



Institute of Actuaries of Australia

# **The development of non-life markets in Asia with a focus on China and India – Opportunities and risks for foreign investors**

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**Abstract**

The Australian non-life insurance market has seen significant consolidation in recent years and there is now a commonly held view that insurers will struggle to achieve sustained growth in the mature Australian market. As a result, some of the large Australian insurers are now following their European and American counterparts and looking for growth opportunities offshore.

Given the current low insurance penetration rates and rapidly developing economies in the region, Asia presents a very attractive prospect for Australian and other foreign non-life insurers looking to secure the next stage of their growth.

The purpose of this paper is to provide a summary of the current state of non-life markets in key Asian countries with a focus on what we consider to be the key countries of interest for foreign non-life insurers, namely mainland China and India.

China and India are the two most populous countries in the world and while currently undeveloped compared to many western economies, they are both expected to emerge as economic power nations of the future. While this presents enormous opportunities for non-life insurers investing in these markets, there are also significant risks.

In this paper, we present our view of the opportunities and challenges presented to foreign insurers who may be considering entering the China and India non-life markets, either through greenfield operations, company acquisition or joint ventures.

All views or opinions expressed in this paper are those of the authors and they do not necessarily represent those of their employer.

*Keywords: general insurance, non-life markets, Asia, China, India*

## **1 Introduction**

We have worked as non-life consulting actuaries throughout Asia since 2001. While significant changes have occurred in the Australian non-life market over the last four years, there have also been noteworthy developments in Asia, including:

- improved economic conditions leading to strong premium growth, particularly in the “emerging power” markets of China and India,
- increased regulatory supervision of companies and progressive (albeit slow) movement towards best practice operating principles by insurers,
- removal (or implemented programs for the removal) of premium rate tariffs in many countries, and
- easing of trade barriers in a number of countries, allowing foreign companies to more easily enter markets.

These changes have not gone unnoticed by foreign non-life companies in the more mature markets (Australia included) to the extent that there has been, and continues to be, significant interest from foreign players to get “a piece of the action” in Asia.

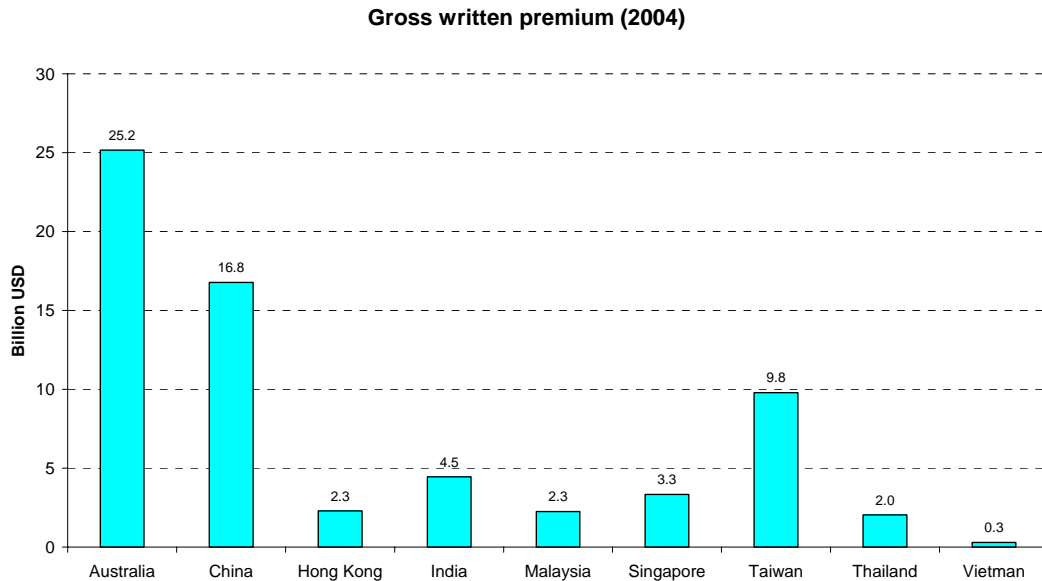
The purpose of this paper is to provide a summary of the current state of non-life markets in key Asian countries with a focus on what we consider to be the key countries of interest for foreign non-life insurers, namely mainland China and India.

We also present our view of the opportunities and challenges presented to foreign insurers who may be considering entering the China and India non-life markets, either through greenfield operations, company acquisition or joint ventures.

## 2 Overview of non-life markets in Asia

### 2.1 Market size and growth

Gross written premium volumes of non-life business in the major Asian countries (excluding the developed markets of Japan and South Korea) in calendar year 2004 are shown below with Australian data provided for comparative purposes.



Source: Swiss Re Sigma No. 2/2005

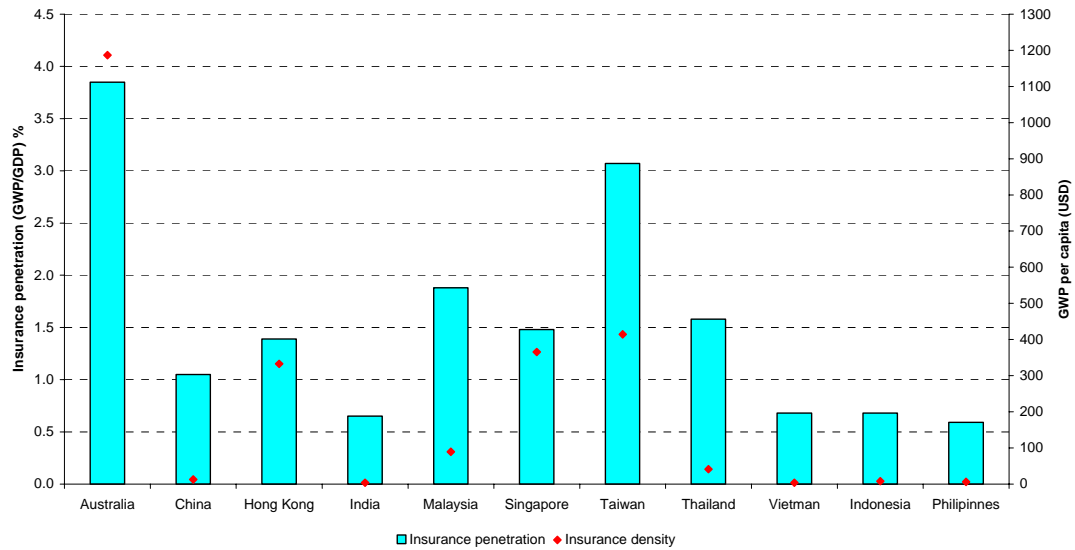
### 2.2 Market penetration

As indicated above, non-life markets in Asia are presently small compared to Australia.

This is further emphasised in the following chart showing:

- market penetration - Gross written premium (GWP) as a percentage of gross domestic product (GDP) for each country (“region” in the case of Hong Kong and Taiwan) and
- market density – GWP per-capita.

Non-life Insurance density and penetration in Asia 2004



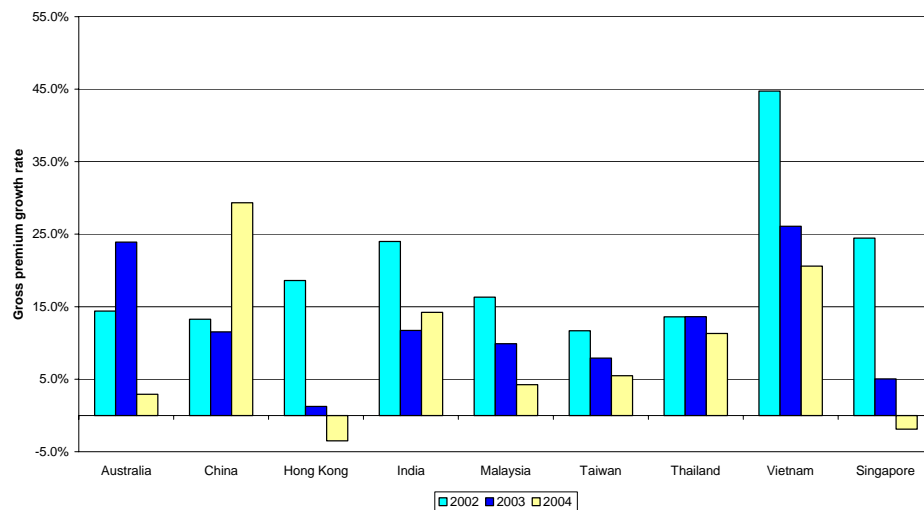
Source: Swiss Re Sigma No. 2/2005

The above chart illustrates the generally undeveloped state of the non-life markets in most Asian countries. Even the more developed countries/regions such as Hong Kong, Taiwan and Singapore fall significantly short of Australia in both insurance penetration and density. Given the fast pace of economic development that is occurring throughout the region, it is not surprising that foreign insurers are taking a keen interest in these markets for their growth potential.

### 2.3 Growth

As shown in the following chart, premium growth rates have been very strong in the less developed Asian markets. Australian industry data compares quite favourably due to the hardening of the commercial market after 2001.

Gross Written Premium Growth Rate



Source: Swiss Re Sigma No. 2/2005

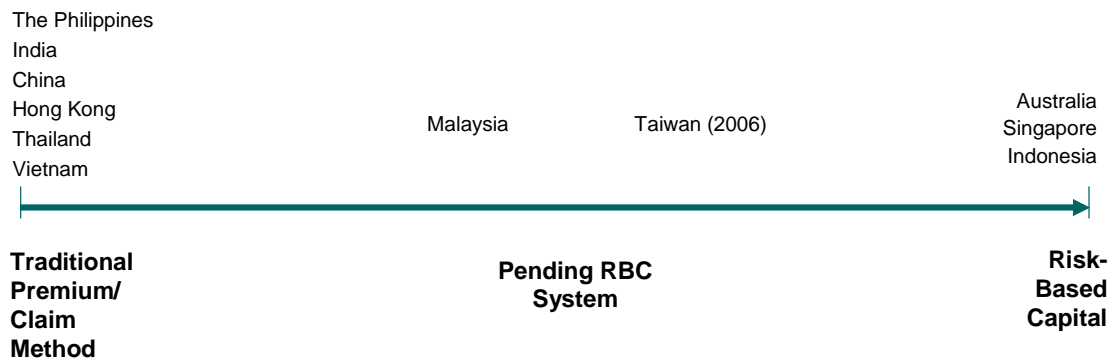
Interestingly, growth in 2004 showed a sharp decline in some markets. This was largely attributed to significant softening of commercial premium rates.

## 2.4 Regulatory developments in the non-life insurance markets of Asia

While the insurance regulators in a few Asian countries (e.g. Singapore) have been very progressive in implementing regulatory reform in the non-life industry, regulators in many countries are still developing their supervisory roles in a number of areas as discussed below.

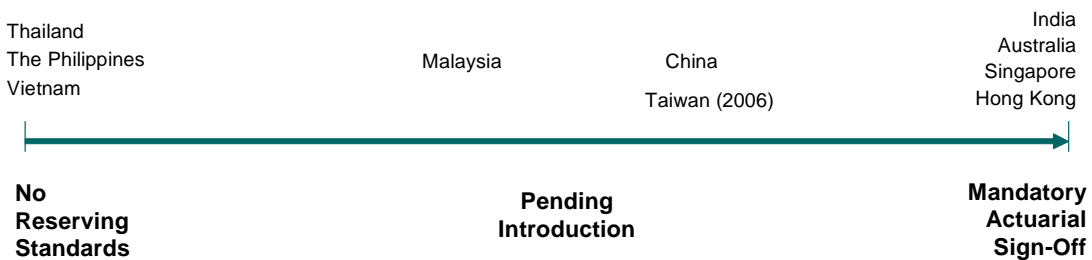
### *Capital and solvency management*

In many countries, the capital and solvency requirements are based on simplistic premium and claim formulae without regard to the specific circumstances of each insurer. For example, as illustrated below, only a few countries have implemented or foreshadowed risk based capital requirements.



### *Monitoring of policy liability reserve adequacy*

A number of countries do not set specific reserving guidelines or require actuarial monitoring of liabilities. This is however changing with a trend towards actuarial certification being required as shown below.



Mandatory actuarial certification of policy liabilities is a requirement in Australia, Singapore, Hong Kong and India. In Hong Kong, certification is limited only to the employees' compensation and motor liability classes. Singapore and Australia are the only countries that require certification of policy liabilities at a 75% level of sufficiency although Malaysia has foreshadowed a similar requirement. In China, details have yet to be finalised but mandatory reporting is required from 2005.

***Promotion of best practice operating principles***

In general, non-life companies in Asia have tended not to embrace best practice operating principles to the same extent as those in more developed markets such as the USA and Europe. For example, the use of technical/statistical based premium rating processes tend to be quite rare in Asia and tend to be used mainly by foreign insurers who already have these skills through their head offices. Regulators are now encouraging insurers to embrace best practice principles.

With the exception of Singapore, operational guidelines, risk management standards and other corporate governance requirements are generally not the norm but many regulators are now starting to focus more attention in these areas.

***Easing of foreign investment and participation restrictions***

While a number of Asian countries (e.g. Malaysia, India, Indonesia and Thailand) still restrict the participation of foreign companies in their non-life industries, many countries have significantly eased foreign investment restrictions in recent years. As a result, the market share of non-life business by foreign insurers has been steadily increasing in most markets.

***Removal of premium rate tariffs***

While premium rate tariffs on non-life insurance are still very common in Asia (especially for major classes of business such as motor and property/fire), there appears to be a trend in the region to removal of tariffs and allowing free markets to operate. China is the most recent country to remove tariffs as part of its entry into the World Trade Organisation.

The following table summarises the current state of tariff markets in a number of Asian countries/regions.

<b>Country</b>	<b>State of tariffs deregulation</b>
China	Tariffs have been removed on all classes but motor premium rates remain subject to regulator approval.
Hong Kong	Fully deregulated – no tariffs.
India	Approximately 70% of non-life insurance business is subject to a strict tariff. Proposed liberalisation in the next few years.
Indonesia	Fully deregulated – no tariffs.
Malaysia	Strict tariffs apply on motor and fire business. No planned deregulation at this stage.
Philippines	Tariffs on motor and bond business. No planned deregulation at this stage.
Singapore	Fully deregulated – no tariffs.
Taiwan	Tariffs on motor and fire business. Removal of tariffs by 2006.
Thailand	Tariffs apply on motor, fire, cargo and personal accident business but in practice, these are not strictly enforced.



## **2.5 Market consolidation**

The non-life markets in many of the countries in Asia have tended to operate with an excessive number of insurance companies (mostly local domestic companies) with most experiencing a difficulty in achieving sufficient scale. For example, Hong Kong, Indonesia, the Philippines and Thailand currently have 96, 100, 112 and 77 direct non-life companies in operation respectively.

While this is an impediment to prospective foreign participants, there is some comfort that many of the region's insurance regulators are keen to see consolidation in the market. The introduction of enhanced capital and solvency requirements by many regulators, including risk based capital requirements in some countries, will speed up the consolidation process.

## **2.6 Dominance of motor business**

The relatively undeveloped nature of the non-life markets in Asia has led to a significant dominance of motor insurance over other classes of business. This has been driven partly by a lack of demand for other classes of business but has also been due to the insurers' general lack of expertise and distribution strategies beyond motor business. This has been somewhat of a problem for insurers in some countries as motor business has often been loss making, particularly after deregulation of premium tariffs has occurred.

However, it is clear from experience with more developed countries such as Singapore and Hong Kong that demand for other classes of insurance tends to increase markedly as economic conditions improve and the wealth of individuals grows.

## **2.7 Focus on China and India**

In the next sections, we explore more closely, the developing non-life markets of mainland China and India. These markets have generally been viewed with most interest from foreign companies looking to expand into Asia.

### **3 China**

#### **3.1 Overview**

Mainland China has experienced an economic boom in recent years with real gross domestic product (GDP) growth since 1999 exceeding 8% per annum. Following its ascendancy to the World Trade Organisation (WTO) in 2001, strong economic growth is expected to continue well into the future. With a current population of 1.3 billion people, this has given rise to a burgeoning (although still relatively undeveloped) insurance industry with enormous potential for future growth, albeit with some degree of risk.

As a result, mainland China currently ranks highly on the lists of foreign insurers looking to expand into Asia.

#### **3.2 A brief history of the China non-life market**

China has a unique history of insurance reflecting the political history of the country.

The first insurance company in China, Guangzhou Insurance Company, was set up by a British trading house in 1805. Other British firms soon established insurance companies in Hong Kong, Shanghai and other major Chinese cities, setting the stage for foreign domination of the industry lasting almost one and a half centuries. The first Chinese-owned insurance company was established in 1876.

By the end of the Second World War, the domestic non-life insurance market was well established in China. However, shortly after establishing the People's Republic of China on 1 October 1949, the Communist Party introduced two far-reaching policies with regard to the insurance industry, namely:

- nationalising of all Chinese-owned insurance companies and
- compelling foreign-owned insurance companies to leave China.

On 20 October 1949, the Communist Party established the People's Insurance Company of China ("PICC"), a wholly state-owned insurance company and by 1952, all foreign insurers had left China. At around the same time, the Government implemented a course of action to effectively shut down the insurance industry.

Following a series of economic reforms commencing in 1978, PICC re-entered the domestic insurance business and remained the only non-life insurer in the market until 1988. Although growing from a small base, its sales achieved an average growth rate of around 40% per annum throughout the 1980's.

Ping An was established in Shenzhen in 1988 and China Pacific Insurance Company (CPIC) was formed in Shanghai in 1991, effectively ending the monopoly of PICC. At almost the same time, American International Group ("AIG") became the first foreign insurer to enter the China insurance market with a license to write both life and non-life business in Shanghai.

At the start of 2000, the Chinese government made a series of commitments to introduce insurance industry reform prior to their formal entry to the WTO on 10 December 2001. The package of reforms included removing the geographical, services and ownership restrictions that existed for foreign-invested insurers over a five year time frame.

As a result, the insurance regulator, the China Insurance Regulatory Commission (CIRC) granted approval for a number of new insurance companies. Moreover, additional branch licenses were granted to regional domestic companies that were previously limited geographically, in key insurance areas such as Shanghai, Guangzhou and Beijing.

Increased foreign participation has since continued with 12 direct foreign non-life insurers operating in China by the end of 2004.

### **3.3 Regulatory environment in China**

The following is a brief summary of some of the key areas of regulation impacting on non-life insurance companies in China including:

- the insurance regulatory body,
- requirements for foreign insurance companies or foreign investors,
- licensing of new insurance companies,
- capital and solvency requirements,
- policy liability reserving requirements and
- pricing regulations and tariffs.

#### ***Insurance regulator***

China's insurance regulator, the China Insurance Regulatory Commission (CIRC), was established in 1995 with responsibility for:

- formulating and enforcing insurance related laws and regulations,
- overseeing insurance business operations,
- protecting the interests of policy holders,
- developing the insurance market, maintaining order and ensuring fair competition,
- promoting insurance industry reforms and restructuring and
- setting up a risk evaluation and advance warning system to minimise insurance risk.

There are ten functional divisions under CIRC, namely the executive office division, policy and planning, finance and accounts, non-life department supervisory enforcement, life assurance supervisory enforcement, intermediary regulations, personnel, communist party propaganda, international and internal discipline supervisory division. There are 31 branches of CIRC operating throughout the mainland.

The role of CIRC is constantly evolving as the fledgling insurance industry develops and in recent times there has been a suggestion that there will be increased emphasis on the regulation of solvency in future in addition to supervision of market conduct.

#### ***Participation by foreign insurers and other foreign investors***

Foreign companies may participate in the China insurance industry in one of two ways; either:

- by investing in a domestic insurance company or

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- by applying for a foreign invested insurance company license.

In China, foreign investment regulations apply to investment in domestic companies across all industries including insurance. Foreign investment in the insurance industry is subject to additional requirements of CIRC.

Foreign insurance companies are subject to separate establishment and operational regulations in addition to the legislation that governs domestic companies. Domestic companies with foreign investment are subject to the same operational guidelines as domestic companies without foreign investment.

Foreign investors (including foreign insurance companies) seeking to take an investment stake in a local domestic insurance company are subject to a number of requirements as follows:

- the total investment from wholly foreign owned companies cannot exceed 25% of the total share value,
- the total investment from a single wholly foreign owned entity must not exceed 10% of total share value,
- the total investment from affiliated entities must not exceed 10% of total share value without CIRC approval,
- foreign investments must be in the form of currency and cannot be arranged through a bank loan or stock swap and
- shareholders may not transfer their stock or be replaced within three years.

Investment in local domestic insurance companies by banks, securities institutions, military, social groups and government-funded institutions is not permitted.

Foreign insurance companies wishing to operate in China other than by way of an equity stake with a domestic insurer can operate in one of three ways, namely:

- an equity joint venture with a (non-insurance) Chinese corporation,
- a wholly owned insurance subsidiary or
- a foreign company operating as a branch in China.

The form of establishment is subject to approval by CIRC. All foreign non-life insurers to date are operating as branches.

### ***Licensing of new insurers***

Licensing can be regarded as a two stage process with application to CIRC to establish a company followed by a formal license application.

Under the relevant regulations, the initial application includes a number of specific requirements including:

- details of the intended senior managerial staff of the company and confirmation that they all meet the qualification requirements set down by CIRC,
- detailed business plans setting out the company's infrastructure, intended size and scale, staff numbers, office and working equipment etc.,

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- details of the shareholders of the company and starting capital and
- various other items as specified by CIRC.

Following submission of the initial application, a six month time frame applies for CIRC to process the application and make its decision on whether or not to allow the applicant to move to the formal license application stage. If approval is confirmed, the company then has one year to complete preparations to establish the company and make a formal application to commence operations. This preparatory period may be extended for another three months subject to CIRC approval.

In practice it appears that both the first stage approval process and the length of preparation time have exceeded the times set out in the regulations.

A foreign insurance company must meet additional requirements including:

- having over thirty years of establishment experience in a WTO member country,
- having a representative office in China for two consecutive years prior to license application,
- having total global assets of at least US\$5 billion at the end of the year prior to application,
- having met all regulatory requirements in the company's country of origin including capital and solvency requirements and
- other criteria specified by CIRC.

In practice, licences are generally provided on a “per branch” basis. Both domestic and foreign insurance companies must apply to open additional branches and insurance services cannot be provided in areas where the company has no branch. Hence, branch licenses are critical to expansion strategies.

### ***Capital and solvency requirements***

The minimum paid-up capital for an insurance joint venture, wholly owned foreign insurance company, or branch of a foreign company is RMB200 million (approximately USD25 million).

Companies seeking to apply for additional branch licences will require an additional RMB20 million (approximately USD2.5 million) in paid-up capital for each additional branch license. However, a company with at least RMB500 million in paid-up capital is exempt from this requirement.

The following additional requirements apply regarding the amount of capital:

- an injection of additional equity capital is required if the balance of assets less liabilities falls below the specified minimum solvency level,
- net written premiums are not allowed to exceed 4 times paid-up capital plus retained earnings and
- the maximum exposure per risk must not exceed 10 times paid-up capital plus retained earnings.

The current minimum solvency level (allowable assets less liabilities) for non-life companies in China is defined as the greater of:

- 18% of net (of reinsurance and taxes) written premium less than RMB100 million plus 16% of net (of reinsurance and taxes) written premium above than RMB100 million, and

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- 26% of the average net (of reinsurance) incurred claims in the previous 3 years less than RMB70 million plus 23% of the average net (of reinsurance) incurred claim in the past 3 years greater than RMB70 million.

An insurance company that has been in operation for less than three years is required to apply the premium basis.

### ***Policy liability reserving requirements***

With effect from 15 January 2005, non-life insurers are required to set minimum policy liability provisions for both outstanding claims and unexpired premiums based on the advice of an approved actuary.

The requirements are in many aspects consistent with international best practice. For outstanding claims, reserves are set up for reported and incurred but not reported (IBNR) claims. Allowance for direct and indirect claim handling expenses is also required. For each component, the requirements stipulate that a number of methods can be adopted, but also appear to offer flexibility allowing the actuary to use a superior method provided the actuary can justify this. Premium liabilities represent a prospective estimate of the cost of claims in the unexpired period. No discounting is permitted to any of the reserves. The guidelines however remain silent regarding additional provisions acting as risk margins.

The guidelines require companies to appoint an actuary to carry out the calculations and provide a reporting framework for submission to CIRC. Reporting requirements appear similar to those specified in other actuarial institutes' professional guidelines and include comments on data quality, methodologies, assumptions, actual experience compared to expected based on the last reserve review assumptions, the adequacy of reserves, performance of the portfolios, changes in underwriting and claim handling procedures, etc.

Companies which commenced their operations prior to 15 December 2004 are allowed to calculate their reserves for statutory purposes based on a former, simplistic method based on a multiple of net paid claims, but are required to submit the reserves calculated under the new basis to CIRC until 1 January 2007. Starting from 1 January 2007, all companies must follow the new reserving basis in their statutory accounts.

### ***Pricing regulations and tariffs***

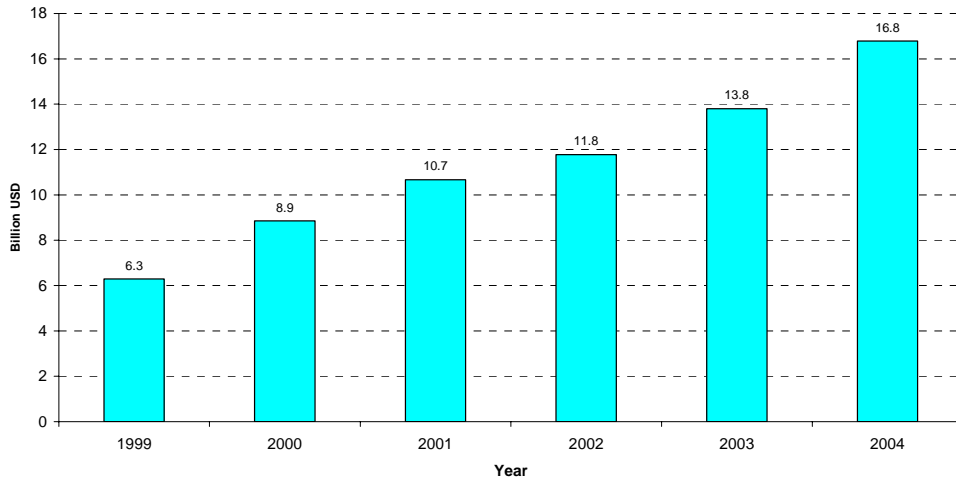
Prior to 2003, non-life business in China effectively operated under a strict tariff market with both premium rates and policy wordings being formulated by CIRC for most classes of business.

With effect from 1 January 2003, significant deregulation occurred such that only motor insurance is now subject to regulatory pricing approval. Policy wordings and premium rates for other insurance classes must be filed with CIRC but there is no special requirement for approval under the revised insurance law.

## **3.4 Market size and growth**

The following chart shows the gross written premium (GWP) volumes of non-life business in mainland China in recent years in USD.

Non-life gross written premium - China



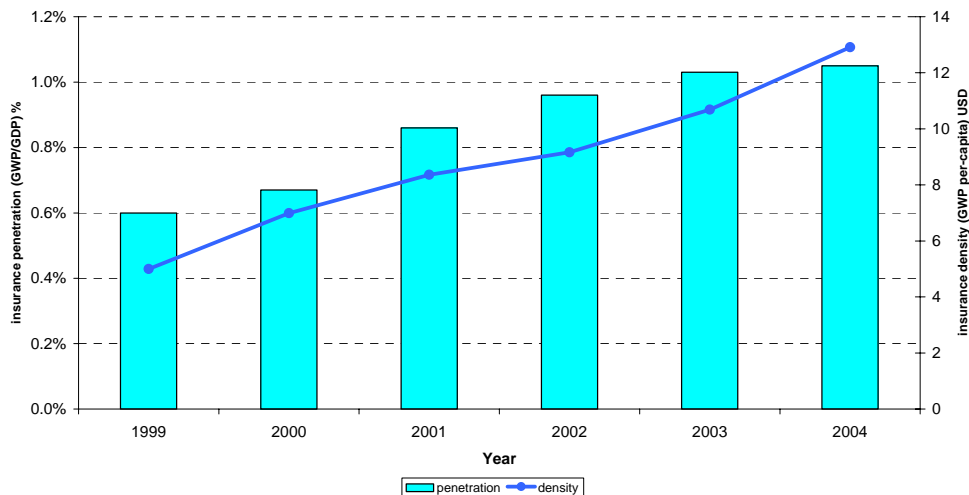
Source: Swiss Re Sigma World Insurance Series

Non-life premium volumes in China have grown at a compound average rate of around 22% per annum since 1999 in local currency. By comparison, the growth rate for the Australian non-life market has been around 9% per annum for the same period, with the majority of this growth arising since 2002 as a result of the hardening of the market and subsequent significant increases in premium rates.

### 3.5 Market penetration

The following chart shows the market penetration indicators over the six year period to 2004, namely market penetration rate (GWP as a percentage of real GDP) and the market density (GWP per-capita).

Non-life insurance density and penetration in China



Source: Swiss Re Sigma World Insurance Series

While the China non-life market has exhibited very strong growth in premium volumes in recent years, the overall insurance market penetration remains very low compared to developed countries with annual gross written premium representing only around 1% of GDP or around USD12 per-capita (c.f. for Australia, the comparative figures are 3.9% of GDP and USD1,100 respectively).

It is worth noting that market penetration varies significantly between different regions of China reflecting the different pace and direction of economic development. The major non-life markets are situated on the eastern coastal regions where the major cities (e.g. Beijing, Shanghai, Guangzhou and Shenzhen) are located.

### 3.6 Market share

By the end of 2004, there were a total of 26 non-life insurance companies writing business in China, comprising 14 domestic and 12 foreign companies. The following table shows the number of non-life companies in operation over recent years.

<b>Number of non-life insurance market participants</b>								
	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Local	9	9	9	9	10	10	13	14
Foreign branch	4	5	5	6	9	9	11	12
<b>Total</b>	<b>13</b>	<b>14</b>	<b>14</b>	<b>15</b>	<b>19</b>	<b>19</b>	<b>24</b>	<b>26</b>

The China non-life market is dominated by local companies, particularly PICC, CPIC and Ping An who together, write around 80% of business in the country. This dominance is expected to continue for some years as a result of:

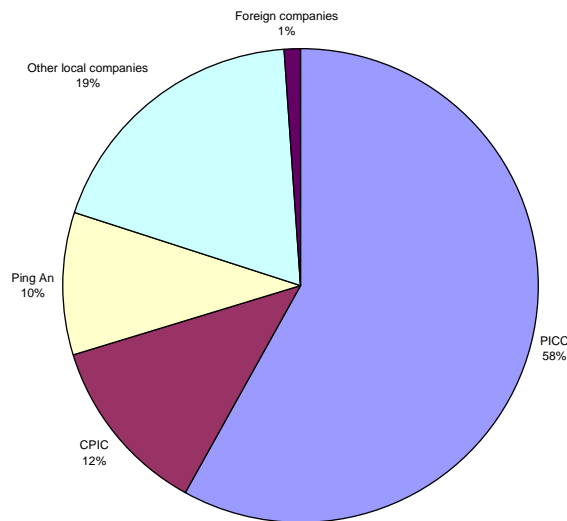
- their strong brand names in the market (particularly PICC which controls almost 60% of the market),
- their very well established distribution channels, and
- the efforts now being made by these companies to move their operating procedures towards best practice.

While we expect the dominance of the top three players to continue, we expect they will all face challenges to avoid reductions in market share due to increased competition from the smaller domestic companies and the increasing presence of foreign companies. This has already been evident with the market share of the top three companies reducing from 97% in 1998 to 80% in 2004. In particular, PICC has been most affected in this regard with its market share reducing from over 79% in 1998 to 58% in 2004.

A high level breakdown of market share based on gross written premium in 2004 is shown in the following chart.



China non-life market share by gross written premium in 2004



Source: China Insurance Regulatory Commission (CIRC) website

The market dominance of PICC can be largely attributed to its previous monopolistic status that has left it with a far more extensive network of branches than its competitors. However, its dominant market share has gradually fallen away in recent years as new domestic companies achieved premium growth. The domestic insurers' market shares, excluding the top three players, increased from 4% in 2001 to around 19% by the end of 2004.

Foreign insurance companies, which were still operating under some service and geographical restrictions, only accounted for 1.2% of the total market in 2004.

#### ***General comments on domestic insurers***

In general, the domestic companies currently have a number of key advantages over the foreign companies, including:

- cultural assimilation, which is not an issue for domestic companies,
- stronger brand names,
- better relationships with the regulators and banks and
- established national distribution networks and stronger distribution capabilities.

Conversely, they also operate under a number of disadvantages, including:

- generally weaker management teams lacking in non-life insurance experience,
- lack of established histories and reputation,
- over-reliance on motor insurance which has exhibited marginal (if not negative) profitability in recent years,
- lack of experience in product development, risk management, underwriting (including actuarial skills), claims management and IT and

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- overall difficulty managing the operational (including cultural) changes required to operate in a best practice environment.

In addition, most of the smaller domestic companies do not have established financial management or corporate governance processes and systems in place.

In the long term, we expect the domestic players to make significant management and operational changes as the foreign companies exert more influence.

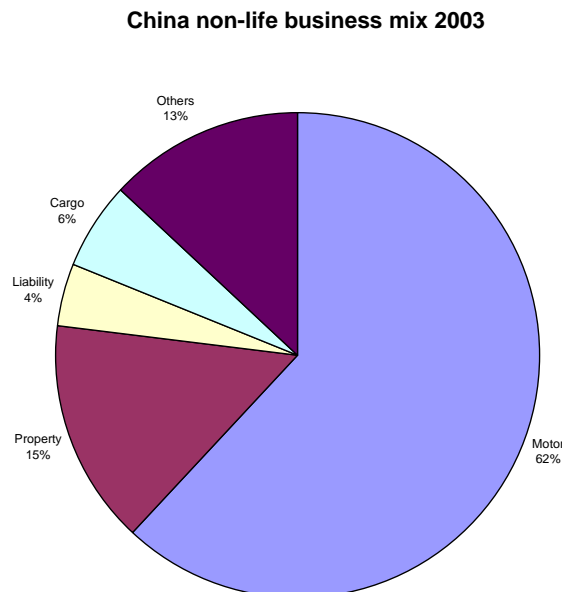
### *General comments on foreign insurers*

The foreign companies are striving to gain market share in a profitable manner, and are generally finding it difficult to address serious challenges in developing an effective sales distribution system in China. Gross written premium in 2004 for foreign companies only accounted for 1.2% of the total market. To put this in context however, the overall market continues to grow rapidly so this effectively means that the foreign companies are participating in that growth even if their overall market shares are not increasing as rapidly.

Furthermore, there are still geographic and other business restrictions that severely constrain the growth of foreign companies. We believe that the gap between domestic and foreign companies in terms of market share will eventually narrow but this is likely to be a gradual process until the restrictions imposed on foreign companies (particularly on geographic expansion) are completely lifted.

### **3.7 Business mix**

The following chart shows the breakdown of 2003 gross written premium in China by class of business.



*Source: Yearbook of China's Insurance 2004 – China Insurance Regulatory Commission*

The non-life market in China is dominated by motor insurance business which is effectively all written by local domestic companies. While foreign companies have been allowed to write motor property damage business since 2003, they are not allowed to write third party motor liability business. As a result, and due to recent poor underwriting performance of motor business, foreign insurers (other than through joint ventures with domestic companies) have generally not written any motor business.

Most local domestic companies focus attention on the sale of motor business due to:

- the well established motor market and the significant growth occurring in motor vehicle numbers in China (e.g. estimates indicate over 1 million new vehicles on the road in China over the next year) and
- a general lack of expertise in other classes of business.

Property business, the second largest class of business, is predominantly commercial in nature with very little domestic property insurance currently being written.

Business grouped under “Others” in the above chart comprises mainly agriculture, credit and guarantee, short term health and accident.

Market leaders PICC, Ping An and CPIC all have similar business mixes whereas the smaller domestic companies tend to write proportionally more motor business and less property business than the market leaders. This is most likely due to either limitations in capacity or general lack of expertise in property business.

The broad similarity of business mix between most of the domestic companies suggests that the market has yet to develop any major niche players or any commercial/personal lines specialists.

Foreign insurers tend to focus on the more profitable cargo, commercial property and liability classes, usually targeting sales to foreign corporations (often of similar nationality) operating in China.

Premium volumes in specialised classes of business such as liability (other than motor liability) and health business are relatively small at present but are expected to increase significantly as the Chinese economy continues to develop and foreign insurers bring technical expertise into the country.

### **3.8 Profitability of the China non-life market**

Due to the lack of detailed historical performance statistics for the China non-life market, it is difficult to gain an accurate picture of the true industry profitability in recent years.

Based on annual financial statements of the market participants published by the regulator, the non-life industry appears to have achieved a reasonable level of profitability in recent years with pre-tax profits averaging around 5% of net earned premium since 1999 and returns on equity (after tax) of around 13%.

However, we believe the published results for most companies would have been overstated as a result of inconsistent, and most likely insufficient, provisioning for outstanding losses. Prior to 2005, actuarial certification of loss reserves was not required and incurred but not reported (IBNR) provisions were based on a simple multiple of 4% of net paid claims. Based on our experience, we believe this reserving basis has been inadequate. The potential overstatement in profitability is compounded by the rapid growth of the companies in recent years.

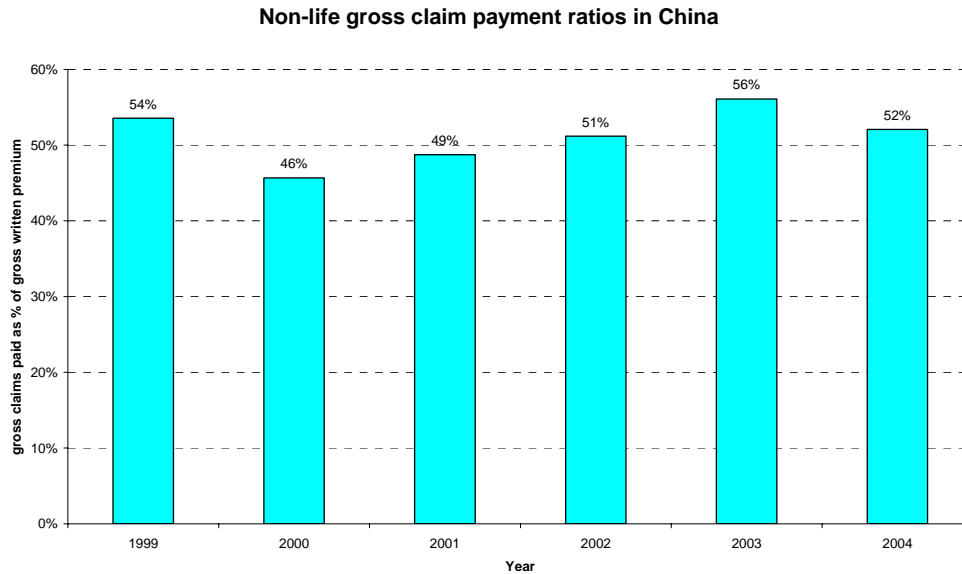
Keeping the above in mind, we set out below some broad profitability indicators revealed from the published statistics.

### *Claim payment ratios*

The published statistics allow analysis of claims experience through the gross claim payment (GCP) ratio:

$$\text{Gross claim payment ratio} = (\text{Gross claim payments}) \div (\text{Gross written premium})$$

The following chart shows the gross claim payment ratio over the 6 years to 2004 for the non-life industry in China.



Source: Yearbook of China's Insurance 2004 and website – China Insurance Regulatory Commission

The gross claim payment ratio has averaged around 50% in recent years.

It should be noted that this simple ratio based on financial year statistics does not compare claims and premium from the same exposure period. In view of the delay between receipt of premium and payment of claims, this ratio will likely provide a distorted view of prevailing true loss ratios. In particular, when portfolios are growing strongly (which is the case for most companies in China) this payment ratio tends to understate the true loss ratio.

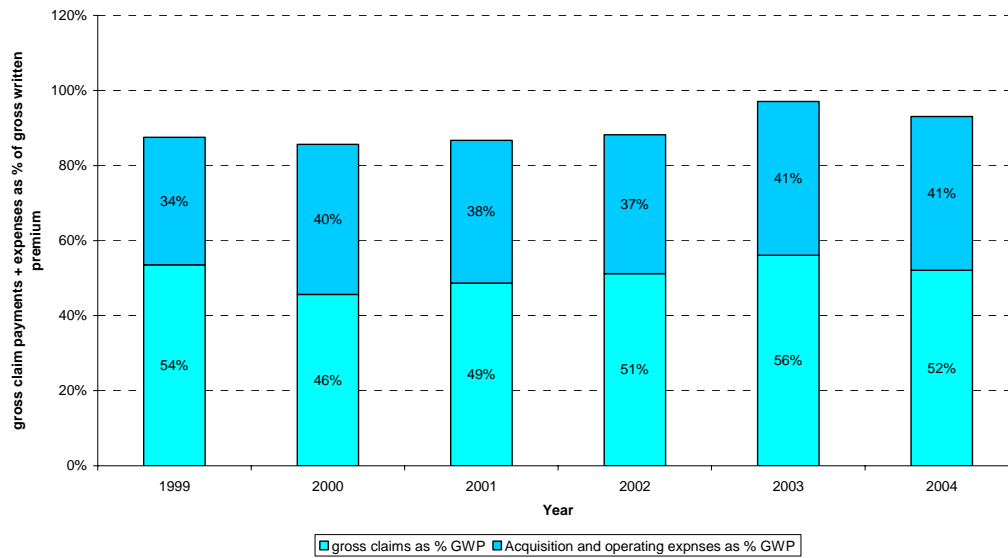
We also suspect that annual claim payments may be distorted by delays and speeding up in settlement, arising from the rapid development of claim handling processes in the industry.

Taking the above into account, we estimate that claim payment ratios shown above could understate the true loss ratios (i.e. fully incurred claims including IBNR as a percentage of earned premium) for the industry by up to 30%.

### *Combined ratios*

The following chart shows the gross claim payment ratios shown above adjusted to include an estimate for acquisition and operating expenses (i.e. gross combined ratios).

**Non-life gross combined ratios in China**



Source: *Yearbook of China's Insurance 2004 and website – China Insurance Regulatory Commission*  
 Acquisition and operating expenses based on major domestic insurers  
 Operating expenses include business tax ranging from 5% to 8% of GWP over the period shown

Based on the estimated combined ratios shown in the above table, it would appear that the overall underwriting performance of the non-life industry has been quite profitable in recent years.

However, the combined ratios shown suffer from the same deficiencies as described earlier with the claim payment ratios. If this deficiency were corrected, we would estimate the true combined ratios to be significantly higher than shown. For more recent years in particular (e.g. 2003 and 2004), this would translate to underwriting losses rather than profit.

***General comments on market profitability***

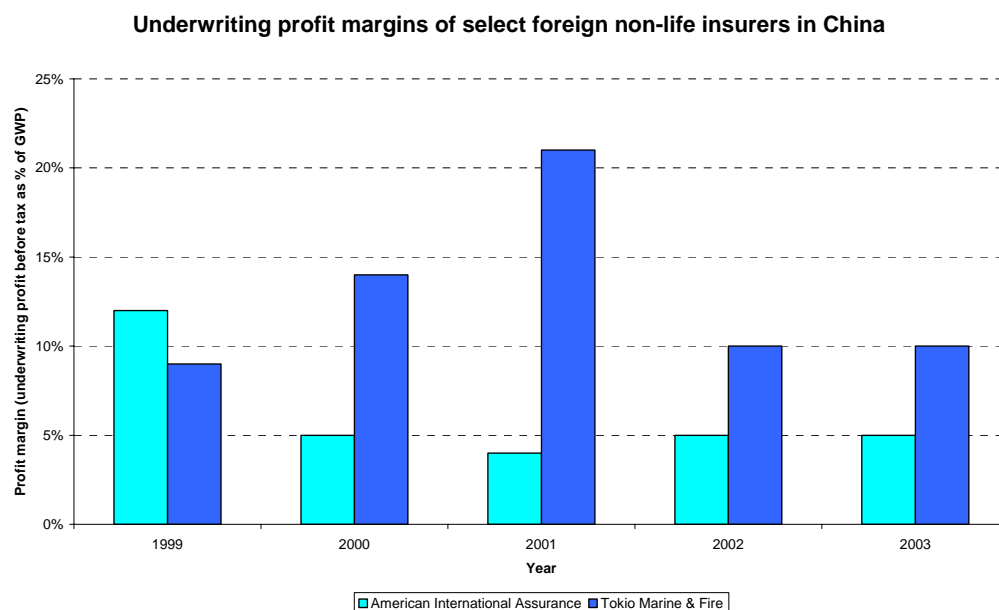
The overall profitability of the China non-life industry is currently driven by the profitability of motor business due to the dominance of this class in the market (see Business Mix above).

The removal of tariff premium rates in 2003 subsequently gave rise to significant competition in the motor market with evidence of significant premium rate reductions by market participants in order to either retain (in the case of established companies) or increase market shares (in the case of newer companies). In addition, this has also been followed by increased sales commissions to agents selling motor business. Combined with significant growth in the motor market, these factors appear to have had a significant adverse impact on overall profitability of the market.

Other major classes of business such as commercial property and cargo however, appear to have been consistently very profitable for a number of years. This would be very encouraging to foreign insurance companies who tend to focus on these classes of business.

### *Performance of foreign insurance companies*

As the foreign companies in China are relatively new to the market, most of the companies are still recording financial losses due to start-up costs and new business strain. However, based on publicly available information from the regulator, it appears that two of the more established foreign companies (namely the branches of American International Assurance which was established in 1992 and Tokio Marine & Fire which was established in 1994) have both achieved underwriting profitability in recent years as illustrated below.



Source: *Yearbook of China's Insurance 2004 and website – China Insurance Regulatory Commission*  
Profit margin equals underwriting profit before tax, divided by gross written premium

### **3.9 Distribution of non-life business in China**

The distribution channels utilised by the non-life insurance sector in China include:

- direct (in-house) sales force,
- authorised representatives/ sideline agencies,
- individual agents,
- brokers and
- professional agencies.

#### ***Direct sales force***

The traditional distribution method for non-life insurance in China, particularly among domestic companies, is the “direct sales” channel based on the use of salaried in-house sales teams. This approach is different to the concept of “direct selling” which is common for the distribution of personal lines business by the major Australian insurers.

Salaried sales representatives sell products to a range of customers from large enterprises through small to medium enterprises and individual consumers. In the early years of insurance market development, all business was sold through direct sales.

## **The development of non-life markets in Asia – Opportunities and risks for foreign investors**

The more established companies such as PICC, CPIC and Ping An are thought to sell more than 50% of their business through direct sales channels although we believe that the proportion has been decreasing in recent years. Smaller domestic companies with less experienced sales staff and possibly less valuable corporate connections will need to place more reliance on other distribution methods. The proportion of business distributed through the direct channel varies by class and a considerably higher proportion of commercial products will be sold directly than other lines.

This method also includes the traditional “direct” concept including:

- telephone call centres and
- internet portals (although these are not significant at present).

### ***Authorised representative and sideline agencies***

Authorised representatives and sideline agents comprise non-insurance companies distributing products for commission. They include:

- banks (bancassurance),
- car dealers (a very important channel for motor business),
- postal savings offices,
- securities firms and
- railway agencies.

This channel is usually limited to the sale of simple, standardised (often fixed price) personal lines policies related to their core business with minimal/simplified underwriting or negotiation with the insured. It is a dominant source of business for motor insurance sales with some companies distributing as much as 90% of their motor portfolio through this channel.

Bancassurance is another form of sideline agent distribution that is becoming an increasingly important source of business to non-life insurers. The majority of products distributed through the banks comprise personal lines sold to mortgage clients of the bank.

### ***Individual agents***

Individual agents represent the insurance company to sell their products, typically targeting individuals or small to medium sized businesses.

Commission driven agents were first introduced to the China insurance market by American International Group following its entry into the Shanghai life insurance market in 1992. This strategy was copied by domestic life insurance companies and also adopted by new joint-venture operations. The commissioned agent is now an important feature of the life insurance market but not as common in the non-life market.

### ***Brokers***

The use of brokers is relatively undeveloped for direct non-life business in China, first being introduced to the market in 1999.

As a result of WTO reform, a number of foreign brokers recently entered the market through joint-venture arrangements and this is a distribution channel that is expected to develop strongly in the future, particularly for commercial business lines.

The broker channel is very important for foreign insurance companies, especially for those who do not have the scale or capacity to set up direct sales channels.

### ***Professional agencies***

Professional agencies distribute a wide range of products for different insurance companies through their links with both small and large corporations.

Professional agencies (numbering over 180 at the end of 2003) are quite often developed by entrepreneurial ex-insurance company sales staff with additional financing from individual backers who have strong relationships with key state-owned enterprises.

### **3.10 Prospects for new entrants**

Our work in the region has included a number of financial modelling and business plan assignments to assist foreign companies in their plans for entry into the market. Based on our findings, we believe that through a well planned and robust business strategy, foreign companies could realistically aim to achieve the following targets for a start-up operation in China:

- profitability after five years from business commencement,
- break-even (i.e. positive cumulative profits) after 8 years and
- a long term return on equity target of 12% to 15% per annum or higher.

However, such targets do not come without significant risks as discussed below.

### **3.11 Common challenges for foreign insurers entering the China non-life market**

While the China non-life market offers great potential for foreign companies, there are a number of challenges that companies will face in establishing and building their businesses. Some of these are described below.

#### ***Insurance market penetration***

The China non-life insurance market is immature and the lack of market penetration of non-life insurance products is a constant challenge.

The low consumption of personal lines relates to historically low levels of private ownership of insurable assets and the reluctance of the population to insure those assets. Motor insurance is compulsory in many provinces, yet consumers typically select the minimum coverage.

In order to improve the quality of the portfolio and increase insurance penetration, insurance companies need to move away from previous practices based simply on following the market leaders and consider investing more resources in product and service innovation. The market participants have remarkably similar business profiles and there may be potential rewards for those companies that can develop and maintain an alternative business strategy.



***Inadequate risk management culture***

A large share of commercial insurable risks are in the hands of State Owned Enterprises that do not fully understand the role of insurance in managing risks that were previously absorbed by the state economy. The problem of building or enhancing commercial lines portfolios can be compounded by overly aggressive sales staff and intermediaries who pay little attention to the underlying needs of the insured or the potential for the insured to default on premium payment in their search for business.

***Competitive strength of dominant players***

Companies have found it difficult to build market share by winning business from the three major local companies, particularly PICC. It appears that most local domestic insurers have, to a certain extent, responded to the market dominance of their more established competitors by attempting to win business on the basis of price rather than differentiate themselves or develop new markets.

The foreign insurers operating in China currently write only around 1.2% of gross premium. While the scope for future growth is clearly present, their ability to make inroads will depend on how they can overcome the dominance and market power of the larger local companies. The companies that will succeed faster will be those that can take advantage of their superior business skills compared to the local companies (e.g. in technical underwriting) and concentrate on more profitable lines (e.g. cargo, property and possibly personal accident and short term health), perhaps within niche markets such as foreign corporations.

***Underwriting control versus growth***

Performance targets in China have typically focused on top line growth and market share, commonly at the expense of underwriting profits.

A key management challenge is to understand the true underwriting results of the business and be prepared to move out of business lines that are unsustainable at prevailing premium rates or to impose stricter underwriting controls that correctly price or exclude inferior risks. In order to achieve this discipline, it is critical to separate the underwriting and sales functions but in practice many companies appear to have given the sales function too much authority.

On the other hand, companies need to balance the need for short term profits against long term objectives of developing the distribution network and building a client base.

***Managing a profitable motor portfolio***

The motor market is fiercely competitive and based on our understanding of claims and expense ratios, the market as a whole appeared to be unprofitable at 2004 premium levels. Furthermore, much of the distribution control is held by increasingly powerful distribution channels of car dealerships and banks that are driving up distribution costs.

It is critical that companies develop the necessary premium rating and market segmentation techniques to underwrite selectively in a market that is so competitive. Companies that target more profitable segments may be able to make underwriting profits and sustain market share, even if the motor market is unprofitable as a whole. The management challenge is to develop underwriting expertise and then adhere to the chosen underwriting strategy while resisting pressure to price to match the competition.

***Lack of industry data and changing insurance experience***

The use of best practice technical approaches to claims reserving and product pricing in China has been significantly hampered as a result of poor data collection practices by insurance companies in the past. While this is slowly improving in the industry, it will be some years before a reasonable volume of historical data is available for such approaches to be used to best effect.

Even if data collection techniques are improved, the relevance of historical experience will be questionable (at least in the short term) due to the rapidly changing insurance experience within China as the market grows. A good example of this is in motor insurance where the number of new motor vehicles and new, inexperienced drivers is increasing rapidly throughout the country. This rapidly increasing exposure and the likely change in risk profile of insured drivers may mean that future experience will differ significantly from that of the past.

***Developing a direct sales force***

There are many challenges in the recruiting, training and retaining of key sales personnel. It can be difficult to motivate and reward a successful individual, especially in an environment where companies continually poach staff to support their expansionary goals. The developing intermediary market with potential for commission based remuneration is appearing increasingly attractive to successful salaried sales staff.

Personal relationships and connections are very important and so loss of key personnel usually means a loss of existing business as well as the future contribution the individual may have made.

For larger established companies, the direct sales force is typically managed through branch management, other than those dealing with specialist risks and large national clients. In many aspects, branches are managed as subsidiaries with a high level of autonomy, but this approach is becoming a concern to management as it is becoming increasingly important to ensure that underwriting and other operational procedures are followed at the branch level. However, this control of sales activity in the branches must be achieved without stifling the entrepreneurial drive that is required to develop new markets.

***Human resources***

The importance of an effective sales force is vital, but there is an equally urgent need to develop the quality of management and technical personnel. A common theme in many of our projects is the lack of insurance experience and other technical expertise, particularly in the areas of actuarial, underwriting and claims management. It is these areas that are critical to maintaining greater control over financial performance.

In view of the relative immaturity of the market, there are very few experienced insurance professionals and demand for quality staff, particularly at a managerial level is very high. The universities in China do offer insurance related courses and are certainly producing bright young professionals. However the vital element of experience is missing. Recruiting from the existing companies is common but the danger is always that such people are too set in their ways and unwilling to adapt to new business practices.

***Regulatory environment***

The regulatory environment in China has developed in line with the growth of the market and as a consequence, many regulations were first implemented in draft form and in fact many “unwritten rules” are still not part of formal legislation. This has created an additional challenge for management who must plan medium-term strategies against a changing environment.

Many of the insurance companies also complain about the amount of management time expended in dealing with the regulators. The regulator, CIRC, does not appear to interfere directly in operations, but it wishes to be informed of any major company decisions, and may indicate that certain strategies are unacceptable. There can also be significant lags in response time that have reportedly varied between 2 weeks to 4 months. The regulator also has many “unwritten rules” and has often used them to move the market in certain directions.

The more established companies do not appear to be affected to the same extent as they have typically already built up their relationships and understand these “unwritten rules” better.

### ***Capitalisation***

Capital is becoming increasingly important to finance regional expansion and provide underwriting capacity to compete with larger established players. Industry sources also report a growing degree of regulatory focus on solvency, also increasing the need for capital.

Several domestic non-life companies are looking for additional capital to bolster their balance sheets and improve future access to capital. This is evidenced by the level of planned IPO and restructured shareholding activity reported in the press in recent times.

Once a company has increased its capital base, it must meet certain performance targets to support that new capital. We believe that few of the local domestic insurers are actually prepared for what this may mean in practice going forward.

### ***Reinsurance***

The reinsurance market in China is immature and undeveloped by international standards. Historically, China had very little dealing with international reinsurance markets and even since market liberalisation, domestic insurers have only gradually introduced the use of reinsurance.

### ***Difficult investment environment***

Due to the restrictions on investments and the general limited number of investment instruments available, it will be difficult for insurers to achieve higher than bank or cash rate returns.

The Government is however contemplating allowing insurers to invest in a greater variety of investment vehicles subject to maintaining an overall low level of investment risk.

### ***Actuarial management of pricing and reserving***

The use of actuarial expertise in pricing products is very low in China although the regulator is keen for the industry to embrace such practices. One problem that the industry will face in this regard is in establishing a reliable data base of relevant historical claims and policy information to enable sound actuarial pricing techniques to be employed. To date, the level and quality of data collection has been low both at the company and industry level.

The regulator has recently announced the requirement for general insurance companies to appoint actuaries for reserving and solvency evaluation.

Foreign companies are likely to have an advantage over domestic companies (particularly in pricing), as the use of actuarial and technical analysis is likely to be a standard feature of their businesses.

***Fraud and corruption***

It is extremely difficult to assess the level of fraud and corruption in the China non-life industry. However, from our discussions with a number of market participants, we believe this is likely to be a problem, particularly at the distribution level in relation to the manipulation and over-payment of commissions to agents.

The threat of capital punishment which applies in China for high level corruption is a major deterrent, particularly at senior management levels within companies.

***Exposure to natural hazards***

China has a relatively high exposure to natural hazards such as earthquakes, typhoons, and floods compared to other countries. This is an important consideration in product development, policy wording (including exclusions) and reinsurance planning.

In practice, policies in China tend to exclude earthquake cover but include flood cover. This is the reverse situation compared to a number of other countries (e.g. Australia) where earthquake cover is provided but flood cover is excluded.

## **4 India**

### **4.1 Overview**

India has enjoyed a period of consistent economic growth with real GDP growing at more than 6% per annum in each of the last 9 years. Most economic forecasts indicate that strong growth is expected to continue well into the future.

With a population of 1.1 billion people, including a rapidly expanding middle class, the insurance industry in India, like China, has enormous growth potential.

As a result, India is now competing with China as the preferred option for foreign non-life insurers looking to expand into Asia.

### **4.2 A brief history of the India non-life market**

The origins of the general insurance industry in India can be traced back to the Triton Insurance Company which was established by the British in Calcutta in 1850. Over the next 120 years, more than 100 additional general insurance companies were established in the country.

All general insurance business was nationalised in 1972 when 107 insurers were amalgamated and grouped into four national companies. The four companies, New India, National, Oriental and United became the subsidiaries of the General Insurance Corporation of India (GIC) with each company operating under strict premium tariff rules for all business sold.

In December 1999, legislation was passed to allow entry of foreign insurance companies into the market through a maximum holding of 26% in a joint venture with a local Indian company. At the same time, the insurance regulator, the Insurance Regulatory and Development Agency (IRDA) was established and plans were developed to restructure the government monopoly GIC and its four subsidiaries.

In October 2000, the first private companies were established with Reliance, a local company with no foreign equity and Royal Sundaram, a joint venture between Royal & Sun Alliance (RSA) and the Indian company Sundaram, entering the market. In December 2000, New India, National, Oriental and United India were de-linked from their holding company GIC and GIC subsequently became the national reinsurer.

Currently there are 14 non-life insurance companies in India. Half of these companies are joint ventures with foreign insurers.

### **4.3 Regulatory environment in India**

The following is a brief summary of some of the key areas of regulation impacting on non-life insurance companies in India including:

- the insurance regulatory body,
- requirements for foreign insurance companies or foreign investors,
- licensing of new insurance companies,
- capital and solvency requirements,
- reinsurance requirements,
- policy liability reserving requirements and

- pricing regulations and tariffs.

### ***Insurance regulator***

The Insurance Regulatory and Development Authority (IRDA) was established in 2000. It has the duty to "regulate, promote and ensure orderly growth of the insurance business and re-insurance business". Its functions include:

- registration and continuing regulations of insurers,
- policyholder protection,
- setting standards for professionals working in the insurance industry,
- promoting the efficiency of insurance business and
- setting requirements on investment, solvency, levies, tariffs and reporting.

### ***Participation by foreign insurers or foreign investors***

According to the IRDA Act passed in December 1999, life and non-life insurance companies in India are not permitted to have foreign equity in excess of 26%. This 26% is defined to include holdings by any foreign entity either through the foreign joint venture partner or via foreign shareholdings in the Indian company. The IRDA is strictly enforcing this regulation. It is notable however that in some insurance joint ventures the foreign partner exercises management control; specifically Dabur CGU (Aviva), Max New York Life, MetLife India, ING Vysya and AMP Sanmar (all of which are life insurance companies).

The IRDA Act states that promoters of insurance companies are required to divest their interest in the insurance company to 26% after the company has been operating for ten years. We understand that companies have already started lobbying with the authorities to amend this provision so that compulsory divestment is not enforced.

In 2004, the Indian government announced that the 26% cap on foreign direct investment would be increased to 49% for the insurance sector. Unfortunately, the Congress Party Government does not hold a clear majority and its coalition partner, the Communist Party, has delayed this amendment.

The IRDA in conjunction with the Reserve Bank of India has recently also decided that the stake of foreign insurers in Indian banks will also be counted towards the foreign equity cap.

### ***Licensing of new insurers***

There are no geographical or business line restrictions on new insurance companies (i.e. a general insurance license allows a new insurer to operate on a nation wide basis). However, licensing as composite insurer (i.e. life and non-life business) is not available. Companies seeking to write both life and non-life business are therefore required to set up separate joint venture companies for this purpose. An example of this in the market is Tata AIG which is present in both sectors through separate joint ventures.

The licensing process is in three stages and the IRDA typically takes two to three months from the date of application to award a license. However, prior to the application, the joint venture company needs to be formally established. In practice, this is quite a time consuming process. To date no application has been rejected.

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During the first stage, the applicant must submit to the IRDA, form “IRDA/R1 – Requisition for registration application” which sets out the details of the capital structure as well as details of any shareholders holding more than a 1% stake in the proposed company. Financial projections including sensitivity analysis must also be supplied.

The second stage involves submitting to IRDA, detailed information on the business plan via the submission of form “IRDA/R2 – Application for registration”. The fee for application is Rs50,000 (approximately USD1,100) for each class of business for registration.

The third stage (i.e. the granting of the licence), happens automatically after funding.

### *Capital and solvency requirements*

The current minimum capital requirement in India is Rs1 billion (approximately USD22.7 million). In addition there is a formula based solvency requirement calculated y class of business based on the amount of premiums and incurred claims in the previous year of operation. It is defined as the greater of:

- 20% of net premium,
- 20% of gross premium multiplied by factor A as specified below,
- 30% of net incurred claims,
- 30% of gross incurred claims multiplied by factor B as specified below.

<b>Class of Business</b>	<b>A</b>	<b>B</b>
Fire	0.50	0.50
Marine cargo	0.70	0.70
Marine hull	0.50	0.50
Motor	0.85	0.85
Engineering	0.50	0.50
Aviation	0.90	0.90
Liability	0.85	0.85
Rural insurance	0.50	0.50
Others	0.70	0.70
Health	0.85	0.85

According to IRDA (Protection of Policyholders' Interests) Regulations 2002, all insurers must maintain a minimum 150% solvency margin at all times.

The IRDA's solvency margin regulations do not represent a risk based capital approach that is sensitive to factors such as class of business, type of asset, reinsurance program or concentration of risk. We understand that the IRDA is looking at this issue but has not made any announcements at the time of writing this article.

### *Reinsurance requirements*

There is a compulsory reinsurance cession to the national reinsurer (GIC) of 20% of all business written. Certain restrictions apply in respect of large engineering, marine hull and fire risks. The GIC also has the right of first refusal of all facultative placements.

Each insurer must have its annual reinsurance programme approved by IRDA. Every insurer must offer other Indian insurers and the GIC participation in its facultative and treaty surplus programmes before overseas placements can be made. There are also restrictions on the quality of such overseas reinsurers. Limits are set on placement with individual reinsurers.

***Policy liability reserving requirements***

Non-life insurers are required to set minimum policy liability provisions for both outstanding claims and unexpired premiums.

For outstanding claims, reserves are required for reported and incurred but not reported (IBNR) claims based on the advice of an appointed actuary.

The liability for premiums (reserve for unexpired risks) is determined as 100 % of premium received or receivable net of reinsurances during the last 12 months for marine hull business and 50% for all the other classes.

Reserves for IBNR claims are determined by actuarial principles following the Guidance Notes issued by the Actuarial Society of India, with the concurrence of and any directions issued by the IRDA.

The latest Actuarial Society of India Guidance Note (Draft) GN 21 recognises that the appointed actuary's responsibilities are critical to the financial soundness of the company. His or her responsibilities are onerous and include:

- a statutory responsibility to IRDA as well as a responsibility to the client,
- a requirement to monitor the ongoing solvency of the company,
- consideration of all aspects likely to affect the financial condition of the company including premium deficiency, business volume, future underwriting policy, etc.,
- a requirement to certify reserves annually,
- responsibility for premium setting and
- monitoring of capital requirements.

Although these responsibilities are onerous there are in practice, very few experienced non-life actuaries performing these roles in India. In addition, the IRDA does not currently employ any specialist non-life actuarial staff to review the estimates produced. The quality of the reserving is therefore not likely to be of a consistent standard that would be expected in a country such as Australia.

***Pricing regulations and tariffs***

The Indian non-life market is heavily regulated with premium rate tariffs applying to around 70% of business lines including motor, property/fire and marine.

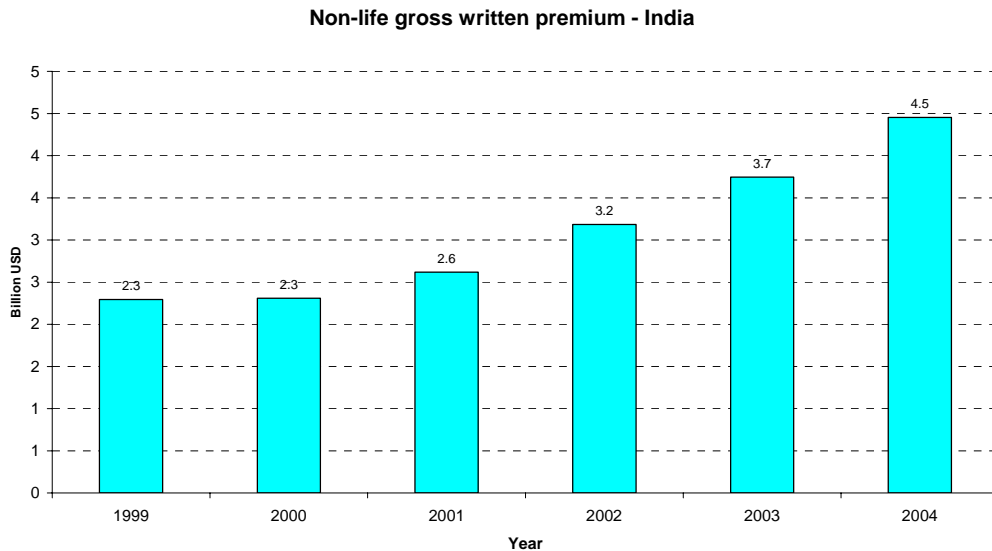
The profitability of each class of business operating under tariff tends to vary significantly with motor business (third party liability insurance in particular) generally being highly unprofitable while property/fire business tends to be quite profitable. This tends to lead to significant cross-subsidisation of business by insurance companies as they are generally forced to sell unprofitable business on an accommodation basis in order to gain access to the more profitable lines.



It is expected that the remaining tariff classes will be deregulated over the next two to three years, but there are currently (to our knowledge) no firm timetables in place. It was planned that motor own damage insurance business was to be de-tariffed in April 2005, but this has subsequently not occurred.

#### 4.4 Market size and growth

The following chart shows the gross written premium volumes of non-life business in India in recent years in USD.



Source: Swiss Re Sigma World Insurance Series

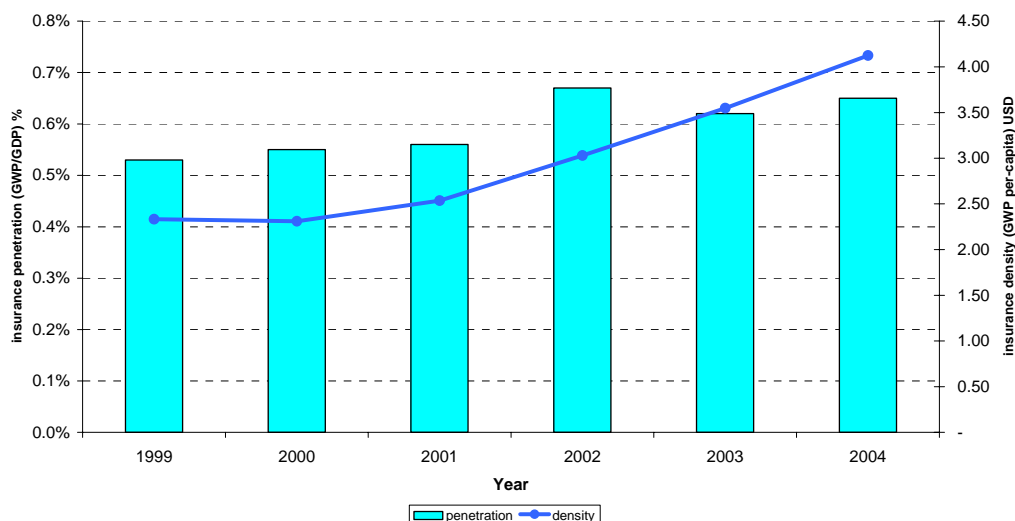
Non-life premium volumes in India have grown at a compound average rate of around 16% per annum since 2001 in local currency.

A significant contributor to this growth has been insurance penetration to the middle class population which is currently estimated to be of the order 250 million to 300 million people, and growing rapidly.

#### 4.5 Market penetration

The following chart shows the market penetration indicators over the 6 year period to 2004, namely market penetration rate (GWP as a percentage of real GDP) and the market density (GWP per-capita).

Non-life insurance density and penetration in India



Source: Swiss Re Sigma World Insurance Series

The current market penetration of non-life insurance is very low in India, despite the strong growth in premium volumes in recent years. Annual gross written premium represents only around 0.65% of GDP, or around USD4 per-capita (c.f. for Australia, the comparative figures are 3.9% and USD1,100 respectively). Both market penetration indicators are among the lowest of developing countries in Asia, Latin America and Africa.

#### 4.6 Market share

By the end of 2004, there were a total of 14 non-life insurers in India. The following table shows the number of non-life companies in operation since the opening of market.

Number of non-life insurance market participants					
	2000	2001	2002	2003	2004
Local	5	5	7	7	7
Foreign JV	2	5	7	7	7
<b>Total</b>	<b>7</b>	<b>10</b>	<b>14</b>	<b>14</b>	<b>14</b>

The 14 non-life insurers consist of:

- the four national public sector companies - New India, National, Oriental and United de-linked from the GIC
- two specialist public sector insurers -
  - the Agriculture Insurance Company of India Limited (AIC) which was formed in 2002 and operates the National Agricultural Insurance Scheme (NAIS),
  - the Export Credit Guarantee Corporation Limited (ECGC) for facilitating international trade, and
- eight companies in the private sector, seven of which are joint ventures with foreign companies.

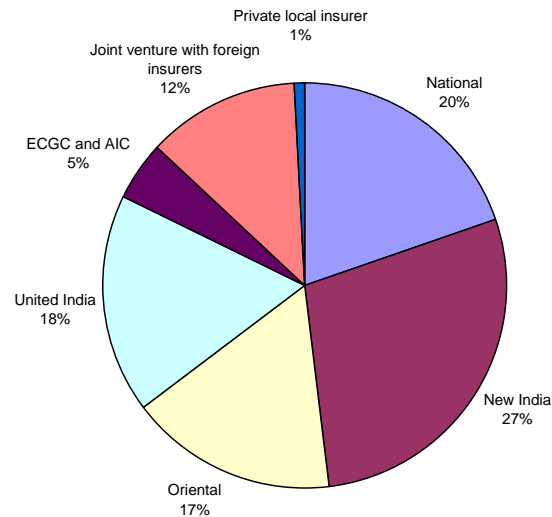
The market is currently dominated by the six state-owned insurers, particularly by New India, National, Oriental and United. In 2004, they wrote over 85% of business in terms of premium income.

## The development of non-life markets in Asia – Opportunities and risks for foreign investors

Despite the domination of the state-owned companies, their market share has been decreasing steadily. In 2002 their premium income represented over 95% and latest figures indicate this has reduced to around 75%.

A high level breakdown of market share based on premium income in 2004 is shown in the following chart.

**India non-life market share by gross direct premium income in 2004**



*Source: Insurance Regulatory and Development Authority (IRDA) website*

### ***General comments on established insurers***

While the four state-owned insurance companies have been structured to compete with each other and with the private sector, they remain closely linked and operate similar business models. In particular, their products have tended to be similar in the past and they employ similar human resource and remuneration practices. In addition, it is common for their senior executives to be transferred amongst the four companies.

The state-owned companies have an advantage over the newer companies in that they have a large and well developed infrastructure throughout the country. However, they are significantly hampered by high operating costs due to large numbers of employed staff compared to the private sector companies that have entered the market in recent years. A critical problem has also been their failure to set up centralised IT systems to assist in claims reserving and underwriting. They have also operated in the past on the basis of accepting all risks and hence have been selected against by some of the private sector companies.

We believe it will be crucial for the state-owned companies to make significant structural changes to their businesses, including moving quickly to efficient best practice operating principles, in order to better compete with the generally more efficient and well managed private companies.

*General comments on the new private sector insurers*

In achieving their rapid increase in market share, the private sector companies have tended to focus their underwriting on the more profitable lines of business the Fire, Marine Cargo, Engineering, Liability and Personal Accident classes. In contrast to the state-owned companies, they have comparatively lower shares of the more problematic classes such as Motor, Marine Hull and Health insurance.

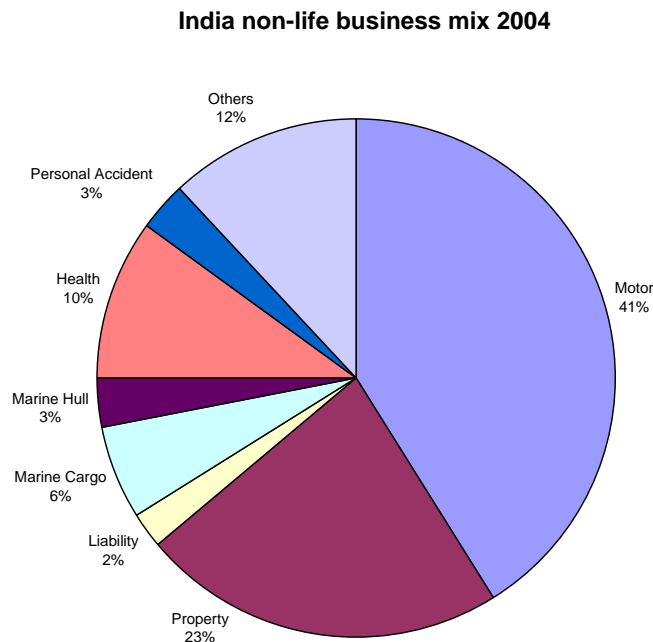
This trend in increasing market share for the private sector companies is expected to continue for the following reasons:

- focus on taking advantage of their local partners’ customer base and distribution network,
- superior underwriting techniques,
- focus on niche markets,
- ability to more readily develop innovative products that better meet customer demands,
- higher standards of customer service, and
- ability to better utilise global capacity to write large corporate risks.

**4.7 Business mix**

The following chart shows the breakdown of 2004/2005 gross written premium in India by class of business.

The mix by class of business by private sector insurers is as follows:



Source: IRDA Journal July 2005

As in China, the non-life market in India is dominated by motor insurance, although property and health classes are also significant.

The large growth in premium volumes in recent years has been driven by growth in the motor, health and personal accident classes. We would expect that other classes (particularly property, cargo and liability) will become more significant as the economic conditions develop further.

It is worth noting that the four main public sector companies have above write proportionally higher shares of motor and health business which have tended to be relatively unprofitable in recent years. It appears that the newer companies are targeting more profitable classes and segments of classes than the established companies.

#### **4.8 Profitability of the India non-life market**

Unfortunately in the past, most likely due to the tariff arrangements that have operated for many years, very little industry information appears to have been retained which would allow an accurate assessment of the true industry profitability in recent years.

We make the following general observations on the India non-life market profitability based on non-confidential work we have undertaken in the country.

##### ***Motor business***

Motor business represented over 40% of the total industry's premium and is broken down into Motor Own Damage insurance (around 28%) and Third Party Liability insurance (around 12%).

Premiums are set by tariff based upon four rating factors, broad geographic location, engine capacity rating, age of vehicle and no claim discount.

Based on various market commentaries, it is thought that the overall loss ratio for the state-owned companies has been as high as 120% in recent years. This is believed to comprise a loss ratio on motor own damage business of approximately 75%, and a loss ratio on third party liability business of over 200%.

In view of this extreme performance, the private sector companies have mainly targeted private comprehensive cars and motor cycles, and have tended to write commercial vehicles on an accommodation basis only. They have avoided insuring third party policies as the private sector's share of the third party liability market was only around 3% in 2004.

In the short time that the private sector companies have been operating in India, it appears that they have been able to achieve significantly lower loss ratios on motor business in comparison to the state-owned companies (e.g. in the range of 70% to 85% in 2003 and 2004) despite the tariff restrictions. We understand that this has been the result of more selective and technical underwriting methodologies. For example, we understand the private sector companies have set up databases that allow them to carry out technical premium rating analyses.

In terms of the likely effects of the deregulation of the motor own damage business, we understand that the IRDA will not permit a totally free market, but instead desires a stable transition. The process therefore is likely to involve a system of file and use of premium rates involving actuarial certification.

The experience in most motor markets has been adverse in the first few years following deregulation. This has been most recently observed in China. We would expect the impact to be negative on profitability however we would not expect such large rate reductions, as say China, due to the IRDA's above intentions.

***Property/fire business***

Fire business represented approximately 23% of the total industry's gross premium in 2004.

This class appears to have been consistently profitable over recent years with estimated loss ratios averaging around 50% to 55% for the public sector companies since 2001.

Loss ratios were adversely impacted in 2001, due in part to a reduction in the premium tariff of approximately 22%, and also due to the heavy industry losses arising from the Gujarat earthquake.

In spite of the reduction in the tariff rate, property/fire business is still considered to be profitable and is highly sought by all insurers. Many insureds use their property/fire insurance requirements as a leverage to obtain coverage or competitive rates in other less profitable classes of business.

The private sector has been quite successful in targeting the fire class and achieved a 23% share of the 2003/ 2004 premium. We understand that this business is mainly SME or corporate business. Some of the individual private sector net loss ratios are shown below:

***Health business***

Health business represented approximately 10% of the total industry's gross premium in 2004.

The non-government health insurance market consists almost entirely of a single scheme, "Mediclaim". Mediclaim is predominantly sold by the public sector insurers as group business to employers. While the private sector companies have subsequently started to write health business with a similar structure to Mediclaim, their market shares remain low.

Health insurance is currently a significant loss making class with industry loss ratios estimated at around 120%. The main contributing factor is the Mediclaim policy which provides hospitalisation benefits for most conditions with very few exclusions. This situation has prevented global specialist companies from entering the market, as it is difficult to write an appropriate risk based policy which can compete against Mediclaim.

Health insurance has attracted a lot of negative publicity in India in recent times, not only in relation to its poor financial performance for insurers but also as a result of a general dissatisfaction from the public in getting appropriate access to benefits and services from the insurance companies when claims are made.

***Marine business***

Marine business represented approximately 10% of the total industry's gross premium in 2004.

Marine Hull is still under a premium tariff, whilst Cargo rates were de-tariffed in 1994. Shortly following the de-tariff, a price war occurred and premium rates fell substantially in the market with a subsequent deterioration in profitability. This has been a contributing factor in the IRDA's requirement for an orderly de-tariffing process to be implemented in the future deregulation of the tariff classes.

Since 2001, Marine business appears to have been reasonably profitable for the public sector companies with loss ratios averaging around 60% to 65%.

***Expense levels and commissions***

Expenses represent around 30% of net premium for the public sector companies. The average expenses ratio for the private sector has been significantly higher but this is likely due to the fact that most companies are still in their infancy and are still recording financial losses due to start-up costs and new business strain. This is supported by an evident downward trend since 2003.

Commission rates paid to intermediaries are subject to approval by the regulator and maximum rates are generally fixed.

Maximum rates of commission vary at around 10% to 12.5% of gross premium for tariff classes and around 15% to 17.5% for non-tariff classes.

***General comments on market profitability***

The profitability of the whole non-life market in India is currently adversely affected by the unprofitable motor class, although this is offset somewhat by profitable fire business.

While there is scope for improved profitability once the tariffs are removed, experience in other markets indicates that performance is likely to deteriorate in the short term once deregulation occurs as a result of competitive forces in the market.

**4.9 Distribution of non-life business in India**

The distribution channels utilised by the non-life insurance sector in India include:

- agents and corporate agents,
- bancassurance,
- brokers, and
- direct sales.

***Agents***

The dominant distribution channel has historically been the agency force.

While the public sector companies are able to attract agents, they suffer from high attrition rates due to indiscriminate agent appointment. The most successful tied agents tend to be local people known in the community who distribute products on a part-time basis. Educating and training these agents is a serious challenge for the insurance companies.

Both the public and private sector use branch networks to manage these agent forces. For the private companies, most branches are located in the major metropolitan areas and larger cities.

***Corporate agents***

These consist of a wide range of entities including motor vehicle dealers, credit card companies, finance companies travel agents etc.

Motor dealerships are a very important distribution channel for motor business.

***Bancassurance and other distribution agreements***

While bancassurance has to date been mainly aimed at the life insurance industry, increasing attention to the distribution of non-life products has been made with numerous bank and other corporate relationships being confirmed in recent years for both public and private sector insurers. A list of the current bancassurance and other corporate relationships is shown in the table below.

<b>Insurance Company</b>	<b>Bancassurance relationship</b>	<b>Other distribution relationship</b>
Bajaj Allianz	Jammu & Kashmir Bank, Bank of Rajasthan, Bank of Punjab, Lord Krishna Bank, Karur Vysya Bank, Punjab and Sindh Bank, Saraswat Cooperative Bank, Karnataka Bank Ltd., Shamrao Vithal Co-operative Bank	Ford, Hyundai, Maruti, Kinetic, Hero Honda, Galileo, Shriram Group, Cosmos Bank
Royal Sun Alliance	Citibank, ABN Amro, Standard Chartered, American Express, RepcoBank, Lakshmi Vilas Bank(LVB), ING Vysya Financial Services Ltd.	Fiat, Sundaram Finance, Lakshmi General Finance, Madras Fertilizers Ltd.
Tata AIG	HSBC, IDBI, Development Credit Bank, Orissa State Co-operative Bank	Kinetic, India Alive tours, Shriram Group, CEAT, HPCL
IFFCO Tokio		Karnataka State Finance Corporation, Andhra Pradesh State Finance Corporation, Gujarat State Co-operative Marketing Society, KSCARBD, Utkal Chamber of Commerce & Industries (UCCI)
ICICI Lombard		Galileo, Amadeus, India Times, Muthoot Group, Indiatimes.com
United India	Indian Bank, South Indian Bank, Federal Bank, Dhanalakshmi Bank, State Bank of Hyderabad, Andhra Bank, State Bank of Indore, State Bank of Travancore, State Bank of Patiala, Syndicate Bank	PNB Housing Finance, Kerala Chamber of Commerce,
New India	Punjab National Bank, State Bank of India, Corporation Bank, Central Bank of India, State Bank of India (Chennai, Hyderabad, Bhopal, Bangalore, Kerala)	Canara Bank, Union Bank
National	Bank of India, Indian Overseas Bank, Vijaya Bank, Kangra Central Cooperative Bank, Allahabad Bank, Bharat Overseas Bank, UCO Bank, City Union Bank, State Bank of Mysore, Bank of Bahrain and Kuwait BSC, State Bank of Bikaner and Jaipur, Nainital Bank,	Maruti, BSNL, Eicher, General Motors, Hero Honda, Bajaj Tempo
Oriental	Oriental Bank of Commerce, State Bank Of Saurashtra, Dena Bank	LGF Services Pvt Ltd(Subsidiary Lakshmi General Finance), Department of Posts
ECGC	Allahabad Bank, Indian Bank, Bank of Rajasthan, Karur Vysya Bank, Corporation Bank, South Indian Bank and Federal Bank, Punjab National Bank,	Union Bank of India
Cholamandalam		Coromandel Fertilizers



### ***Brokers***

At present, there have been around 170 licenses issued for insurance brokers in India. These organisations include large global firms such as Aon, Boda, Howdens and Willis, as well as smaller firms and individuals.

Brokers are currently in a difficult position under the current tariff structure in that a 5% reduction in the tariff rates that apply to direct placement of large property risks with insurers is not available through placement with brokers. In addition, as there is no premium rate reduction incentive for insured companies to implement risk management procedures, the risk management services often provided by brokers tend to be under-valued by prospective clients.

### ***Direct***

Other less common (although increasingly popular) distribution techniques in India include:

- direct mailing, either using the customer base of the insurer's joint venture partner or in some cases, with a bancassurance partner,
- telemarketing which is increasing in popularity for personal lines marketing and
- use of the internet in the sale of motor, personal accident and home insurance, although business volumes remain quite small.

## **4.10 Prospects for new entrants to the non-life market**

Unlike China, the track record to date of the Indian private sector joint venture companies has been a huge success. They have in the space of four years or less, captured over 25% of the market. Most companies have posted maiden profits in their third years of operation. We would not however suggest that such performance would necessarily be available to a new entrant in 2005. Nevertheless we do have somewhat more optimistic views on the potential achievements from a start-up operation in India than in China.

For example, based on our findings, we believe that through a well planned and robust business strategy, new joint venture non-life companies could realistically aim to achieve the following targets for a start-up operation in India:

- profitability after three to four years of operation,
- break even (i.e. positive cumulative profits) after five to six years and
- long term returns on capital of 12% to 15% or higher.

However, as is the case with the China non-life market, such targets do not come without significant risks as discussed below.

#### 4.11 Prospects for acquisition

To date there have not been any acquisitions of the established joint venture companies. However, we see prospects for this to occur. Some reasons include:

- capital increases arising from the strong premium growth (these could encourage investors to reassess their positions),
- uncertainty surrounding future deregulation,
- frustration over delay to increases in the maximum foreign investment in joint venture companies (currently 26%) and
- changing focus from current foreign investors.

#### 4.12 Common challenges for foreign insurers entering the India non-life market

Similar to China, the India non-life market offers great potential for foreign companies, but there are a number of challenges that companies will face in establishing and building their businesses. Some of the challenges are described below.

##### *Premium tariffs and potential deregulation*

About 70% of the total non-life market is still under tariff. The process of deregulation of tariffs is slow, but is likely to occur in the next two to three years. This is likely to have an adverse impact on the profitability of the motor property damage and fire classes in particular. Some classes under tariff are currently already unprofitable (e.g. motor) and insurers will need to identify profitable segments of such business in order to achieve profitable results.

##### *Foreign ownership constraints and exercising management control*

Due to the current 26% ownership cap on foreign investors, management control is usually effectively in the hands of the local joint venture partners. A challenge therefore is for the foreign players to be able to effectively add the value of its expertise in the insurance operation of the joint venture.

It is one of the main reasons that there is no foreign reinsurer in India to date.

##### *Lack of product innovation*

Whilst the tariff exists, insurance product innovation is stifled. This is frustrating to companies wishing to produce tailored solutions that meet their clients' needs.

##### *Absence of risk management culture*

The tariff does not encourage thorough underwriting of pricing and policy terms or the implementation of risk management initiatives by insurers. Adoption of risk management principles is therefore going to take time and will involve a cultural change, particularly among the dominant public sector companies.

***Fierce competition***

As companies cannot currently compete on price for the tariff classes, they are providing enhanced customer service offerings (e.g. cashless claim settlements, representatives at distribution outlets, etc.) as incentives to attract sales. These are adding significant costs to the operations that currently cannot be adequately factored into premiums.

***Shortage of experienced staff***

The private sector companies have staffed many positions from the public sector companies. Acquiring and retaining senior and experienced staff is a significant problem in the insurance market. Poaching of staff is a common practice.

***Lack of industry data and changing insurance experience***

While not to the same extent as has been the case in China, the use of best practice technical approaches to claims reserving and product pricing in India has been significantly hampered as a result of poor data collection practices by insurance companies in the past. While this is slowly improving in the industry, it will be some years before a reasonable volume of historical data is available for such approaches to be used to best effect.

***Effective distribution***

Developing an effective distribution strategy is critical for foreign insurers entering the Indian insurance market. For this reason, finding a local joint venture partner with a large potential insurance customer base and effective distribution channel is a critical factor to success for foreign insurers looking to enter the market.

***Fraud***

Fraud is a major concern in India. For example, motor repair shops are often cited as contributing to excessive claim leakage by over-inflation of repair costs. In addition, from a corporate governance perspective, there are concerns particularly in respect of breaching tariff rules.

***Exposure to natural hazards***

India is subject to severe natural hazards including earthquakes, cyclones and floods.

While India has experienced some of the world's worst natural catastrophes in recent years, the events have, until July 2005, not produced high insurance losses due to the low level of insurance penetration.

The recent Mumbai floods have changed this. Although the full extent of insured losses from this event are yet to be confirmed, it is expected that the amounts involved will adversely impact on international reinsurers as well as the direct market.

## **5 Conclusions**

The non-life insurance markets in many developed countries (e.g. the United States, Japan, Australia and others throughout the European Union) are now very mature and insurers will face significant challenges in achieving sustained growth within their home markets. As a result, many of the large insurers in these countries are now actively looking for further growth opportunities in the relatively undeveloped Asian insurance markets.

Asian insurance markets are seen as particularly attractive for foreign non-life insurers due to strong long term economic growth prospects and the flow on effect that this will have in increasing the current very low level of insurance penetration that exists in the region.

While a number of Asian countries are viewed favourably by potential foreign investors, mainland China and India are generating by far the most interest. This is not surprising given the booming economies, large populations and current low level of insurance penetration in both countries.

Both the China and India non-life insurance markets offer significant growth and long term profitability prospects for foreign insurers wishing to enter these markets. However, there are also significant risks. We hope that this paper has adequately presented both perspectives to interested readers.