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Guy Carpenter Views

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The Liberalization of India's Insurance Industry

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Since late 1999, the Indian insurance market has undergone major structural changes. The government monopoly was dissolved, private companies were permitted to operate, and brokers suddenly had a role to play. In this country of one billion people, the untapped potential for insurance and reinsurance business is enormous. Nevertheless, impediments to an open and competitive market still exist in the form of restrictions on foreign investments, compulsory tariffs, and mandatory reinsurance cessions.

Guy Carpenter Views speaks with Clive Baker, Guy Carpenter's expert on the Indian marketplace, about insurance and reinsurance developments in India since 1999's Insurance Regulatory and Development Authority (IRDA) Act set market liberalization in motion.

In Part One, Clive talks about the specific market changes that were implemented by the IRDA Act. Part Two will continue with a discussion of how the market has evolved since liberalization efforts began, the role of global companies, and the remaining impediments to an open and competitive market.

■ Part One

The Pre-Liberalized Market

Guy Carpenter Views: Can you provide a brief overview of the insurance market in India before recent liberalization efforts began? How was the market structured in terms of participants, products, and pricing?

Clive Baker: From 1972 to 1999, India's non-life insurance sector operated as a state monopoly under the General Insurance Corporation (GIC) and its four subsidiaries – the New India, Oriental, United India, and the National Insurance companies. The non-life categories of insurance business included engineering, fire, marine, motor, and miscellaneous.

In addition to running the general insurance industry, the GIC arranged its subsidiaries' reinsurance programs either by having them cede reinsurance business to each other or by using industry pooling.

The rates, terms, and conditions that the insurers could offer for their products were established by the Tariff Advisory Committee (TAC), a statutory body created under the Insurance Act of 1938 – the major piece of insurance legislation in effect at the time. The nature of this tariff system meant that premiums were fixed at the same rate for all companies, products were undifferentiated, and coverage was limited in almost every line. The monopoly structure and the closing of the market to foreign and domestic private companies also meant that domestic insurers could thrive without having to face any external challenges.

In this market, there was not much need for brokers. In any case, they were effectively kept out of the country by regulations that prevented them from charging fees or commissions for their services. Nevertheless, some international brokers did conduct business in this market from their offices outside of the country.

Passage of the Insurance Regulatory and Development Authority Act

GCV: What were the government's objectives in moving towards a free and open market? How did the Insurance Regulatory and Development Authority Act of 1999 help to initiate this process? What were the Act's specific provisions?

CB: Passage of the Insurance Regulatory and Development Authority (IRDA) Act of 1999 set market liberalization in motion. The Act represents the Indian government's unanimous agreement, after years of deliberation, that opening the market to both Indian and foreign private companies could help the economy meet its growing insurance needs, spark the growth of rural areas, and promote India as a regional reinsurance hub.

The specific provisions of the IRDA Act were to repeal the GIC monopoly (and that of India's state-run life insurer, the LIC) and:

- Establish the Insurance Regulatory and Development Authority (the IRDA) to oversee and regulate industry operations;
- Redesignate the GIC as a national reinsurer to which all of the country's direct insurers must cede 20 percent of their business;
- Lift the ban on domestic private companies; and
- Open the market to foreign participants – albeit with certain restrictions.

Establishment of a New Industry Regulator

GCV: What is the role of the Insurance Regulatory and Development Authority in overseeing India's insurance industry?

CB: The IRDA is charged with regulating and overseeing the orderly growth of insurance and reinsurance business in India. This includes:

- Protecting the interests of policyholders;
- Establishing guidelines for the operations of insurers, reinsurers, and brokers;
- Specifying the code of conduct, qualifications, and training for insurance intermediaries and agents;

- Promoting efficiency in the conduct of insurance business;
- Regulating the investment of funds by insurance companies;
- Specifying the percentage of business to be written by insurers in rural sectors; and
- Handling disputes between insurers and insurance intermediaries.

GCV: How is the IRDA ensuring that India's domestic market is not at a disadvantage as liberalization efforts continue?

CB: Although India's Parliament recognizes the need to create an open and free insurance market in India, the IRDA appears to be intent on maximizing retentions within the country until the market stabilizes.

To further this objective, all Indian insurers must cede 20 percent of every policy written in the country to the national reinsurer, GIC, and must exhaust local capacity before looking outside the country for reinsurance coverage. Even then, there are certain limits on the amount of risk that can be ceded to any one external reinsurer.

IRDA guidelines also stipulate that in addition to providing reinsurance to domestic companies, the GIC will facilitate the formation of market pools to further ensure that the bulk of insurance premium remains within India.

In addition, all Indian insurers must have their reinsurance programs approved by the IRDA. Quota-share arrangements are generally not favored when reliable pricing data are available, because these arrangements can cause too much premium to leave the country.

Re-designation of the General Insurance Company as National Reinsurer

GCV: What was the IRDA Act's goal in redesignating GIC as India's national reinsurer? How has this re-designation changed the way in which domestic insurers arrange their reinsurance coverage?

CB: In its new reinsurance capacity, the GIC accepts both the 20 percent statutory cessions on business written in the country as well as reinsurance business from other markets. It is aggressively seeking to expand beyond its domestic borders and participate in world markets. Sharing its business with the global broker community can help the GIC achieve this goal.

The GIC's current mission is to protect its market share and acquire new customers, and only time will tell how successful it will be in building a sound reinsurance portfolio. At present, it is by far the main reinsurer for Indian direct business, and as I discussed earlier, the IRDA wants this role to continue until the market stabilizes.

Nevertheless, the presence of international reinsurers in India will continue to grow. As GIC's assumed reinsurance business expands, both from within and outside of the country, it will need to further reinsure this business with the major global reinsurers.

Now that the GIC's four subsidiaries are no longer linked to their parent, they are also free to arrange their own reinsurance and will increasingly turn to the major international companies. The same holds

true for domestic private sector companies, who are quickly learning how to place their reinsurance programs.

Entry of Private Companies

GCV: To what extent are private companies now allowed to operate in this market? What are the IRDA requirements that govern their licensing and operations?

CB: Under the IRDA Act, private companies can now operate in India's insurance industry. However, they must obtain a license from the IRDA before being permitted to write business.

To have its license application considered, a domestic private company must be registered in accordance with the Companies Act of 1956 and have approximately US$20 million of investment capital. The specific licensing requirements that private Indian companies must fulfill are set forth in the Registration of Indian Insurance Companies Regulations, published by the IRDA in 2000.

Global insurers and reinsurers can also apply for licenses, but they face additional requirements and restrictions – which I will discuss later in this interview.

In addition, the IRDA requires that every insurer operating in India write a certain amount of business in rural areas. For a general insurer, this amount is two percent of total gross premium written in the first year of operation, three percent in the second year, and five percent thereafter. Furthermore, a new Indian insurance company will be permitted to invest policyholders' funds only domestically.

Lifting of Barriers to Foreign Investment

GCV: To what extent are global insurers and reinsurers allowed to invest in this market? Have many international companies established operations in India?

CB: The IRDA Act also lifts certain barriers to foreign direct investment in India's insurance industry.

Global insurers are now permitted to set up and register a domestic company in order to write business in India. However, regulations stipulate that they have a capital base of at least US$20 million, and their investment in such company is capped at 26 percent. Thus, to participate in the market, they must form a joint venture with an Indian partner that is able to invest the remaining funds.

The equity investment limit is the same for global reinsurers seeking to write business in India, but they are required to put up capital of approximately US$45 million in order to establish a domestic company.

Since the IRDA first enacted these rules, 8 new global non-life and 13 new life insurance companies have entered the market.

On the other hand, no global reinsurer has established a domestic company. Instead, most of the top international reinsurance companies operate from their overseas offices by sharing the reinsurance risks picked up by the GIC. A recent proposal has been put forward to increase foreign direct

investment to 49 percent. In addition, global companies are pushing for the right to establish branch offices in India. These changes are likely to substantially increase the presence of international insurers, reinsurers, and brokers in India.

GCV: Are insurance and reinsurance brokers currently permitted to transact business in this market? What are the regulations governing their operations?

CB: The IRDA Insurance Brokers Act in 2002 permitted overseas insurance and reinsurance brokers to enter the market, but with the same equity cap as that governing the operations of foreign insurers and reinsurers. Thus, foreign brokers must also form a joint venture with an Indian partner in order to establish an Indian broking house.

The 2002 IRDA legislation established four broker categories, one of which brokers must select when applying for a license:

- Category 1A: Direct General Insurance Broker
- Category 1B: Direct Life Insurance Broker
- Category 2: Reinsurance Broker
- Category 3: Composite Broker
- Category 4: Others, for example Insurance Consultants and Risk Management Consultants

Each category has different solvency margins and capital adequacy ratios, and all categories need to carry professional indemnity insurance at different minimum levels.

In the years since market liberalization was initiated, the insurance sector has witnessed some impressive changes. The needs of insurance and reinsurance buyers have grown; the market is introducing new products to address these needs; and the services of brokers are now seen as critical to making informed insurance and reinsurance decisions.

In Part Two of this interview, I'll discuss in more detail the impact of recent reforms on the domestic market; the opportunities that are developing for private insurers, reinsurers, and brokers; and the obstacles that must still be overcome to strengthen India's position in the global insurance and reinsurance marketplace.

■ Part Two

Overview of the Current Insurance Market

Guy Carpenter Views (GCV): Could you briefly characterize the current market in India? How has it changed since liberalization efforts began?

Clive Baker (CB): In the years since the IRDA Act initiated market reforms, the insurance sector has experienced some remarkable changes.

The entry of a large number of Indian and foreign private companies in non-life insurance business has led to greater choice in terms of products and services. Increased consumer awareness of the benefits and importance of insurance and reinsurance has generated many more buyers; and new distribution

channels – among them brokers, bancassurance, the Internet, and corporate agents – have provided additional ways of getting products and services to customers.

GCV: What has been the impact of the entry of private insurers? Do the state-owned insurance companies still write the majority of the business?

CB: Private insurance companies have to date written a small percentage of business in this sector during the last three years, but they have ushered in a competitive environment that has accelerated market growth.

State-owned insurers still write the bulk of insurance business, and they have the net worth required to underwrite large corporate risks without depending almost entirely on reinsurance support. However, their focus on restructuring is beginning to put them at a disadvantage against private competitors.

Over the next few years, the share of the market held by the public insurers is expected to drop substantially, with private companies assuming a growing percentage of the business written.

The Transformation of the General Insurance Company

GCV: How successful has been the restructuring of the General Insurance Company as India's national reinsurer? What steps is the GIC taking to ensure that it remains a strong market presence?

CB: As of March 2004, the GIC held about an 85 percent share of India's reinsurance market. This number one position has been reinforced by the IRDA requirement that domestic companies cede 20 percent of every policy as well as a share of their reinsurance business to the national reinsurer.

To further counter Western competition, the GIC is seeking to form an Asian trade block with such companies as China Re and Korean Re to share each other's major commercial risks. The reinsurer is also offering a comprehensive range of risk management solutions to the Afro-Asian market as part of its effort to become the region's "professional reinsurance solutions partner."

Despite steps to safeguard the GIC's position in India, its dominance will likely diminish as it expands its focus on foreign business and as global companies increase their presence in the country.

GCV: Is the GIC able to handle all of the reinsurance business that is ceded to it?

CB: Although it tries to retain as much risk as possible, the GIC has historically ceded a portion of its reinsurance business to Lloyd's and a number of the major global reinsurers. As India's market develops and the need for reinsurance coverage grows, the GIC will likely need to export even more of its business. In fact, if the potential of such market segments as agricultural insurance is achieved, the reinsurance requirements will be far too massive for the GIC alone to handle.

Developing Opportunities for Global Companies

GCV: Have many global insurers entered the market since reforms were initiated? How much business do they write?

CB: As of April 2004, there were a total of 13 private life and 8 private non-life companies operating in India. The four public sector insurers – National Insurance, New India Assurance, Oriental Insurance, and United India Insurance companies--are still strong and have a long track record. However, private companies run by experienced Indian and foreign partners are building their customer base and over time will probably acquire a larger share of the market.

GCV: What about global reinsurers? Why have they been reluctant to enter this market?

CB: In the three years since the IRDA established the 26 percent cap on foreign investment, not one global reinsurer has set up a company in India. Instead, most of the top 50 global reinsurers operate indirectly from their overseas offices by sharing the reinsurance risks assumed by the GIC.

One reason for this unwillingness to invest in a domestic company is that global reinsurers feel that rates for reinsurance products are inadequate and not at all reflective of global market conditions.

Another reason is that the reinsurers must put up a huge amount of capital for only a 26 percent share in a domestic company. Recently, the Indian government has started to discuss increasing this foreign direct investment cap to 49 percent for reinsurers, which may ultimately change the face of the market.

GCV: Given the fact that the tariff structure is still in place for most products, how are global reinsurers protecting themselves from taking on too much risk for too little premium? How are reinsurers' actions affecting primary companies?

CB: Recently, certain global reinsurers called for dissolution of the tariff structure before they would renew their treaty coverage. When this condition was not accepted, the reinsurers replaced their treaty arrangements with facultative coverage, which is arranged on a risk-by-risk basis and commands higher rates.

Increased reinsurance costs have had an effect on the profits of both public and private insurers. Because primary companies are still constrained by tariff pricing for most of the insurance products that they offer, they are unable to pass on their reinsurance price increases to their own clients.

GCV: What opportunities may still be available for global reinsurers given the retentions by direct writers and the compulsory allocations to GIC?

CB: Commercial coverage in India is reinsurance driven, since the domestic market is able to absorb risk of only about US$5 million. Most of India's large commercial insurers have been turning to foreign reinsurers for specialized liability risk coverage, and the premium outflow for this product was estimated at more than US$100 million for 2002 through 2003.

In addition, global reinsurers have been providing the following categories of coverage and services:

- Facultative coverage for the largest Energy and Construction projects as well as the more hazardous risks;
- Proportional treaty capacity to both direct insurers and the GIC;

- Excess-of-loss coverage for these insurers' accounts;
- Expertise and capacity for specialized risks.

GCV: Is commercial crop coverage an area of opportunity for global reinsurers?

CB: Yes, global reinsurers stand to benefit greatly from the expansion of commercial crop coverage in India. The country is heavily reliant on agriculture, and as it becomes more market oriented, a strong agricultural insurance scheme is a necessity.

In 2004, the Agriculture Insurance Corporation of India (AICI) introduced the Farm Income Insurance Scheme (FIIS). The aim of this new insurance plan is to protect farmers' income against such risks as natural perils, disease, and price fluctuations.

With India's farmers estimated at almost 100 million, the reinsurance needs would be massive if all of these farmers were covered under this national scheme. Even with the 20 percent compulsory cessions in place, the GIC would need to turn to the global reinsurance market for assistance with this huge reinsurance burden.

Changing Reinsurance Needs

GCV: How have reinsurance buyers' expectations altered since market reform began?

CB: There has been a massive change in the knowledge level and expectations of insurance and reinsurance buyers since liberalization efforts began. This can be accounted for partly by market efforts to educate clients as well as by the entry of intermediaries with global skills and experience that are helping clients make informed purchasing decisions.

GCV: What are insurers looking for in terms of managing their reinsurance requirements?

CB: Historically, primary insurers did not need a very sophisticated method of managing their reinsurance requirements. The GIC took over the responsibility for reinsurance placements, which were based on the profitability of the underlying business rather than on the collection and evaluation of risk data.

In their effort to globalize, Indian corporations are encountering new risks, which they are seeking insurers' help to understand and manage.

Insurers, in turn, are looking to reinsurers to assist them in offering the products that their cedents require. They expect reinsurers to understand their business, their strengths and weaknesses, and their opportunities and to develop risk management solutions that effectively address their needs.

Pricing and Product Trends

GCV: Which products are currently priced by the Tariff Advisory Committee? Can you describe some of the problems that exist with tariff pricing? Is the tariff structure likely to be dismantled?

CB: The Tariff Advisory Committee (TAC) still sets prices for such business lines as fire, aviation, engineering, motor, marine hull, and workers compensation. The market can determine pricing only on non-tariff lines of business, which include liabilities, indemnity, and personal lines like health insurance.

Tariffs have been based on assumptions rather than on an analysis of claims data. Consequently, they have not reflected international market conditions. In fact, because the TAC set current reinsurance tariffs when global rates were very low, India's reinsurance pricing was completely out of sync with the world market when global reinsurance rates surged after the September 11 attacks. This discrepancy was compounded by the fact that the country's insurers were still forced to sell their products at low tariff rates despite the hardening of international reinsurance rates.

Global reinsurers have been pressuring the Indian government to completely deregulate insurance tariffs, arguing that the rates do not reflect market realities. The government appears to recognize that eliminating tariffs is critical to getting all general insurers on an equal footing, and tariffs are expected to be slowly phased out over the next few years.

In the meantime, to protect themselves against assuming too much risk for too little premium, reinsurers have begun to restrict claims limits on liability covers to $150 million and to impose caps and restrictions on certain other risks assumed.

GCV: Are there certain regulatory procedures that insurers and reinsurers must follow before they are able to sell non-tariff products in this market?

CB: All non-tariff products intended for general sale in the Indian market need to be filed with the IRDA and approved by that body before being offered for sale.

GCV: What form of reinsurance is being offered to insurers in this market? How is coverage structured?

CB: Although proportional treaties are popular among insurers, they have become less well supported by the major reinsurers as reinsurers are not satisfied with the minimal returns that they provide, largely due to high commission levels. Instead, insurers are forced to look for non-proportional excess of loss covers and facultative placements for many of their risks.

Evolving Need for Broker Services

GCV: In what ways are domestic insurers permitted to use the services of global brokers? How is the need for broker services expected to evolve?

CB: Domestic insurers are allowed to access coverage through global brokers to the extent that they are unable to obtain adequate reinsurance through the GIC.

As the risk management needs of Indian insurers grow, the GIC will likely become increasingly unable to handle their coverage requirements. In addition, the need for a global reinsurance broker's perspective should increase as insurers encounter new exposures. Whether insurers are looking for global programs, for captives, for quantitative services and catastrophe modeling, international

brokers will have the experience to bring to India the products of the global marketplace as well as the technical know-how and exceptional customer service.

Challenges to Further Market Expansion

GCV: What obstacles to a free and competitive market remain?

CB: The remaining impediments to an open and competitive market include limitations on foreign direct investment, compulsory tariffs, and mandatory reinsurance cessions.

Limitations on Foreign Direct Investment

GCV: How are global reinsurers responding to the current rules governing their foreign direct investment in India?

What do they propose as an alternative to their 26 percent share in a joint venture company?

CB: As I discussed in Part 1 of this interview, in order to write reinsurance business in India, global reinsurers must establish a domestic company in which they invest a minimum of 2 billion rupees ($43.5 million). However, because they are limited to only a 26 percent share of this company, they must find one or more Indian partners to put up the remaining share.

Global reinsurers are uncomfortable investing so much capital in, and sharing their expertise with, a company over which they have so little control. They also argue that finding Indian companies that are able to invest in a joint venture – given the large equity base and risk-taking capacity needed – is difficult.

Instead, a number of global reinsurance companies are eager to set up branch offices in India, arguing that only through a branch office will their insurance company clients have full access to the international reinsurance market, additional capacity, and international expertise.

The GIC has resisted allowing reinsurance branch offices because it fears that they will introduce even tougher competition than what India now faces. Under the present joint venture arrangement, a reinsurer can only write business up to its capital limit. However, a branch office could access the capital of its parent and thus conceivably write much more business. On the other hand, the branch office is legally liable to cover all of its claims, whereas its current liability under the joint venture structure is limited to 26 percent.

As I mentioned earlier, the IRDA is currently re-evaluating the laws governing foreign direct investment and is considering raising the percentage to 49 percent.

Compulsory Tariff

GCV: If compulsory tariffs are phased out, what challenges will surface with regard to developing market-based pricing?

CB: If the IRDA approves the phased dismantling of the current tariff system, the market's challenge will be to develop a database of reliable premium and claims information upon which insurance pricing can be based.

Historically, India's insurance industry has lacked such a database. However, the Tariff Advisory Committee (TAC) has compiled this information and in the years ahead will organize it so that it can help insurers and reinsurers with their rate-making decisions.

Mandatory Reinsurance Cessions

GCV: What are the drawbacks of the current system of compulsory reinsurance cessions?

CB: The purpose of obligatory cessions has been to maximize retentions within the country while the market was restructuring, but insurers feel that it is a restrictive practice and that they should be free to choose their own reinsurer.

GCV: Has the IRDA taken any steps to phase out obligatory reinsurance cessions?

CB: The IRDA's reinsurance advisory committee proposed a gradual reduction of 5 percent per year in compulsory cessions to the GIC, stating that insurers in a free market should be able to decide where and if they want to place reinsurance business. The IRDA has not yet firmly responded to the committee's recommendation and discussions continue.

GCV: What is likely to happen if the IRDA implements the recommendation to reduce the compulsory cessions? What will this mean to the global reinsurance community?

CB: The need for risk capacity will grow, and this is likely to be absorbed in the main by treaty reinsurance capacity, which will increase the volume of business to global reinsurance entities.

Role of Guy Carpenter

GCV: What is Guy Carpenter's role in this market?

CB: Guy Carpenter deals with both public and private sector clients using foreign reinsurers in an effort to meet the requirements of Indian customers that are unable to obtain sufficient coverage from the GIC. Marsh India, which is licensed in India, is able to deliver a comprehensive range of services such as risk assessment, insurance placement, claims servicing, loss prevention and risk control to clients in India.

The Future

GCV: What are your thoughts about the future of India's insurance and reinsurance markets? Please discuss, in broad terms, the changes that you expect to see in the next few years.

CB: Because such a small segment of this market has been tapped, the potential for growth is enormous – particularly as rural segments open up. In addition, as the GIC expands internationally, it will look for reinsurance partners to help it manage its growing portfolio of business.

In addition, Indian consumers are increasingly aware of risk and insurance. When this growing knowledge is considered in light of the low penetration levels of insurance and reinsurance in this country, the potential opportunities going forward are immense.

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