistent regulatory interventions. How the insurance industry in India maps its progression in the future will be ascertained by the effectiveness with which all the stakeholders collaborate and create enabling conditions. An ideal state will be an industry which is extremely efficient in managing costs, generates high returns for shareholders, actively engages all the distributors with confidence and most importantly attracts high customer loyalty.

b. Insurance industry's role as a key enabler for economic growth

The development of any modern age economy cannot be realized, if its insurance sector remains underdeveloped. The insurance industry plays a crucial role in mitigating risks, supporting critical social levers, providing long-term capital for infrastructure development, and rendering poise to equity markets.

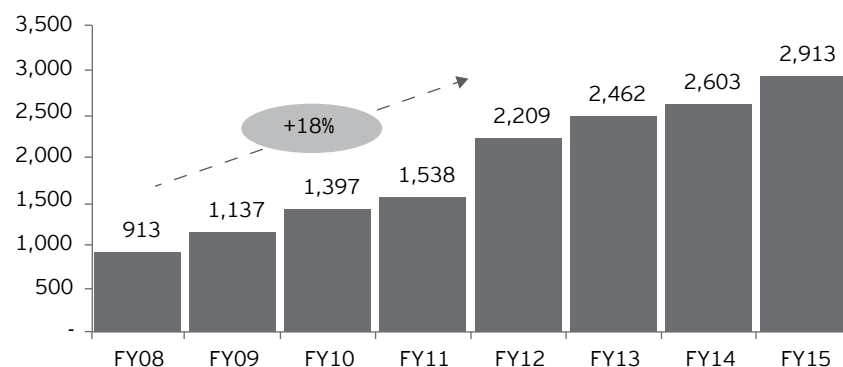
Risk management

Insurance supports institutions in keeping a tab on unforeseeable losses, which can otherwise jeopardize the institution's existence. Insurance brings consistency to earnings by capping damages. It instils confidence among investors to take business risks in areas where they would not participate normally.

Infrastructure development

With limited instruments available in the Indian market to support long-term asset liability management, the insurance sector has successfully channelized savings toward nation building through infrastructure development. The fact that the size of life insurers' infrastructure investments has been growing at a rate (FY08-15 CAGR: 18%) faster than India's GDP growth exemplifies the criticality of this sector. Nearly one-eighth (FY15: 12.4%)² of the life insurers' assets under management are currently being leveraged by infrastructure projects.

Exhibit 2.2: Infrastructure investments by life insurers (in INR billion)



Source: Life Insurance Council

2. Life Insurance Council data

Supporting equity markets

Insurers, being among the largest fund managers in India, are instrumental in checking adverse swings in equity markets, as they tend to transact in relatively large volumes during market corrections.

Generating employment

The insurance sector is a major employment provider in India, as it has around 350,000 individuals on its payroll (life and general), and indirectly employs at least 2 million more individuals (count of life insurance agents alone exceeds 2 million, while thousands more are employed at channel partners and in other associated sectors).

Social security and financial inclusion

Insurance allows sections of the society with low income to address risks that directly impact their livelihood. Most insurance policies in this segment are being offered in conjunction with the Government, or through policies sold under "rural or social sector obligations."

Since liberalization in 2000, India's insurance industry has grown in significance with each passing year and has now turned into a major enabler of economic growth. However, its increased significance also implies that the sluggish industry growth, seen in recent years, may become a drag on India's economic growth in times to come. Hence, to reenergize this growth engine, it will be critical that corrective measures are taken at multiple levels through reinforcing regulatory interventions, collective efforts by the industry and corrective actions by each insurer.

c. The growth story - Liberalization, expansion and introspection

While the insurance sector's journey over the last 15 years has been fast-paced, it hasn't been flawless. Post the opening of the sector for private participation and foreign funding in 2000, insurers went on an overdrive to ramp-up distribution and operations in a bid to win market share. Rapid economic growth, rising middle class population, and wealth and bullish equity markets enabled a 23% average rate of growth for the life insurance industry's first year premium between FY02 and FY11, and 16% for the non-life sector's gross direct premium between FY02 and FY15³.

However, as the building scale took precedence over creating a quality business, the regulator stepped in to establish checks at every strata of the business. This led insurers to reflect upon the viability of their operating models in the new product landscape. Insurers were compelled to undertake multiple corrective measures, as efficiency and profitability became paramount for long-term value creation. As a result of these measures, the customer took its rightful place as the central figure and the focus moved towards winning customer trust.

Life insurance industry

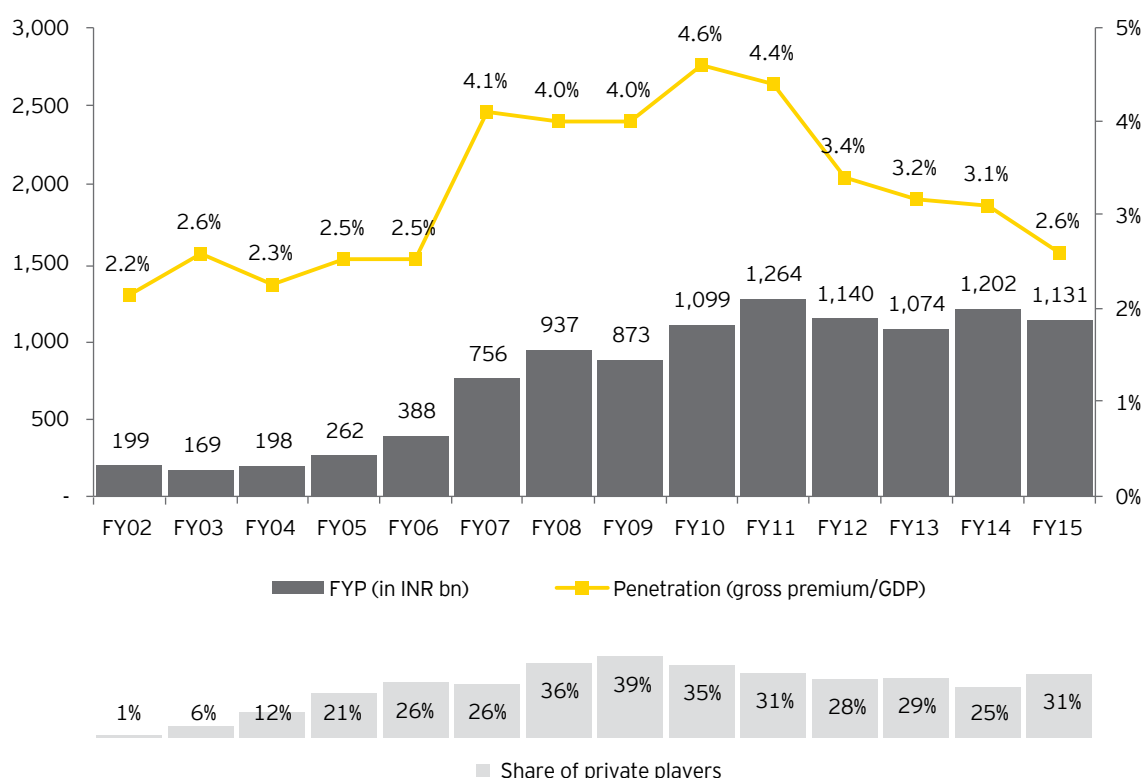
Growth over the years

The first year premium for life insurers grew from INR262 billion in FY05 to INR1,264 billion in FY11, at a CAGR of 30% on account of growing awareness about life insurance, favorable demographics, buoyant equity markets, rapid distribution expansion (particularly in the individual agency channel), and launch of innovative products.

3. IRDAI Handbook 2013-14 data

However, the implementation of the revised ULIP guidelines in 2010 (which restricted margins and distributor pay-outs significantly), multiple restrictions on corporate agents and brokers, coupled with persistent high-inflation and low-growth scenario, resulted in stagnation in the new business premiums since FY11. As a result, new business premium collections dropped from INR1,264 bn to INR 1,131 bn in FY15 (4 year CAGR: -3%). However, in the near term, the life insurance sector is expected to grow by around 6% (till 2018)⁴.

Exhibit 2.3: Evolution of India's life insurance industry



Source: Life Insurance Council, IRDAI, Swiss Re 'World Insurance' reports

Competitive landscape

During the high growth phase in FY05-11, the share of private players (current count: 23) rose to 39%⁵ of the first year premium in FY09, while that of the public sector behemoth Life Insurance Corporation of India (LIC) dropped to 61%. With unit-linked products (ULIPs) losing favor among both distributors and customers post FY11, and private players forced to reorganize their operations to better manage costs, the private players' market share shrunk to 25% in FY14, with LIC regaining some of its lost turf. However, FY15 witnessed a strong performance by bancassurance-dominated insurers, owing to the increased take-up of insurance in a rapidly expanding private bank branch network (the top 3 private banks increased their combined branch count from around 4,700 in March 2010 to 10,653 in March 2015), revival of ULIPs following a rebound in equity markets, and greater use of technology. This, coupled with a relatively weak performance by LIC in recent quarters, again led to a drop in LIC's market share in FY15 (69% vs. 75% in FY14). The top four private players are all bancassurance-led and now command 54% of the private market share and 17% of the total market share.

4. Source: Timetric - Insurance Intelligence Center data

5. IRDAI data

Penetration and global position

A strong growth run during FY05-11 had taken India's life insurance penetration (FY10: 4.6%)⁶ beyond the global average (FY10: 4%). However, stagnation in life premium collections since FY11 against a high nominal rate (real + inflation) of GDP growth led to a drop in the penetration level from 4.6% in FY10 to 2.6% in FY15 (FY15 global average: 3.4%), a level not seen since FY06. Similarly, India's life insurance density (premium per capita in US\$), which continues to be much lower than the global average (FY15: US\$368), fell from a high of US\$56 in FY11 to US\$44 in FY15. Despite the low rate of adoption, India's life insurance market is the 11th largest in terms of gross written premiums.

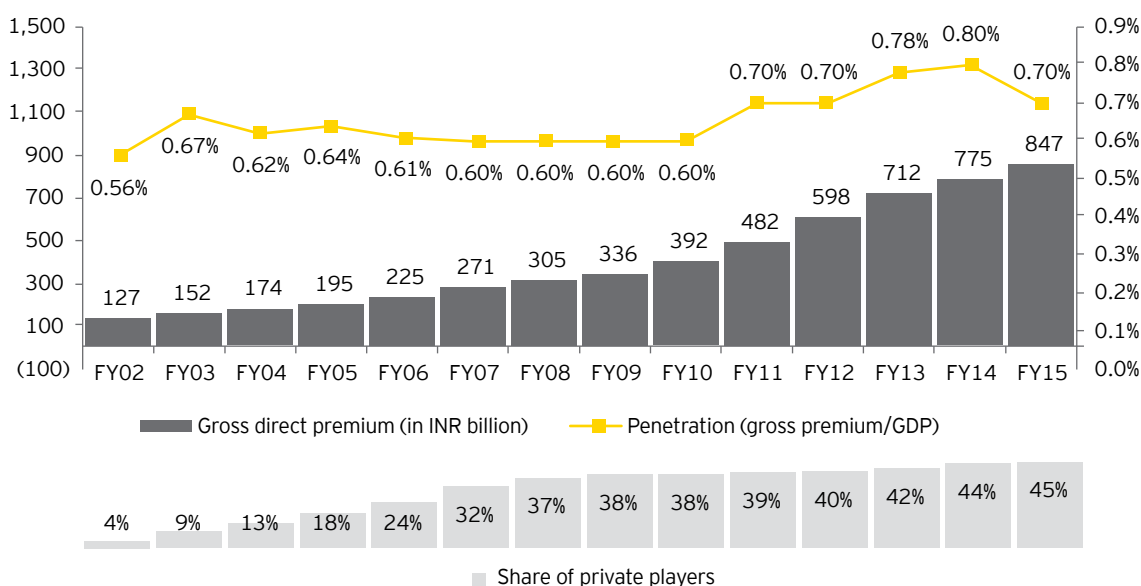
Non-life insurance industry

Growth over the years

Non-life insurance sector's volume growth has been more consistent, when compared to life insurance sector's growth. The gross direct premium of the non-life insurance sector stood at INR847 billion in FY15, having grown at a CAGR of 16% since FY02. The non-life sector's growth has been largely in line with the nominal rate of GDP growth during this period. The lines of business leading this growth have been motor (CAGR of 18% between FY06 and FY14) and health (CAGR of 30% between FY06 and FY14).

However, steady volume growth didn't materialize into comparable value creation, particularly since 2007, when price deregulation came into effect. Before 2007, insurers could drive profitable growth by altering distributor payouts. Starting 2007, non-life insurers were pulled out of their comfort zone, as profits eroded across lines of business, owing to increased price-led competition. Volume growth too, has come under pressure over the last two years, on account of weaker auto sales and slow execution of infrastructure projects among other factors. (FY15 growth: 9.3%). Despite the recent slowdown, the non-life sector is projected to grow at a CAGR of 14% over the next three years (till 2018)⁷.

Exhibit 2.4: Evolution of India's non-life insurance industry



Source: Life Insurance Council, IRDAI, Swiss Re 'World Insurance' reports

6. Source for all penetration and density related information: Swiss Re 'World Insurance' reports

7. Source: Timetric - Insurance Intelligence Center data

Competitive landscape

Currently, the non-life insurance sector has a total of 28 insurance companies, with six being public and the remaining being private. Of the 22 private players, five are stand-alone health insurers, which are rapidly gaining volume, having grown at a CAGR of 22% since FY10 (FY15 growth: 31%). Despite having lost considerable market share over the years, the top four public sector players (the remaining two public sector players being specialized insurers) continue to dominate the non-life space with a market share of 50% in FY15 (FY06: 71%).

Penetration and global position⁸

Non-life insurance premium, as a percentage of GDP, has increased from 0.56% in FY01 to 0.70% in FY15, and the per capita premium income increased from US\$2.4 in FY01 to US\$11 in FY15. However, both these indicators continue to be much below the world average of 2.70% and US\$294, respectively, indicating a very high long-term growth potential. Despite extremely low penetration and density, the Indian market ranks 20th in terms of the size of premiums underwritten.

8. Source for all penetration and density related information: Swiss Re 'World Insurance' reports





Global insurance market trends

Quest for growth amidst a complex reality

As the global insurance industry is gradually recovering from the impact of the global financial crisis, the focus of insurance companies is shifting from sustenance to driving growth. Insurance companies in mature markets are shedding non-core businesses to de-risk and streamline their operations, and are also investing heavily in technology to improve the core process. At the same time, insurers are cautiously rebalancing their geographic footprint and seeking business line expansions to drive future growth. However, this growth is being restricted by multiple macro-economic variables such as a sluggish Euro zone economy, persistent low interest rate environment and softening prices in the non-life segment.

- ▶ Life insurance: During 2014, global life insurance markets benefited from a combination of strong equity markets, realignment of product portfolios toward unit-linked and fee-based policies, and a return to double digit growth in some of the emerging Asian markets. However, ongoing macro-economic uncertainties in the Euro area and persistent low interest rates continue as strong headwinds.
- ▶ Non-life insurance: While below average catastrophe losses and a gradual upturn in economic activities drove improvements across the non-life sector in 2014, softening rates in most markets are expected to impact both top-line and margins through 2015.

In the near-term, insurers are expected to be favorably influenced by a gradual rise in bond yields and efficiency gains made on account of investments in technology and digitization across the value chain by insurers in recent years. Several factors, stemming from the recent environmental, technical and organizational developments, are driving the following key trends in the global insurance industry:

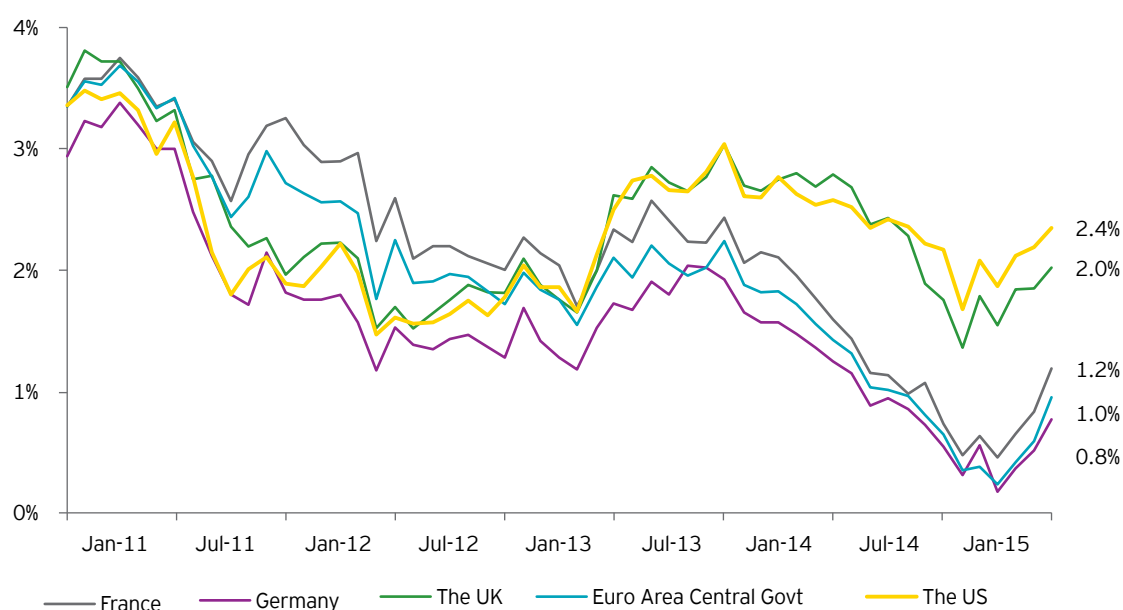
- ▶ Life insurers mitigating the impact of persistent low interest rates
- ▶ Non-life insurers facing a gradually softening pricing environment
- ▶ Rising investments in advanced technology and digitization
- ▶ Emergence of health insurance as a growth opportunity
- ▶ Regulatory reforms becoming more frequent and stringent

Mitigating the impact of persistent low interest rates by realigning the product mix, reorganizing operations and accessing high growth markets

The impact of prolonged low interest rates and falling yields on earnings and capitalization ratio remains a key concern for the insurance industry, especially for life insurers as they offer savings products with guaranteed returns. European life insurers are particularly exposed to low interest rates as the guarantees offered are more generous and the duration of liabilities longer as compared to other markets. Also, a shift in the product mix toward guaranteed benefit policies during 2009-12 further increased the insurers' sensitivity for low interest rates.

The recent rise in bond yields will likely help stabilize the sales of saving type products, such as annuities and universal life, which have been under pressure for a long time. Moreover, if bond yields continue to improve slowly in 2H15, it should boost the investment income and ease the pressure on sector's earnings as well. However, the ongoing low interest rate environment will continue to put pressure on guarantees and will gradually drive down the earnings for the life insurers.

Exhibit 3.1: Ten year government bond yields, 1Q'11-2Q'15



Source: S&P Capital IQ data

Despite the modest growth in bond yields, the overall low interest rate environment remains a key concern for the insurance sector, mainly for the life insurance sector due to their guaranteed savings product offerings. To ease the pressure, life insurers must continue to de-risk and realign their operations.

To navigate through this prolonged phase of low interest rates, life insurers are adopting several strategies, such as realigning the product mix, minimizing guarantees, selling non-core businesses and focusing on emerging markets.

- ▶ **Realigning product mix:** Most life insurers are shifting their product mix away from spread-based products to fee-based products. Several insurers have reduced the emphasis on the spread business, while raising the share of fee-based retirement, pensions and protection business. These product mix shifts are aimed at reducing the exposure to low interest rate risk. In addition, insurers are aggressively revamping their product design, including increasing fees, limiting features, reducing guarantees and rationalizing bonus rates.
- ▶ **Restructuring to streamline operations:** Several life insurers are restructuring their operations and shedding non-core businesses to reduce their exposure to interest rate sensitive businesses such as banking and asset management. Insurers are also streamlining their operations to improve efficiency and risk management to drive long-term profitable growth.
- ▶ **Expanding footprint in high growth, emerging markets:** With the focus returning to growth and combating low interest rates in matured economies, insurers are seeking to expand their presence in emerging markets, in order to capitalize on better growth dynamics. Many global insurers are targeting acquisition opportunities in the emerging markets of Asia, Latin America, and Central and Eastern European region.

Negotiating soft market conditions (non-life) through tactical reinsurance ceding, and smart capital deployment

The global non-life insurance premium growth, that remained relatively resilient during the financial crisis, is observing a downward trend (dropped to 3.7% in 2014 from 7% in 2011). This moderation is primarily driven by the softening of non-life rates across most regions and lines of business (particularly personal and commercial), which in turn is due to relatively low volume of insured losses from major catastrophes since 2012.

- ▶ Property lines experienced the largest rate decline during 2014 across regions, due to continued strong capacity and below average catastrophe losses in 2013 and 2014.
- ▶ US commercial lines price, although still positive, were mostly flat to up low-single digits.
- ▶ The UK and Continental Europe also witnessed a continuous drop in rates since 2013, particularly in the casualty, and the financial and professional liability lines.
- ▶ Although the current low penetration and increasing wealth of the middle-class population are driving the demand in emerging Latin American and Asia-Pacific markets, continued inflow of new capital is adding to the capacity and putting pressure on the rates.

Exhibit 3.2: US P&C insurance rate changes (%)

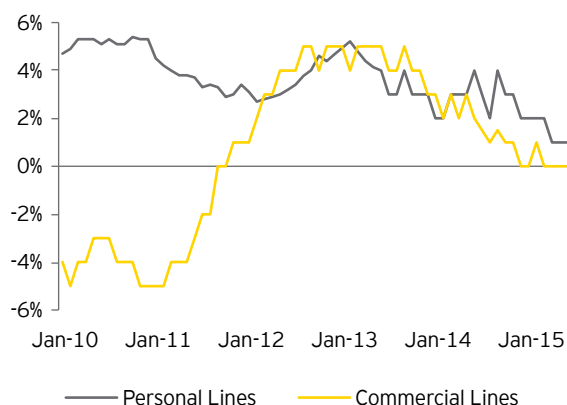
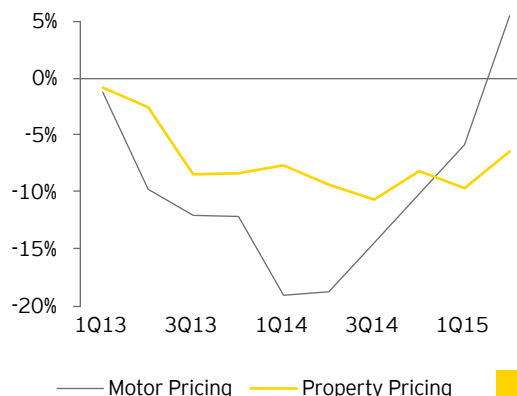


Exhibit 3.3: UK non-life pricing change (%)



Source: MarketScout Commercial Lines and Personal Lines Barometer Reports; Association of British Insurers - AA Index

The industry has continued to experience rate softening across most markets and lines in first half of 2015 which is likely to put further pressure on premium growth. While a divergent trend appeared in the UK, where motor insurance rates rose in 2Q15 due to higher claims and imposition of premium tax, the property insurance rates continued to decline.

To mitigate the growth challenges arising from rate declines, non-life insurers are adopting various capital management strategies to protect margins and keep investors interested

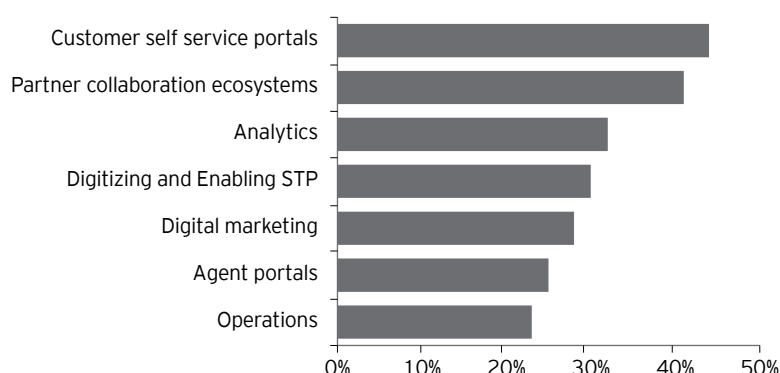
- ▶ Harnessing the soft reinsurance market: Insurers are looking to take advantage of the currently favorable reinsurance rates and terms to expand their exposure to high margin coastal property risks.
- ▶ Scaling up inorganically: Insurers are deploying excess capital for mergers and acquisitions to sustain growth and scale. During 2Q15, industry witnessed several high value deals.
- ▶ Maintaining investor confidence: Several groups are returning excess capital to shareholders through increased dividends and share buy-backs.

As pricing power declines, cyclical adversities have begun to set-in for the non-life sector. Though benign catastrophe losses have masked the impact of the rate softening on earnings, sustaining a profitable growth will become a critical issue for the insurers in the coming years. Nonlife insurers must continue to implement more effective capital and cycle management practices.

Increasing investments in technology and digitization to create a harmonious ecosystem for all stakeholders

The continued rise in competitive pressures within the insurance industry has led to an increase in the customers' buying power and related changes in the customers' and intermediaries' preferences. These environmental changes are driving insurers to invest in the transformation of core processes and the modernization of legacy systems, particularly policy administration and claims systems, and to develop and implement an effective digital strategy. Several major insurers have already initiated core system transformation projects to improve customer service and speed to market. Digital channels and customer analytics are also the priority investment areas for insurers to improve customer experience, distribution, and process automation. According to Forrester's research, the world's largest insurance companies see the Internet of Things (IoT), digital marketing, and big data as the key disruptive digital technologies for the sector. According to estimates by Celent, the global insurance IT spending is expected to grow to US\$189 billion by 2017 (CAGR 2011-17: +6%).

Exhibit 3.4: Insurers' key focus areas for digital initiatives in 2015
(No. of insurers surveyed 200)



Source: The Digital Insurer in 2015; Forrester Consulting

With global economic growth outlook gradually improving, insurance sector's investments in new IT capabilities is likely to increase further. Insurers will continue to invest in emerging technologies, including sensor-based technology, to improve operational efficiency and extend customer reach

Forrester's research also indicates that development of customer self-service portals, collaboration ecosystems, and analytics competency are the top focus areas for insurance companies' digital initiatives for 2015 and beyond.

- ▶ Several insurers are investing to develop better digital self-service portals to improve customer experience
- ▶ Enhancing customer value and stakeholder (distributors, TPAs and other partners) engagements through a holistic digital ecosystem is another key priority for insurers
- ▶ A large number of global insurers are seeking to drive smarter decision-making by applying data/customer analytics tools to leverage big data

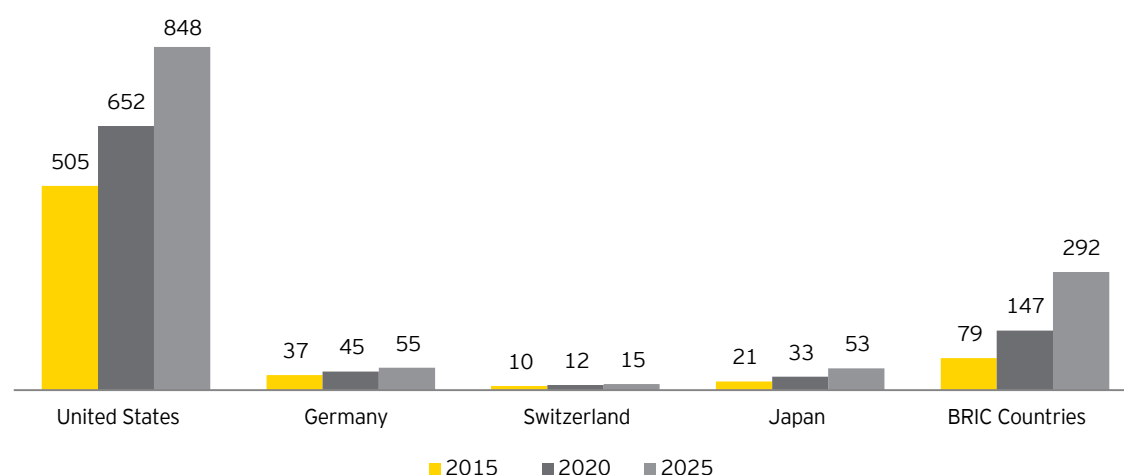
Emergence of health insurance as a key growth opportunity

The global health insurance sector is forecast to grow at a CAGR of 5%⁹ during the period 2013-17, and reach US\$1.2 trillion¹⁰ by the end of 2017. Moreover, the private health insurance market is forecast to grow at a faster pace across several markets.

9. EY analysis based on timetric - Insurance Intelligence Center data

10. EY analysis based on timetric - Insurance Intelligence Center data

Exhibit 3.5: Personal health insurance - Net premiums earned forecast: 2015 - 2025
(US\$ billion)



Source: Timetric - Insurance Intelligence Center data

Multiple factors, stemming from macro-economic, demographic and regulatory changes are catalyzing the growth of the private health insurance market

- ▶ **Aging population with chronic health care needs:** The global population of individuals aged more than 60 years is estimated to triple from the 2010 levels to reach over 2 billion¹¹ in 2050 – increasing from 11% to 22% of the world's population. The individual health insurance and nursing care offerings are likely to replace death coverage insurance as the main growth and profit drivers.
- ▶ **Rising health care costs:** Globally, health-care expenditures are continuing to grow rapidly. Since 1970, health care spending has grown at an average annual rate of 9.8%¹².
- ▶ **Reductions in the Government's welfare spending:** In several large economies such as Italy, France, Japan and Canada, the Government is adopting various fiscal tightening measures, including reductions in social welfare spending. As social schemes become less generous, people will have to increasingly spend out-of-pocket for their health care needs, which will lead to an increase in the demand for private health insurance plans.
- ▶ **Increasing disposable income in emerging markets:** The middle-class population in the emerging markets is expanding and their disposable income is increasing, enabling more individuals to afford insurance policies. In 2015, the number of households with an annual disposable income of over US\$10,000 (PPP) in the 25 key emerging market economies is likely to be around 845 million, which is expected to increase to 1300 million by 2030¹³.
- ▶ **Health insurance reforms:** In several markets such as Switzerland and Netherlands, the Government has mandated compulsory enrolment to basic health insurance provided through private insurers. In addition, insurers have the opportunity to write supplementary health insurance that can be attached to the mandatory basic health insurance plans.

Against the backdrop of rising costs, aging populations, stressed infrastructure, constrained resources and shifting regulations, health insurance offers a huge growth opportunity for the insurance companies across the globe.

11. Population Challenges and Development Goals, The Department of Economic and Social Affairs of the UN

12. How Changes in Medical Technology Affect Health Care Costs; Kaiser Family Foundation

13. 2015 Outlook for Emerging Market Economies; EuroMonitor International

Against the backdrop of rising costs, aging populations, stressed infrastructure, constrained resources and shifting regulations, health insurance offers a huge growth opportunity for the insurance companies across the globe.

Regulatory reforms becoming more frequent and stringent

Globally, insurance regulations are becoming more intrusive and stringent, encompassing continuous monitoring of risk management activities and financial performance of the insurers. The insurance regulators, across regions, are seeking to introduce a new approach for setting reserve and capital requirements that not only focuses on improving capital adequacy and liquidity, but also ensures insurers' long-term ability to honor commitments.

The European Union (EU) insurance sector regulator, the European Insurance and Occupational Pensions Authority (EIOPA) is leading the way with the introduction of the landmark risk-based capital regulatory regime, known as Solvency II. The Solvency II norms, which will become effective from 1 Jan 2016, will affect multiple facets of the insurance business, including costs, governance and reporting. It aims at enhancing policy holder protection, modernizing supervision to shift supervisors' focus away from basic compliance monitoring, deepening the EU market integration through harmonization of various supervisory regimes, and increasing international competitiveness of EU insurers. Similarly, the International Association of Insurance Supervisors (IAIS) also has plans to develop new global insurance capital standards (ICS) by 2016.

Most regulators are developing Solvency II type frameworks to ensure the protection of policy holder wealth and confidence. Some key reforms in prominent geographies have been highlighted below:

| Geography | Major developments |
|-------------------|---|
| The United States | Federal Insurance Office (FIO) submitted its long-awaited recommendations to modernize insurance regulation, including capital adequacy, safety and soundness, and marketplace regulation (December 2013) |
| China | The China Insurance Regulatory Commission (CIRC) started the technical tests to quantify the risk-based minimum capital for life insurers under its second-generation solvency reform |
| Germany | German insurers may need to build up more than €10 billion in extra regulatory capital by 2016 to meet requirements under Solvency II regime (As per BaFin, the German insurance regulator) |
| Canada | The Office of the Superintendent of Financial Institutions plans to finalize the life insurance capital framework by 2016 |
| Mexico | A three-pillar solvency framework, similar to Solvency II, being implemented |
| Oceania | Eight Pacific Island nations' regulators have developed regional and individual country action plans to improve supervision of insurance and reinsurance regulatory regimes. These are aimed at increasing insurance penetration in this region's under-developed insurance markets and attract long-term capital |

The insurance regulations are likely to continue to become more stringent in coming years. With these reforms underway, insurers need to proactively start preparing for changes to their risk management processes, systems, and reporting.



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Trends and Issues - Indian Market

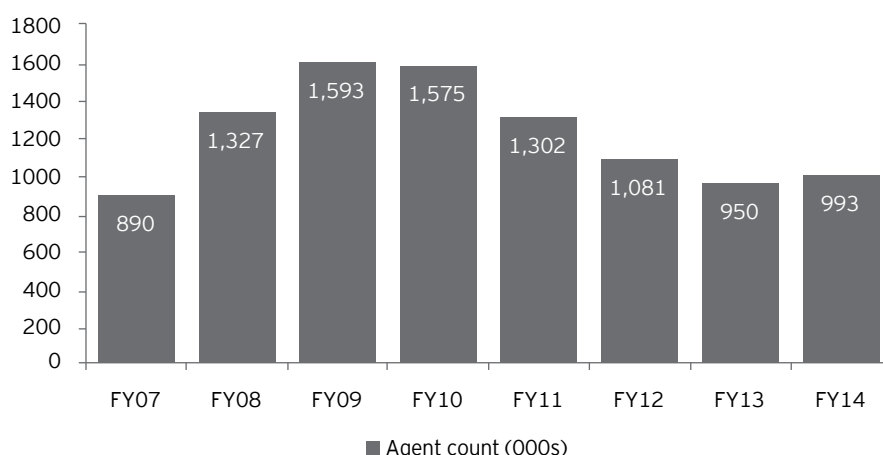
a. An elusive pursuit of a 'cost-effective' distribution channel (life insurance)

Industry's initial surge, particularly for life insurance, was driven by a myopic yet relentless hunt for capturing market share. However, a relook at the cost structures to drive profitability in the ULIP 2.0 era post 2010 forced insurers to alter their distribution mix in favor of channels with lower overrides.

Agency: a flawed fixed cost model for most private players

The agency channel was the key growth driver for the sector until 2008. However, with reduced commission structures on short-term products, extremely high attrition (at both agent and front line sales manager level) and customer acquisition becoming tougher, agency's viability remains under pressure. Also, high agency costs on account of a fixed cost model amidst declining average productivity per agent despite reduced size of agency makes the revival trickier.

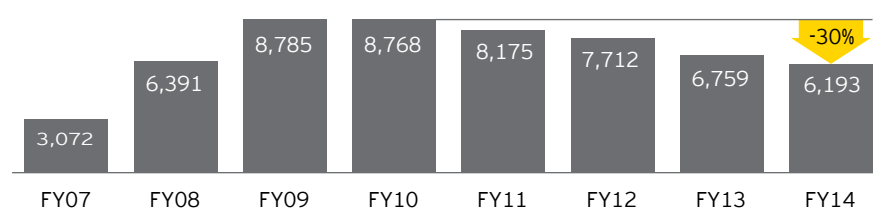
Exhibit 4.1: Individual agent count - private life insurers



Source: IRDAI Handbook 2013-14: state wise distribution of individual agents of life insurers

Lack of attractiveness of the agency as a career proposition is another factor, which is hampering this channel's growth, as recruiting the right talent is becoming increasingly challenging. As a result of these adverse trends, most agency-led insurers, apart from LIC, have either seen a drastic drop in new business volumes, or have progressively raised their dependence on bancassurance. Subsequently, the number of offices in the private space has gone down significantly from a high of 8,785 in March 2009 to 6,193 in March 2014 and at less than a million, the agent count too is at a level not seen since 2007.

Exhibit 4.2: Number of offices of private life insurers



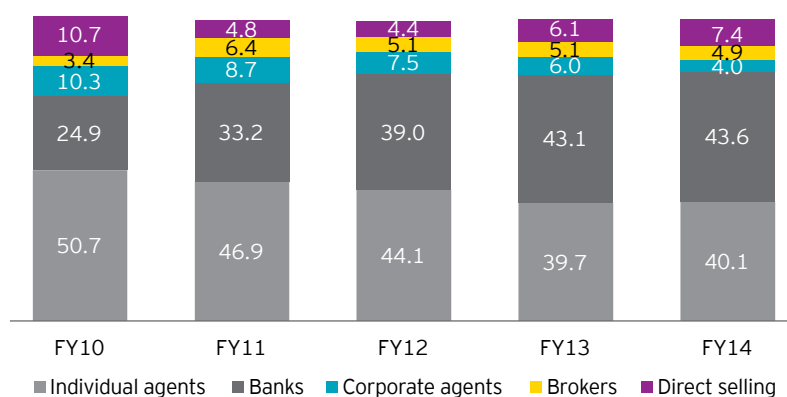
Note: Number of offices as on 31st March
Source: IRDA Annual Reports

Bancassurance: driving growth and profitability for some

With other channels struggling to match the new economic reality post 2010 changes, bancassurance was the only major channel which performed favorably. A captive customer base, banks' strong brand recognition, ability to sell insurance as an add-on product with other banking products and a rapidly expanding bank branch network allowed private banks to scale up their insurance business.

However, the benefits were restricted to a few players which successfully reduced their dependency on agency and other third party channels and improved their cost to premium ratios significantly while gaining scale and market share. As banks have increasingly influenced both volume and margin, insurers' share in profits has been on a wane in most recent bancassurance deals.

**Exhibit 4.3: Channel-wise distribution mix - Private life insurers
(as % of individual New Business)**



Source: IRDAI

Brokers, still low on maturity

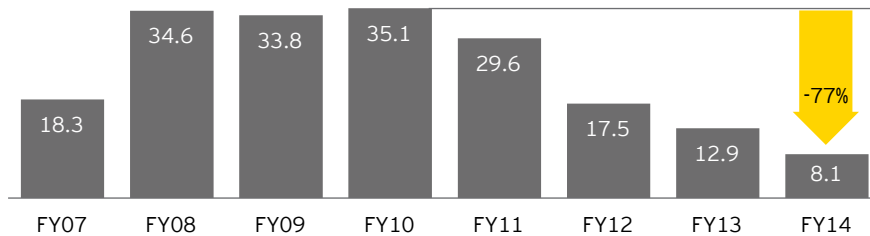
Insurance broking is a significant channel in developed markets, for both life and non-life segments. Globally, this channel has been successful mainly because brokers are seen as customer representatives who advise their clients on the most relevant product/solution to meet their requirements. However, in India, this market is highly fragmented, with few large organized brokers, which often behave as expensive agents. Moreover, most brokers are unable to offer a full range of services to the customers and lack specialization, often failing to customize offerings in accordance with the customers' requirements.

Corporate agents: shrinking insurance play

Of all major channels, corporate agents have witnessed the biggest decline in recent years. Between FY10 and FY14, the individual new business written by corporate agents dropped by more than 79%. The key factors driving this trend have been

- ▶ Excessive regulatory intervention in the corporate agency space to ensure a minimum level of sales quality
- ▶ Reduced interest from insurance companies on account of unviable terms from the established corporate agents
- ▶ Extremely low quality business (particularly low persistency) written by fringe corporate agents, leading to a lack of participation by insurers in tie-ups with such entities

Exhibit 4.4: Corporate agents' individual new business - overall industry (INR billion)



Source: IRDAI

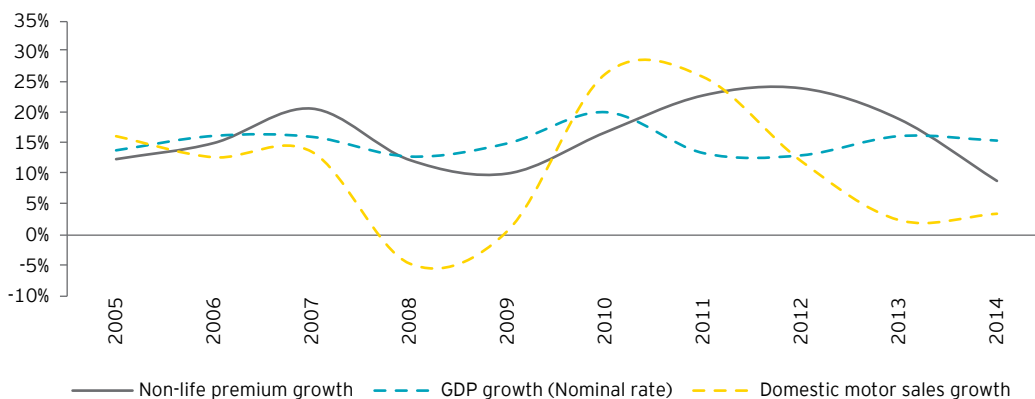
b. Non-life: slowdown in volume growth after a strong run

Globally, the non-life insurance market is known to grow in line with economic growth. Even in India, its growth has moved in tandem with the nominal rate (real + inflation) of economic growth. In the last 10 years (FY05-14), non-life gross direct premiums grew at a CAGR of 17%, which was slightly more than the nominal rate of GDP growth (c.15%; real rate of GDP growth during this period was 7.7%). While growth rates averaged 22% between fiscal years 2011 and 2013, the market has since witnessed a relatively modest expansion (FY15: 9%).

The key factor driving this relative slowdown has been the lagged impact of sluggish economic growth in recent years. The motor insurance segment, which continues to be the biggest line of business within the non-life space (contributed 46% of non-life gross direct premium in FY14), grew at its slowest pace in four years (FY14: 14; CAGR of 25% during FY11-13). Weakness in motor insurance premiums' growth is caused by the slow expansion in the passenger vehicle segment where sales grew at 4% both in the domestic market and for exports.

The representation below depicts the correlation between non-life premiums with the country's GDP growth and annual motor sales. While motor sales have an immediate impact on the non-life premiums, there is a lag between GDP growth/ decline and non-life premiums.

Exhibit 4.5 Growth trends - nonlife gross direct premium, GDP growth (nominal) and domestic motor sales



Sources: General Insurance Council, IRDAI, World Bank, Trading economics, Society of Indian Automobile Manufacturers (SIAM)

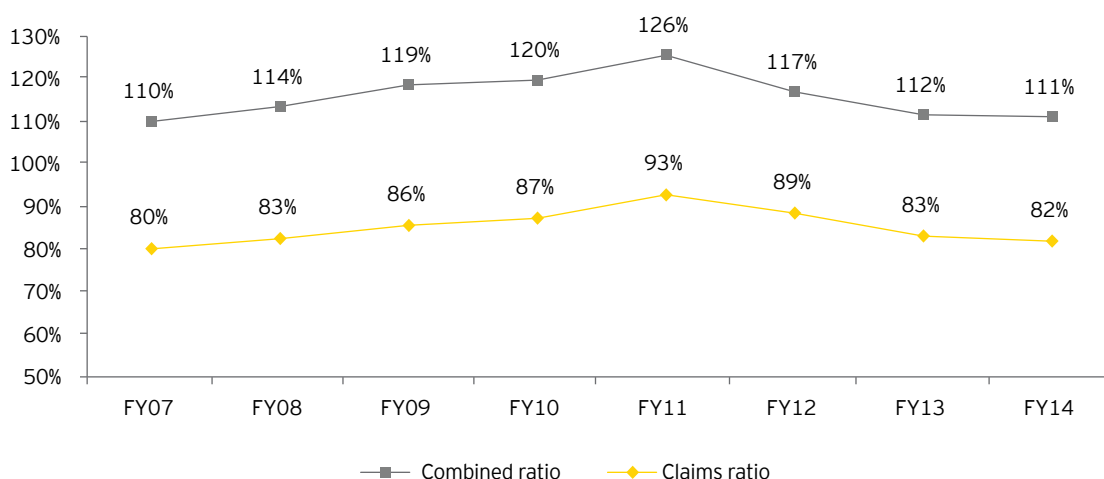
However, economic slowdown is expected to have bottomed out and economic activity will remain strong in the medium term leading to a rebound in the non-life segment. According to World Bank's estimate, India's GDP is expected to grow at a rate similar to that recorded in FY15 (7.4%), which is higher than the average 6.2% recorded during FY12-FY14.

c. Despite recent improvements, claim ratios remain adverse (non-life)

Despite recording a double digit growth in eight out of the last 10 years, the sector has been making significant underwriting losses from its core operations since 2007. The only major source of profits has been the investment income on policyholder funds.

In FY14, the net incurred claims for the industry rose 15% to INR 457 billion up from INR 396 billion in FY13 and the underwriting profits have been non-existent since FY11. Among various segments, the health and motor insurance lines, which are also the biggest and the fastest growing segments, had the highest claims ratios (101% and 80%, respectively)¹⁴.

Exhibit 4.6:



Source: General Insurance Council Yearbook (Underwriting)

The high claims cost has been driven by a combination of factors which include third party liability losses, incessant price competition and unchecked fraud, particularly in the two largest segments - motor and health.

Motor third party liability pool: no respite in sight

The motor third party liability pool which was setup in 2007 was one of the main sources of underwriting losses for non-life insurers up until 2011. The Indian Motor Third Party Insurance Pool (IMTPIP) was a mechanism where all motor third party liability premiums for commercial vehicles were ceded into a pool and claims were shared by all non-life insurers. This setup prevailed for almost five-years between 2007 and 2011 leading to huge losses. The incurred claims ratio for motor segment rose to as high as 103% in FY2011.

The eventual dismantling of the IMTPIP in 2012 and introduction of Declined Risk Pool allowed insurers to transfer only those risks which related to commercial vehicle third party liability that they were unwilling to have on their books, to a pool administered by the General Insurance Corporation. This development provided some relief to non-life insurers by freeing the pricing model and giving insurers the flexibility to price vehicles based on claims. As a result, despite being adverse, claims ratio has been improving since FY11.

14. Source: IRDAI Handbook 2013-14

The challenge of managing motor insurance losses is expected to continue as the regulator has made it mandatory for insurers to have a minimum percentage of motor third-party (TP) business underwritten, starting this year. This, coupled with a much lower increase in motor third party tariff than expected, could prove to be a challenge for non-life insurers going forward.

Relentless competition with price being the only differentiator

Rise in the number of non-life insurers from 15 in FY07 to 28 currently coupled with the 2007 de-tariffing, led to persistent price wars in a bid to gain market share. However, continued restrictions on the premium pricing of the biggest non-life segment i.e. third party motor liability (which continues to be administered by tariff) implied that the insurers continued to book major losses. Additionally, the inability of general insurers to differentiate on the basis of product offerings along with the lack of customer awareness towards product features has kept customers' relationship with the general insurance industry to be extremely price driven.

The case of missing 'utmost good faith': Extremely high incidence of claim-related frauds

Indian insurers have been struggling with controlling the costs incurred from fraudulent claims since a very long time. While on one hand insurers face high cost of investigation and litigation, on the other hand, they grapple with reduction in customer contentment levels due to delays in claims settlements for genuine customers. Therefore, insurers often find honoring a fraudulent claim cheaper than investigating it.

Some common forms of frauds include:

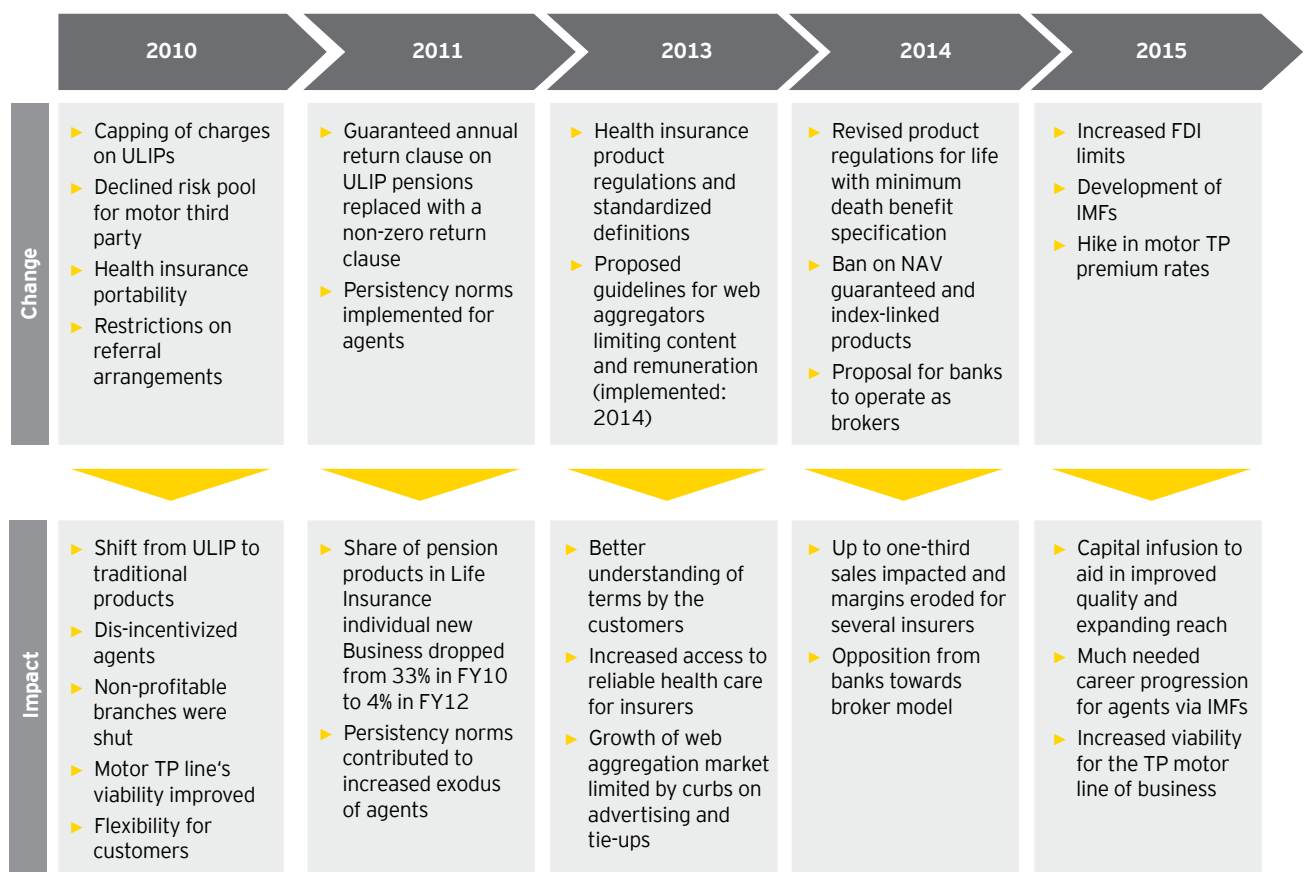
- ▶ Tampering with the date of loss
- ▶ Exaggerated repair bills
- ▶ Concealment of pre-existing diseases
- ▶ Providing false information regarding the purpose of hospitalization
- ▶ Fake hospital bills and exaggerated claims
- ▶ Fraudulent pathology lab reports

d. Insurance regulations – from oversight to cautious optimism

Regulations aim at driving transparency, simplifying products and services and creating a favorable ecosystem for all the stakeholders. While the intent has been right, frequent changes in regulations continued to disrupt the business models of insurers during the last decade. A plethora of changes within a limited span created multiple operational and economic complications for both insurers and distributors. Some of the key changes which played a dominant role in charting the course for the industry were the introduction of cap in charges on linked products, restrictions on pension and index-linked products, and persistency norms for agents; while the general insurance sector was affected by price de-tarrification and motor third party risk pooling arrangements.

Following is a snapshot of some of the key changes introduced since 2010:

Exhibit 4.7:



Source: EY Knowledge Analysis

While a number of changes in the recent past had an adverse impact on the sector, some of the recent regulatory developments have shown a progressive outlook, while focusing on interests of all stakeholders:

1. Insurance Laws (Amendment) Act 2015 - multiple positives for insurers¹⁵

Increase in insurance FDI limits as a part of the new Insurance Bill is expected to help insurers with more capital, technical know-how and expose them to global best practises.

Foreign partners keen on larger equity participation

Considering the positive market sentiments in the country and improved investor confidence, several Indian parents of insurance companies are looking at diluting their stakes to capitalize on a good valuation. Global insurance companies are equally excited at the prospect of having a greater stake in the growing, under-penetrated Indian insurance market. So far, multiple global majors have shown interest in raising stake in their Indian subsidiaries.

Elimination of standard prescribed expense limits

As per the old provisions, an insurer's annual management expenses had to be within prescribed limits, which restricted the ability of the insurer to diversify into untapped geographies entailing high set-up costs. With the passage of the law, this clause has been eliminated from the act, giving more power to the local regulator (Insurance Regulatory Development Authority) to regulate management expenses. It provides flexibility to the regulator to prescribe a broad architecture to define expense limits.

Flexibility on the maximum commission to agents

Earlier provisions prescribed the maximum amount of commission which is payable to an insurance agent or any other intermediary. While this clause was aimed at containing the inorganic growth by insurers who could heavily compensate the intermediaries for getting business, in reality insurers managed to create alternate routes in making high distributor payouts. In response to an already prevalent practice adopted by most insurers, the restriction on commission payouts has been dropped. Instead, the regulator is expected to regulate the commission at a product level, thereby ensuring meeting of product margins.

Elimination of renewal commission to non-agents

The amended bill has responded well to the burning issue in the insurance industry of high agency attrition, impacting both productivity and activity. As per the earlier provisions, an insurer was required to continue paying renewal commission to an agent who has served a minimum of five years with the company, irrespective of whether he/she is still an agent of the company or not. Post the amendment, insurers are not required to pay agents who cease to be associated with them.

Responsibility of appointing advisors entrusted to insurers

The new regulation equips the regulator with the power to frame regulations to regulate the agent's eligibility, qualifications and other aspects. In lieu of the same, and the consultative approach of the regulator, insurers have now been given the sole right to appoint the agents without any intervention from the regulator.

Withdrawal of requirement of deposit with the RBI

Insurers were earlier required to maintain a deposit of USD 1.5 mn with the Reserve Bank of India. In the amended bill, this requirement has been waived off, offering flexibility to new insurers with lower top-line to effectively deploy this additional fund.

15. Press Information Bureau, Government of India, Ministry of Finance, 13 March 2015

It is desirable that the industry is allowed adequate time to adjust to major regulatory changes post a thorough regulatory impact assessment. After all, such changes often have a notable impact on customer experience and perception towards insurance industry. With a greater flexibility post the Insurance Laws (Amendment) Act 2015, the regulator can take stronger steps to facilitate financial education and awareness about insurance products. Considering that currently a majority of sales, particularly in the life segment, is accounted for by tax incentives rather than any specific demand from customers, such steps can go long way in creating a customer pull and driving growth for industry in the long run.

2. Development of Insurance Marketing Firms (IMFs) - the birth of a new channel

IMF as a new distribution channel is expected to give distributors, especially agents, a logical career progression and at the same time limit mis-selling for customers due to a professional outlook expected to be adopted by these firms.

The lower capital requirement for setting up of an IMF combined with the fact that they can be a one-stop-shop for all financial needs of a customer makes IMF a lucrative choice for independent financial advisors and certified financial planners. For insurers, especially the newer ones, IMFs can thus be an effective distribution channel to help increase footprint in untapped segments without significant capital drain.

3. Insurers mandated with fiduciary responsibility and accountability towards customers

The regulator has often taken steps towards the protection of the policyholder and customer interests, by mandating processes, several reporting requirements, and imposition of penalties. However, the new bill has further tightened the regime:

- ▶ **Governance:** As per a provision of the Insurance Laws (Amendment) Act 2015, no life insurance policy can be questioned on any grounds for three years from the date of the policy.
- ▶ **Intermediary accountability:** Insurers are now responsible for all the acts and omissions of their agents, including violation of the code of conduct specified by the regulator.
- ▶ **Increased penalty:** Insurers are liable to a penalty of up to US\$0.15 million for the acts and omissions of their agents. Similarly, a standard penalty of up to US\$4.0 million has been included for failing to comply with the rural or social sector obligations of the or third party motor insurance.

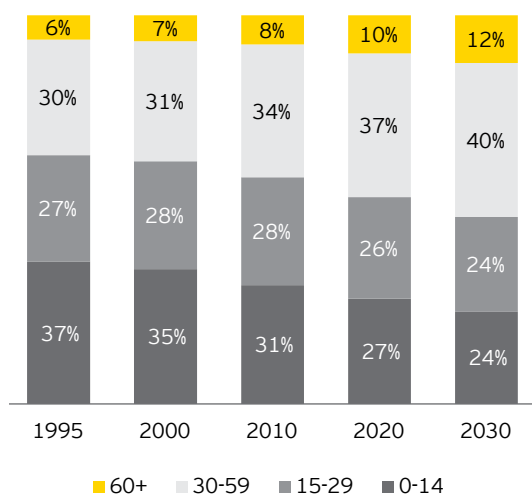
4. Revision of third party motor premium rates and assessment limits

IRDAI raised the Third Party motor premium rates in order to curtail the persistent losses recorded by the non-life sector in recent years. While the hike was below the original draft released by IRDAI, it was still a step in the right direction. Additionally, IRDAI is also contemplating hike in third-party insurance assessment limits, i.e. the level of claims that would require surveyors to assess losses. If implemented, this would imply that insurance companies will be able to settle claims of a higher value for property and motor lines without engaging surveyors. However, this can be detrimental to the c.11,000 surveyors who may end up losing a bulk of their business.

e. Pensions and retirement offerings – a major gap in life insurers’ product portfolio

India is currently one of the world’s youngest nations with 31% of population under 14 years of age, and around 60% under the age of 30. However, with rising life expectancy and declining birth-rates, the rate of growth of India’s elderly population (those above 60 years of age), during 2010 to 2030 (est. 3.6%), will be much higher than the average rate of overall population growth during the same period (est. 1.1%). As a result, the percentage share of 60+ populations, which was 8% in 2010, is expected to reach 12% by 2030.

Exhibit 4.8: India’s population projection



Source: “Population Division”, United Nations Department of economic and social affairs

The factors which necessitate the presence of a strong pension market in India are:

- ▶ Absence of a robust Government-backed social security system
- ▶ Limited segments of population, such as the organized salaried class, being currently covered by the existing pension plans
- ▶ Diminishing social support system with the reducing size of families
- ▶ High rate of inflation implying high cost of living in future years

All these drivers are certain to spur the demand for retirement products such as pension and annuity in the times to come. Pension products cover longevity risk and are typically an important segment in the financial services space for most economies. Hence, given the increased longevity in an inflationary environment combined with the absence of a Government-sponsored social security plan, post-retirement income and health-care insurance are critical for the Indian population.

Challenges which ail the penetration of pension products in India

The prime factors responsible for the unexpected absence of pension as a major product segment in India are competition from other financial products, lack of specific government interventions, deficient risk transfer mechanism, an underdeveloped annuity market, low level of awareness towards retirement savings and customers' high preference for tangible assets:

Competition from other financial products

Higher returns offered by other financial products and lack of specific tax breaks for pension products imply that pension products appear low in the order of preference for most customers.

Preference for physical assets and short-sightedness

A major part of society in India still finds physical assets such as gold and real estate to be a more reliable bet for old age savings than a pension product. Also, most customers are interested in short-term returns, and are unwilling to participate in a very long-term investment. As a result even fixed deposits have a much higher demand.

Lack of awareness among customers

Customers are still not aware about how much they need to save for retirement and why they need to start early. As a result, they end up making wrong bets when it comes to managing their savings.

Absence of a dynamic market for annuities

A dynamic annuity market, which is imperative as a support system for a strong pension market, is poorly developed in India. Without a well-defined regulatory framework, the market has limited products to offer and lacks innovation. While low financial literacy, a false notion of life expectancy, inheritance motives and alternative savings restrict the demand for annuities, the supply is equally restricted by an insufficient supply of long-term financial instruments for the purpose of hedging long-term risks and adverse selection, among others.

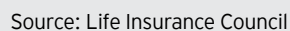
Scarcity of annuity providers and narrow product market

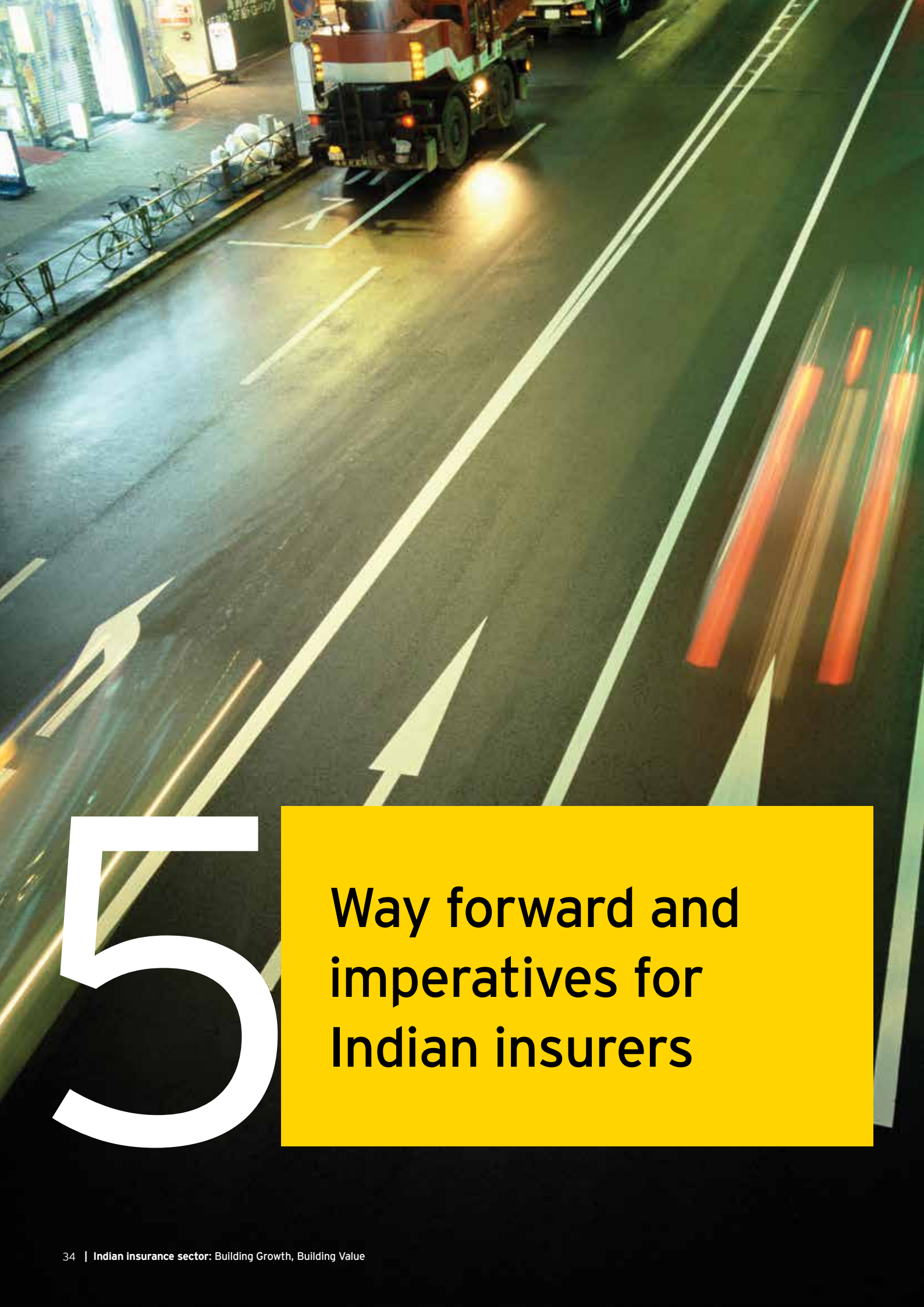
There are not many annuity providers in the market. Not many life insurance companies in the country have the necessary experience in risk management, and the requisite solvency capital to serve in this capacity. An authorization exercise to select these providers is still pending. With the majority of plans launched being either participating or non-participating deferred annuities, India's annuity market is very restricted in terms of the range of products on offer. Immediate annuities on offer are very few in number, and are launched only by a single insurer. This hardly gives options to interested investors.

Difficulty in providing long-term insurance guarantees

The absence of an effective reinsurance mechanism for hedging long-term annuity business and the adverse experience of global insurers due to their earlier long-term guarantees on annuity yields have prevented life insurers from participating aggressively in the pension space. Till FY10, when insurers were actively promoting pension products, the risk was completely with the customers, as most pension products were market-linked. However, with IRDAI mandating capital guarantee for such products, most insurers exited this particular segment.

Exhibit 4.9: Share of pensions and general annuities in individual new business premium

[illegible]



5

Way forward and imperatives for Indian insurers

a. Pursuing efficiency in distribution

A distributor is typically the first touch point through which a customer identifies an insurance company and is the enabler who pitches products based on customers' needs, and finally closes the sale. In the process, it serves as the backbone for ground level insurance operations in terms of driving KYC and enabling the transaction. A distributor is also the default listening post for most customers. Owing to its' criticality for the success of an insurance business, a cost-effective distribution model is naturally the biggest logistical challenge which the insurers face.

While the larger players with captive bancassurance tie-ups have been successful in achieving distribution cost efficiencies, others are yet to reach a stable state. All the other key channels – agency, corporate agency and brokers have struggled to keep costs low in proportion to the value of new business underwritten. Given the complexities in the current distribution models, a complete revamp is unlikely in the short-term. However, what should work are incremental yet strategic interventions, which gradually improve the face and reputation of insurance distribution.

Collaborating to drive pan-industry talent development

The key reason most channels are unable to operate in a cost effective manner is skill-deficiency among the salesforce. This lack of proficiency, in identifying the right customers, approaching them in the right manner and with the right offerings, leads to low performance and a subsequent lack of interest in the job for a frontline employee/agent. This finally reflects as an exit by choice or as a termination by the insurance company. The insurance industry currently faces a major scarcity of manpower with the right acumen to drive customer engagements and sales.

While creating a strong learning and development infrastructure may not be feasible at an individual insurer level, it can be realized by an industry-wide effort. A common and robust skill building framework can go a long way in creating a large pool of resources for the industry to depend on.

Unified service support for third party distributors

Typically, the partnership between an insurer and a third party distributor (primarily corporate agents, including banks, and brokers) has been transactional. The distributor engages customers, closes a sale and finally, receives a relevant compensation from the insurer. However, what will make this process efficient is the insurer partnering the distributor at each level of the value chain. The insurer can proactively provide relevant customer analytics, create a product portfolio aligned to the distributor's own attributes, make available appropriate sales tools, and provide dedicated operational support for policy servicing. Such an integrated partnership will simplify sales for the distributor's sales personnel, improve customer experience, and will allow the insurer in aligning the distributor with its own priorities.

Optimizing network distribution

Insurers must revisit their network planning strategies and re-align the distribution network mix in line with the economic potential of a region or a city. The right mix of full service branches, satellite branches and presence through a local partner must be carefully assessed based on the region's potential and the insurer's ability to successfully address the requirements of the local customers.

Insurers continue to take multiple productivity enhancing bets across the value chain such as technology enablement of individual agents, targeting each channel with the dedicated product mix in line with a channel's cost structures, and eliminating costs wherever possible. However, to disrupt the status quo, concerted efforts will be required not just by specific insurers but by the industry as a whole in collaboration with the regulator.

Multi-channel approach:

The new age customer doesn't interact with just one distribution channel. Through multiple touch-points/channels, the customer first knows about a product; then compares it with similar products offered by the insurance company itself and by those being offered by competitors, and finally completes the sale through any one of the channels. Insurance companies that can seamlessly integrate the operations of new and alternative channels with traditional channels to present an integrated view to the customer, will likely be best positioned to enhance operational efficiency and benefit from customer's behavioral changes. By developing a multi-channel distribution network, insurers are likely to derive tangible benefits in the following ways:

1. Multi-distribution model will allow the insurer to derive the benefits from each channel to enable a unified service delivery for customers.
2. Integrating new, alternative channels is likely to boost the productivity of the traditional channels by increasing the volume of the leads generated. Also, the lead generation through one channel can be used to close sales via another channel, thus improving the overall lead conversion rates for the insurers (while ensuring that there is no cannibalization among partners).
3. Interacting with a particular customer or customer segment via multiple channels will allow the insurer to gain greater insights about customers' preferences

b. Making the most of the Insurance Laws (Amendment) Act 2015

After nearly seven years of being tabled in the Parliament, the Insurance Laws (Amendment) Act 2015 finally came into effect earlier this year. The major changes included greater availability of capital, enhanced flexibility for the regulator, higher power to the life and the general councils and permission to foreign reinsurers to set up shop in the country. Following are some ways in which insurers can leverage these positives into a long-term advantage:

Collaborating to drive customer awareness

With capital infusions allowing a higher spending power, insurers can now actively work in partnership with the Government, the regulator and the industry bodies to attract public interest towards insurance. Such a drive can alter insurance's current perception among customers of being a mere tax saving instrument to being a critical component for long-term financial security.

Avail reinsurance expansion to design higher margin products

With the amended law enabling foreign reinsurers to set up branches in India and with major global players displaying keenness to enter the Indian market, risk transfer through reinsurance by insurance companies is set to get a fillip. This will allow insurers to design high margin high-risk products for specific customer segments and channels; and enter product categories such as long-term care without taking significant risks on their balance sheet.

Reach out to hitherto underpenetrated customer segments

Increased investments will allow insurers to beef their distribution muscle and expand in the under-penetrated segments of the population, particularly those in smaller towns and non-urban areas, where other than public sector companies; only a few private players have a strong presence. Insurers can better equip their sales personnel with technology enabled tools and adequate training to effectively meet the requirements of the identified target customer segments.

Adopt global best practices to enhance operational efficiency

Increased availability of the capital and know-how from foreign parents will go a long way in plugging the infrastructural gaps faced by insurers. From revamping policy administration systems to improving claims settlement processes, insurers can raise operational efficiency at each level of the value chain. Such improvements can provide a major boost to the long-term profitability of insurance companies.

Raise service delivery standards to boost customer engagement and reputation

Through greater foreign participation, insurers will be exposed to world class customer servicing tools and methods which can significantly improve the way in insurers reach out to their customers. Insurers can make greater investments into customer relationship management, which will have favorable implications in the form of improved persistency and reduced surrender rates, both being much higher than the global average.

These latest policy changes are expected to go a long way in driving the sector's next wave of growth. However, to realize the true potential of these changes, insurers must ensure that their actions are carefully thought through and aimed at driving a growth which is balanced in all respects.

c. Awaiting a paradigm shift: exploring possibilities in the pension space

To develop the long-term pensions market, it is imperative that the Government and the regulators put together a concerted effort in encouraging and developing the long-term asset market. With the right assets available in the market for long-term risk free investments, the pension providers will be in a position to develop and distribute appropriate pension products.

The possible options which can lead to the establishment of a robust pension market can only be arrived by identifying the broad issues faced by the industry, which are:

- ▶ Customers' lack of awareness about the need for pensions
- ▶ Absence of relevant products
- ▶ Pensions system's low penetration
- ▶ Dearth of appropriate incentives for all stakeholders

A combination of the following initiatives, addressing each of the above issues can be a game

changer for the industry¹⁶:

1. Addressing customers' lack of awareness about the need for pensions

Some of the possible desirable actions on this front are:

- ▶ Understanding customer aspirations and identifying the needs of specific segments, e.g., rural and urban, working age groups and people past retirement age through in-depth market research
- ▶ National level education campaigns by the Government, regulators covering the need for pensions, inadequacy of current pension provisions and the avenues available for retirement savings
- ▶ Investing in the training and certification of individual pension advisors for providing the right pensions advice to customers on a large scale

2. Creating relevant pension products for the market

In order to create appropriate products, pension providers may take the following possible actions:

- ▶ Enhance attractiveness of annuity plans through appropriate pricing and innovative offerings e.g., impaired life annuities
- ▶ Pension fund managers should aim to achieve adequate returns to enable customers in achieving the desired fund corpus on retirement
- ▶ Offer guarantees and price them adequately
- ▶ Pension Scheme actuaries to advise trustees and sponsors of occupational pension schemes. Insurance companies' actuaries to design and manage pension plans as per principles of "public interest," allowing for appropriate profit margins and ensuring regulatory compliance
- ▶ Global mobility of human capital means that the cross-border movement of retirement funds could potentially be a big opportunity. This would require initiatives at Government, regulatory and product manufacturer/plan sponsor's level to seek approval of overseas pension's regulatory bodies to agree upon mutual recognition of the pension schemes

3. Improve participation into the pensions system

The key initiatives that may be considered to enhance coverage of pension plans are:

- ▶ Auto enrolment into pension schemes, e.g., NEST scheme in the UK
- ▶ Mandatory enrolment into pension schemes, e.g., raising the salary ceiling for EPFO subscription
- ▶ Use prevailing distribution networks like India Post, co-operative banks, NGOs, self-help groups, micro-finance institutions
- ▶ Open up the existing schemes for wider participation, e.g., access to EPFO for the people working in the informal sector, allowing higher contributions in PPF

4. Incentivize stakeholders to actively develop the pensions sector

All stakeholders need incentives to play their role in the development of the pensions sector. The customers need tax breaks, the providers aim at reasonable profits and the regulator expects that customers are treated fairly along with the smooth development of the sector, as well as 100% compliance with regulations.

- ▶ India can have a preferential tax rate for the income-earned from retirement funds and for retirees, similar to the practice being followed in Netherlands, where the tax rate of a pensioner is 18% lower than the tax rate of an employee.

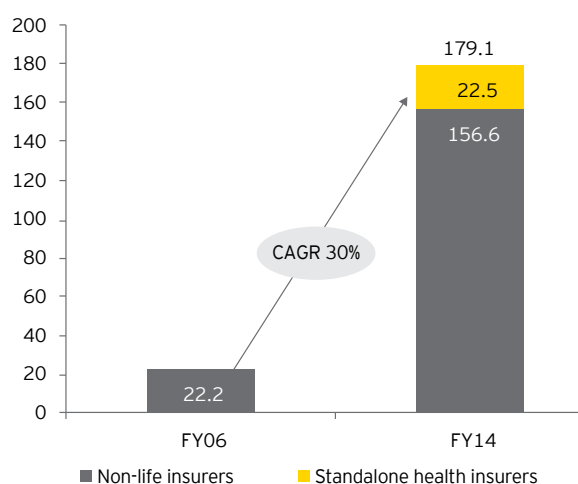
16. Pensions business in India, November 2013, EY

- ▶ The pension product structure needs to allow for appropriate income for all stakeholders, e.g., incentive for the distributors to advise customers. The regulatory framework should help in striking a balance between the profitability of pension providers, the income earned by distributors and the value delivered to the customers.
- ▶ The regulations around occupational pension plans would help improve the governance of employer-sponsored retirement plans and also help employees achieve the desired income replacement ratio after retirement.
- ▶ The Government may provide appropriate financial support for economically deprived sections of the society example, paying a contribution equal to the contribution by the member of the plan, providing capital guarantee.

d. Further penetrating the health insurance market

Increased customer awareness, high health-care inflation, fast progression of medical technology and greater incidences of diseases/sickness due to changed lifestyle has facilitated the growth of health insurance segment in India over the last 15 years. Health insurance premiums grew at a CAGR of 30% between FY06 and FY14. As a result, the share of health insurance in the total non-life gross direct premium has increased from 10% in FY06 to 22% in FY14. The fact that five standalone health insurers have entered the Indian market in the private space in recent years signifies the interest which this segment has generated. Its growth has also been enabled by the availability of a greater number of choices for customers (products like Daily Hospital Cash benefit, and add-on critical illness rider) and favourable regulatory interventions, such as rural health schemes and health insurance portability.

Exhibit 5.1: Health insurance gross direct premium (FY06-14)
(in INR billion)



Source: IRDAI Handbook 2013-14, General Insurance Council

The biggest test for the health insurance segment in the coming years will be to ensure that it transforms from being a provider of basic health protection products to providing holistic offerings which cater to the ever evolving life style changes across customer segments. With favorable regulatory developments, such as recognition of health insurance as a separate vertical (as per Insurance Laws (Amendment) Act 2015) and IRDAI's efforts towards creating a new health insurance framework, lending support to the current growth drivers, health insurance segment is expected to maintain its status as one of the fastest growing lines of business for the foreseeable future.

Despite this meteoric rise over the years, the health insurance space is plagued by a host of issues which directly impact the profitability of the insurance companies and the overall customer experience. At 100.7%¹⁷ during FY13-14, the industry continued to observe an adverse claims ratio, partly on account of high incidences of fraud. In order to maintain this growth momentum and to enhance the viability of this business, the following measures can play a critical role:

Improved framework to curtail fraud

Fraud risk exposure from claims is a major area of concern which continues to have an adverse impact on the overall costs for insurers and premium charges for policyholders. Each insurer needs to adopt a definite methodology to identify and address risks of fraud within it. Some of the areas that a good fraud risk management process should cover include a well-defined whistle-blowing policy, periodic fraud risk assessments, a pre-employment screening, and vendor background checks.

Greater role by life insurers

Health insurance products contributed just 0.3%¹⁸ of life insurance companies' individual new business premium in FY14. Given the long-term nature of the health products offered by life insurers (contrary to the short-term nature of products provided by non-life and standalone health insurers); these products may appeal to a large section of population. Also, the fact that these can be bundled with other long-term life insurance products makes an interesting value proposition for customers.

Engaging customers early

Unlike a life insurance policy, where a customer gets a lower premium rate for the entire payment duration if enrolled at a younger age, there is no such incentive in case of health insurance. As a result, customers tend to purchase a health insurance policy only in the later stages of their life when they expect a greater health risk. By providing incentives and signing up a larger pool of healthy and young population, health premium rates can be expected to moderate and become more attractive for a wider population.

Cost effective health insurance products for the elderly

Currently, the industry offers limited products for the population above the age of 60. Also, the high premium charges for the existing products generally make these products unviable for most customers in this segment. In a scenario where the population growth for those in the age bracket 60 or more is expected to be much higher than the overall rate of population growth, developing a cost effective solution for this customer segment is crucial for the overall growth of health insurance segment.

Combo products with savings elements

The fact that customers typically buy insurance as an investment or a savings product makes a strong case for combo offerings, which add a savings component to the health insurance premium, where a customer also participates in creating a long-term fund.

Raise service proficiency

Improved servicing capabilities for customers towards claims management, when a customer is in distress and helping them understand the technical aspects of the policy during the purchase will create a strong sense of trust among customers.

17. General Insurance Council

18. Life Insurance Council data

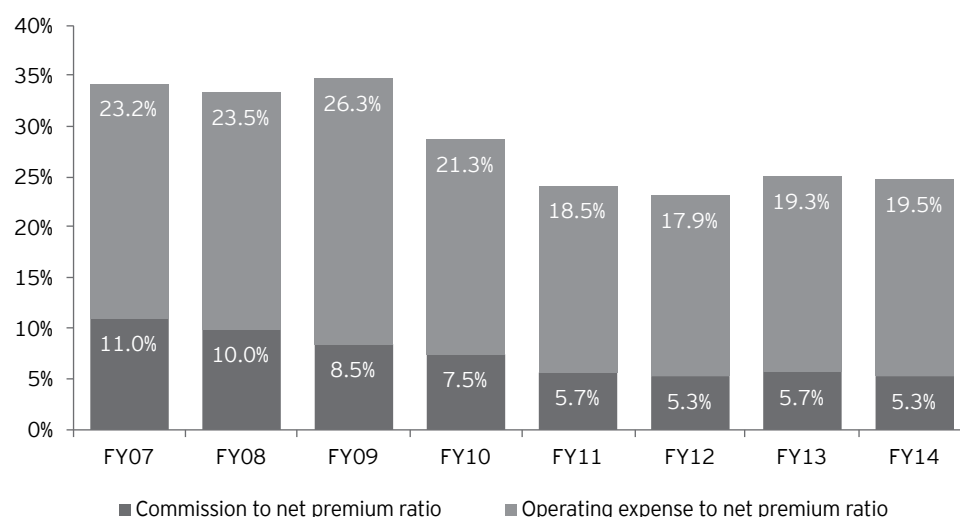
e. Solving the cost conundrum by a greater use of technology

India's insurance sector has faced significant regulatory headwinds over the last decade, which necessitated greater price transparency, condensed margins and reduced flexibility to price products. As a result, managing costs has increasingly developed into a key lever for profitability.

While for life insurers, the key pain area from a cost perspective is their high fixed-cost operating models, for the non-life insurers it is their inability to correctly price products leading to excessively high claims in proportion to the premium collected.

For private life insurers, the cost ratios have failed to moderate beyond FY11 as aggressive cost rationalization efforts starting FY11 led to substantial drop in new business collections, particularly for players sans a major bancassurance alliance.

Exhibit 5.2: Cost ratios¹⁹ for private life insurers



Source: IRDAI Handbook 2013-14

While the non-life insurers have seen improvements since FY11, their combined ratios continue to be adverse and worse than the global norms. (The average non-life claims ratio for most North American and European economies in recent years has been roughly 70%²⁰, compared to a figure of around 90% for Indian insurers.)

A robust cost management framework requires targeted investments in technology across the value chain, particularly to drive operational efficiencies, minimize redundancies across channels and reforming the claims management process.

19. Operating expenses includes both 'Operating Expenses related to Insurance Business' & 'Expenses other than those related to Insurance Business'

20. World Insurance report 2014 by Capgemini

Achieving operational efficiency through information system integration across partners

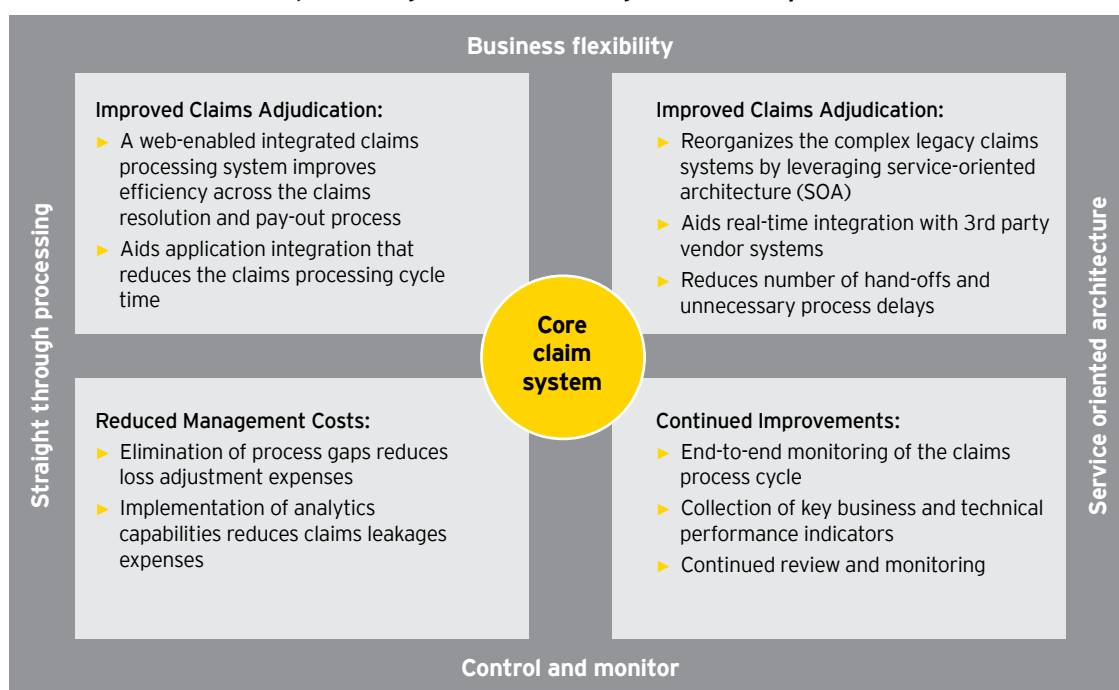
Manual processes, prolonged processing cycles, and disparate systems act as barriers to the speed at which the insurance industry conducts business. Insurers interact and transact with several third party entities, such as individual and corporate agents, brokers, third-party administrators (TPAs), vendors, etc. During these interactions, real-time exchange of data usually becomes a logistical issue due to a lack of integration between the information systems at the insurance company and those at the external partners. Partner integration systems help insurers integrate their systems and data repositories with those of their partners, and enhance operational synergies. These systems automate data transfer, reduce the sales cycle and minimize the time required to service customers. Moreover, these systems support web services and provide insurers the flexibility to adapt to the changing business needs.

Implementing a modern and integrated claims management system

An integrated claims-processing system aids in simplifying processes and improving claims resolution, resulting in lower costs and enhanced customer fulfillment. Such a system can minimize the complexities of the legacy systems and can achieve compatibility across multiple internal systems (such as policy administration and management reporting systems) and third party systems.

An integrated claims management system avails modern technologies such as service-oriented architecture (SOA) to enhance business flexibility, enable straight-through processing, and support control and monitoring functions. It allows for efficient online filing of claims and supports integration of systems across product lines. Additionally, an integrated system minimizes the number of hand-offs, manual interventions, and process delays by making the claims resolution process a lean one.

Exhibit 5.3: Benefits of implementing a modern and integrated claims system



Source: EY Analysis

Leverage analytics to manage fraudulent claims

Fraudulent claims cost continues to be a major issue being faced by insurers. Insurers face a twin challenge on frauds – on one hand they face high cost of investigation and litigation and on the other hand, it leads to customer remorse due to delays in claims settlements of genuine customers. Therefore, frequently insurers find honoring a fraudulent claim cheaper than investigating it. While most insurers have instituted a claims fraud detection framework, they need technology enabled processes which can detect and prevent fraudulent claims at a cost less than the costs for honoring such claims. Following advanced analytics tools can help in this regard:

- ▶ Rules-based systems to test each claim instances against a set of pre-defined business rules to detect fraud patterns.
- ▶ Exception reporting to highlight claims cases where a threshold for a particular measure is exceeded.
- ▶ Predictive modeling to produce fraud propensity scores by using data-mining tools and programs to detect complex fraudulent claims patterns.
- ▶ Social networking analysis to identify fraudulent activities by establishing relationships with people involved in claims.

By implementing an analytical solution to calculate the propensity for fraud at each level of the claims value chain, right from the first notice of loss to the final claim settlement, insurers can boost their effectiveness in combating fraud.

Reducing costs is a key area where technology plays a major role. However, greater use of technology also ensures that insurers stay future ready, minimize risks on account of manual interventions and enable robust decision making at both the leadership and operational level.

Adopting usage based insurance technologies - particularly in motor

Usage based technologies such as telematics will go a long way in the correct assessment of risk and pricing products based on the real experience. Globally the adoption rates for technologies like telematics are rising at a fast pace while reaping advantages for both the insurers and the customers. By 2020, it is expected that more than a quarter of the US and Canadian auto insurance premium revenue will be generated via telematics, representing over US\$30 billion²¹. While some Indian non-life insurers are also known to have begun pilots in this area, there is a need for adopting such technologies in a big way. Correct pricing or elimination of customers with undesirable traits at the underwriting stage can lead to huge savings from unwanted claims.

f. Embracing 'Digital' - disrupting the traditional business structures

Digital transformation represents the continuous disruption to existing business models, products, services and experiences enabled by data and technology. With traditional operating structures being challenged, insurance executives must re-evaluate their future direction and make the digital agenda a high priority.

Digital technologies can be embedded across the core elements of the insurance value chain, right from product development to claim settlement. An effective digital strategy can allow insurers to reduce customer service costs, increasing customer fulfilment and retention, while enhancing

21. <http://telematicswire.net/navigating-the-telematics-journey-through-motor-insurance-industry/>

process efficiency. In pursuit to become a true digital company, developing mobile applications and enhancing data capabilities to leverage analytics are the key investment areas for the insurance companies. Developing mobile applications is also critical owing to the brisk pace at which smartphone adoption is increasing in turn driving an increasing demand for real time services. Mobile applications offer a huge potential for enhancing customer service experience in the form of speedier sales closure, greater access to policy details and even for making hassle-free renewal payments.

Exhibit 5.4: Potential impact of digital transformation on the insurance value chain

| Product design | Front office | Underwriting | Policy administration | Claims Management |
|--|---|---|---|---|
| Product Design and Manufacturing | Marketing, Distribution and Channel Management | Underwriting New Policies | Policy Acquisition and Servicing | Claims Servicing and Payout |
| <ul style="list-style-type: none"> ▶ Advance customer analytics and diagnostic tools, like telematics ▶ Channel sensitive pricing and product differentiation ▶ Customization of product ▶ Optimization of speed to market ▶ Ease of product configurability ▶ Regulatory responsiveness | <ul style="list-style-type: none"> ▶ Integrated multi-channel marketing ▶ Extended multi-device and mobility offering ▶ Centralized distribution-related support functions ▶ Customer needs management - 360° view of customers ▶ Self-service processing capability ▶ Real-time information on policy application status | <ul style="list-style-type: none"> ▶ Real-time information capturing ▶ Advanced risk analytics enabling risk based pricing ▶ Customer value-led promotions and discounts ▶ Automated workflow management and rules engines ▶ Straight through processing (STP) | <ul style="list-style-type: none"> ▶ Integration with analytics and data management system ▶ Self-service capability and STP ▶ Automated renewal notice, premium reminder ▶ Automated billing with multiple payment options ▶ Anytime access to policy details/view policy document in electronic format | <ul style="list-style-type: none"> ▶ Instant notification of the claim through advanced hand-held devices ▶ Digitally enabled claims document submission ▶ Real-time claims status monitoring ▶ Claims status updates through E-mail, Alerts, SMS ▶ Analytics-based fraud detection ▶ Digitally enabled data management |

Source: EY Knowledge Analysis

EY's recent Global Digital Survey²² found that insurers who can differentiate their customer service experience through a carefully designed, thoughtfully executed and adaptable digital strategy are more successful than their competitors at reducing customer service costs while increasing customer retention.

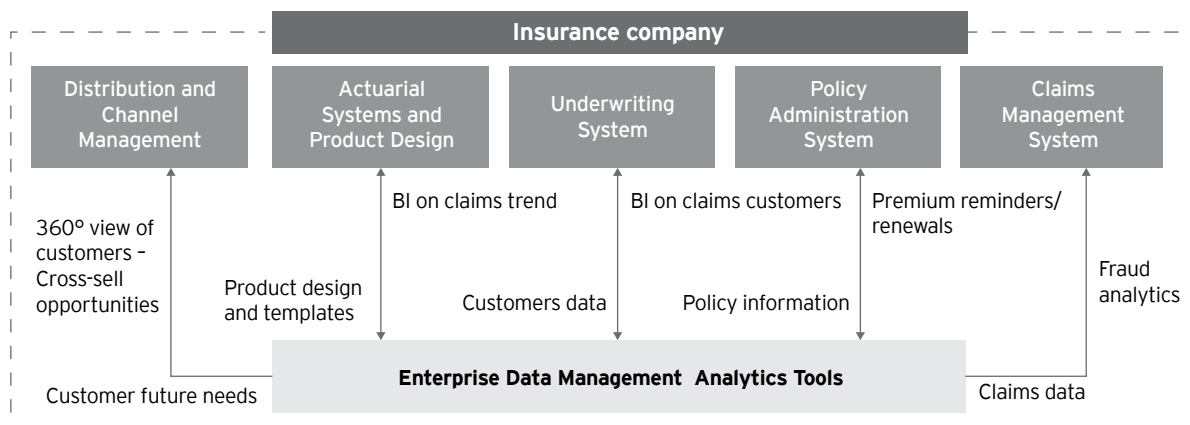
Analytics - a critical element for digital success

With technology changing so rapidly, insurers need new skills to exploit the digital opportunity. According to EY's Global Digital Survey, analytics capabilities (segmentation, customer data and predictive modeling) emerged as the most in-demand skill set for the insurance sector.

The insurance companies need to gradually move from analyzing historical data to predicting future patterns by leveraging business intelligence (BI) and predictive analytics. BI and analytics will also help in addressing the increased sophistication of processes and rising quantum of information.

22. Insurance in a digital world: the time is now; EY Global Insurance Digital Survey 2013

Exhibit 5.5: Integrated business intelligence and analytics tools



Source: EY Knowledge Analysis

Analytics platforms can provide a complete view of the customer, creating opportunities to cross-sell and upsell²³. For example²⁴, when a customer adds a new vehicle to an existing auto policy, sales representatives can use insights churned out by an analytics tool to decide whether the customer owns a home, and whether a homeowner policy can be offered to the customer. Similarly, the sale of a term product can trigger a cross-selling opportunity for a complementary long-term care (LTC) rider. This big-picture view of the customer's profile across all lines of business, when combined with extensive information from marketing database providers, results in personalized interaction, and improved customer retention.

Insurers can further leverage data analytics for underwriting by moving away from broader historical rate models and integrating user-specific data to develop more accurate underwriting models and potentially customize premiums. For example²⁵, in motor insurance space, several global insurers have started using advanced tracking technology to monitor and record unprecedented levels of information about customers' driving habits via telematics.

Similar to telematics in cars, life insurers can now extend this model to include data gathered from wearable technology, such as smart watches or fitness trackers. Wearable tech products have made significant advances in detecting humans' physical activities and biometrics, and these capabilities are expected to continue advancing at a rapid pace²⁶. Life insurers can leverage the extensive amount of health data gathered to make richer risk assessments using ongoing data for longer-term health indicators, such as changes in body mass, blood pressure, and blood sugar and cholesterol levels.

Many insurance organizations run the risk of not delivering digital analytics soon enough, and prefer to wait until digital is strongly embedded into the overall insurance sector. However, analytic capabilities are already emerging as a key competency area for some insurers and are likely to provide these insurers a competitive advantage in a not so distant future.

23. Hot Topics' for Insurers: Social, Mobile, Analytics, Big Data, Cloud and Digital," Novarica

24. Transforming customer service in insurance through digital innovation; EY

25. Transforming customer service in insurance through digital innovation; EY

26. Rude Health: Fitness Tech one of the internet's fastest growing sectors, The Irish News, 27 May 2014

Protection from cyber risk will require insurance companies to transform and improve existing security programs and invest in systems that cater to future threats³⁰.

Cyber security

As insurers are increasingly migrating to advanced IT platforms, cyber security threat has emerged into a key risk area. The ever-increasing dependency on technology combined with the interconnected (with suppliers, vendors, customers, and business partners) nature of insurance business, has resulted in increased potential for cyber security risks.

Insurance companies maintain a number of information systems for core processes such as sales management system, policy administration system and claims management system. All these systems deal with an ever increasing volume of highly sensitive customer data, such as credit card details, account numbers, health records, address and other underwriting data. As a result, insurance companies have emerged as one of the prime targets for cyber-attacks. The fact that these systems interact with multiple peripheral systems (managed by external partners), the risk for cyber-attack and data breaches is significant.

A full-fledged cyber-attack²⁷ can impact shareholder value, tarnish the brand, hurt reputation and expose the company to litigations which can result in loss of competitive advantage and have steep financial consequences running into huge sums, which can be catastrophic to the business.

EY believes²⁸ that insurance companies should maintain the data security triad of confidentiality, integrity and availability of information systems and data channels that are functioning correctly to reduce the exposure to cyber security risk.

- ▶ **Confidentiality:** preventing the disclosure of information to unauthorized individuals or systems
- ▶ **Availability:** making sure that the computing systems, the security controls, and the communication channels are functioning correctly
- ▶ **Integrity:** Maintaining and assuring the accuracy and consistency of systems and data

To improve in these three areas of information security, insurance companies need to develop a strong risk management and governance practice²⁹, including:

- ▶ Developing and implementing a long-term, enterprise-wide security program that addresses processes, controls, organization and governance, as well as reporting, metrics, privacy and data protection
- ▶ Investing in cybersecurity and doing a better job of articulating and demonstrating the value of that investment to stakeholders
- ▶ Establishing a framework of continuous improvement in analytics and reporting, people, processes, and technology
- ▶ Designing and executing initiatives to measure, monitor and report the effectiveness of the security program
- ▶ Refine strategies based on changing threats, risks and business imperatives

27. "Cyber Security– What's Your Plan?", EY published editorials

28. Cyber insurance, security and data integrity, EY

29. Cyber insurance, security and data integrity, EY

30. Reference: Mitigating cyber risk for insurers, EY



Conclusions

After a tough course correction in recent years, the Indian insurance landscape is looking at the future with renewed optimism. Favorable policy action, albeit delayed, has set in motion a new phase for the sector, which is expected to drive the next era of growth. However, to realize the full potential of these positive developments, the industry must focus on the aspects that will build value for all the vital stakeholders.

Value for customers, the prime stakeholder, can be enhanced by providing more options at the time of purchase by developing segments such as pensions and long-term care, which are essential yet currently being offered in a very limited way. Besides developing options, it will also be critical to accurately assess the customers' needs and ensure transparency in communications to embed a feeling of trust among customers. Customer experience can be enhanced significantly by raising service delivery standards through a greater use of mobile technologies, analytics, and through implementation of global best practices adopted from the foreign partners, who can now be expected to play a greater role in the overall operations. All of these aspects, when coupled with providing sound payouts at the time of exit, will create enormous value for customers and earn their long-term allegiance.

For distributors, the real evidence of value creation will be when a distributor is able to stay engaged, can work like a partner and is confident of a long-term growth in its earnings. The insurance industry can create such value only by developing unified service capabilities between the insurers and the distributors through greater use of technology and sharing of resources. Additionally, creating a common skill development framework at an industry level will allow distributors to access the required manpower which is often a key challenge, particularly for the smaller distributors.

The insurance industry will create substantial shareholder value if it successfully caps costs across the value chain, primarily in the area of claims, by adopting robust claims administration systems, greater use of analytics for preventing frauds and adopting new methods of accurately pricing new business (like usage-based insurance). Shareholder value can also be amplified by writing higher margin products by identifying niche segments and greater engagement with global reinsurers, who are now (post the passage of the Insurance Laws (Amendment) Act 2015) expected to set up local offices. However, the industry must strive to maintain high governance standards and eliminate risks, particularly the relatively new ones such as cyber risk.

Finally the stakeholder who puts it all together, the insurer, will create value for itself by focusing on a balanced rather than rapid growth. It must be careful in identifying the right ways to employ the additional capital inflows which it may receive over the next few years. Also, it should harp upon the adequate skilling of its employees and setting practices aimed to make it future ready.





End notes

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