

Transition to Non - Tariff Regime-Issues before Indian Insurance industry

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1. Introduction:

Indian Insurance Industry is awaiting non tariff regime as it is expected to bring in pricing efficiency, lead to improved prices for good risk and higher prices for substandard risk and end of cross subsidy. Rating is expected to reflect the company's book of business, be in step with financial objectives, and consistent with solvency conditions. It presupposes pricing flexibility to the Insurance companies. Pricing would become a factor for competition in addition to marketing and service.

On the down side, the companies would become selective in their customer base there by leading to skimming of the cream. Availability of insurance would become scarce for customers with bad history and substandard risks. There is the possibility of unhealthy competition amongst the insurance companies to increase revenue and customer base.

This paper analyzes the current ratemaking scene in India, and issues to be resolved prior to introduction of open market.

2. Current scenario

The Tariff Advisory Committee (TAC) has developed tariff for in-tariff business and is adopted by all insurance companies operating in India. Risks of high sum insured fall outside the purview of tariff, and the pricing of these risks is generally governed by Reinsurance market. In case of new risks not defined in the tariff, provisional rate is charged, and the risk is referred to TAC for appropriate rate.

The current tariff considers all risks at the overall level and the territorial differences in the risk are limited to few classifications. The rating factors are to the basic, simple and those that are obvious. Products, policy forms, clauses, conditions and warranties are prescribed in the tariff. Thus, differentiation between insurance companies is in servicing, investment efficiency, underwriting discipline and claims practices.

Earlier instances when transition from tariff to open market was resorted to in marine cargo, select miscellaneous insurance such as personal accident, and marine hull it resulted in drastic reduction in rates, relaxation in policy terms and condition and brought down the contribution of these lines of business to the overall portfolio, to the detriment of the insurance companies and industry. The market share of these portfolios being small, the loss cost and combined ratio being favorable did not have much of an adverse effect on the industry. With proposed Fire and Motor portfolios detariff it is essential that risk mitigation efforts are taken upfront to prevent the scenario from repeating, for fire Insurance is the most profitable portfolio and the Motor Insurance the least, but both are major contributors to the industry by way of revenue. There is cross subsidization between these portfolios. Any decision towards non-tariff should consider that the ensuing steps be taken before moving to non-tariff regime.

3. Issues before Indian Insurance Industry:

Rate making depends on the availability of data on loss costs, profit and contingency expenses, expense provision, investment income offset, and other charges. These data is analyzed at the granular level of exposure basis, territorial relativity, class relativity, experience history and base rate modifying factors. As past is not the representation of future, these data is trended for future result based on economic indicators, inflation factors, legal and societal trends. The change in loss ratio, loss development patterns, emergence of new risk, all need to be factored in to while making rates. The rates developed should be adequate, not exorbitant and should balance the interest of policy holders and insurance companies.

There following obstacles are to be removed before ratemaking can be left to choice of individual insurance companies.

3.1. Expose underlying assumptions in current tariff:

The risk profile in Indian Insurance Industry has undergone structural change in recent times by way of number of players, business mix of the players, policy objectives, customer profile and ways of conducting business. The assumptions on loss cost, expense provision, investment return, to claims handling procedures, payment patterns, reserving practices, and operations which have been factored in to while developing the current tariff have undergone change. The assumptions with respect to economic, legal, social, and political environment are no more valid and keep changing dynamically.

New risk with differing risk propensity has hit the market. So also new industries, techniques of production, method and cost of repair has transformed many of the risk to heterogeneous risk.

To revise tariff on loss cost basis these assumptions under the current tariff need to be decoded and made known to the market such that the validity of the assumptions can be tested and modified to come up with new tariff reflecting reality. Rendering the assumptions open would also help in obtaining buy in for the inevitable rate increase in Motor liability portfolio.

3.2. Publish Ratemaking Standards and Guidelines

IRDA/TAC could provide basic guidelines for ratemaking. Ratemaking procedures are often complex. The complexity begins with basic elements, such as earned premium to be used, exposure base, relativities such as territory, class, and industry group, years of experience, losses, and expenses to be factored and weights to be allocated for each factor. Minor variation in each of these factors will lead to divergent results. It is suggested that minimum guidance on accepted elements and the treatment be specified upfront. Treatment of optional elements can be decided on case to case to basis.

Pure premium methods can be used where loss data by exposures is available. For heterogeneous risk pure premium method is not feasible. Loss ratio method can not be used for pricing purpose as they do not have adequate established rate and premium history. Hence selecting the appropriate method for rating is complex and depends on the availability of data. Guidance on various scenarios on selection of rating methods would be highly appreciable. This guidance can be modified as the industry gains experience.

3.3. Data Collection, availability and quality

The value of collecting, analyzing and mining of data becomes an urgent necessity both at the insurance company and at the industry level. A statistical agency at the national level to collate

data and a structured framework for data collection is needed. Internally the insurance companies with the help of their IT need to enhance the quality and accuracy of data collected.

Collection of data at the granular level of risk, risk classes, industry groups, territory wise, over a period of time is necessary to understand the loss development patterns. The balance between historic and current data, the assumptions currently being carried on, the volume and correctness of data have importance in rating a risk. The data is currently available at the aggregate level for the nation as a whole. With the advent of private insurers with limited geographic focus, and selective client base the aggregate level data is not appropriate for rating purpose.

The risk profile has changed considerably in the past decade and the data available with the industry might not be representative and hence data might not be adequate for the purpose of pricing. For example in Motor private car insurance, from being 3 model industries, private car industry has now grown to a 15 model with multiple makes. Indigenous vs. imported, new vs. used, Small, mid-size, and huge cars, old and the new, compete in the market space. With the new risk there is only limited volume of statistical data. In most cases, there are so many classes that a number of years of experience would be necessary to obtain credible experience for individual classes even on a countrywide basis.

The rating effectiveness depends on the judgment that insurers make in including factors and the quality of data. Inclusion or exclusion of factors depends on the impact it has on the loss cost. Quality data at granular level of coverage, location, customer, loss basis, manufacturer, product and value are to be captured for estimating the rates.

3.4. Develop specialist with necessary skill set

With the centralization of ratemaking functions at TAC, the public sector insurance companies had not perceived the need to develop the ratemaking expertise internally. General Insurance Industry in India is currently depended on the international actuarial resources as the actuarial practice in general insurance is still in nascent stage.

Ratemaking calls for combinatorial skills such as GI pricing actuary, reserving actuary, wording specialist, research associate, economist, statisticians, underwriter, can claims manager. While international actuaries, are well qualified in the actuarial techniques and practices, their skill need to be supplemented with people with of understanding of Indian Insurance Industry, the risk profile, the customer base, the political, economical and social environment in which the industry operates, competition and investment climate would sure be disadvantageous. To be successful both actuarial judgment and business acumen needs to be combined.

Drafting of insurance policy is so far limited to identifying the policy format, and appropriate condition from the tariff. The open market scenario would lead to introduction of new products which would include drafting and modifying of new policy documents, clauses, conditions, and warranties. This would result in multiple policy wordings and formats.

Understanding and predicting developing trends in the marketplace, technology, economy, financial market, legal and political economy has influence on the rate. This is a continuous activity, which will lead to changes to the existing rates of introduction of new products of modification to existing products. Insurance research would now become a specialized function on its own.

Industry should gear up to this challenge in paucity of resources and augment training for suitable candidates.

3.5. Strengthen supply side of economics

Insurance companies with good underwriting base, data and IT would be able to slice and dice the data, identify superior risk, rate the risk and charge premium accordingly. Skimming the cream would result in reduced premium, and better service for superior risks. This is a double edged sword, for while it is beneficial for insured with good risk the insured with substandard risk would see increase in premium and some might not be able to place the risk. For example if motor is detariffed, more than 25% of the risk would find it difficult to get placed. This raises the question of making insurance available to all insured with ability and willingness to pay the price. A market mechanism to cover high risk insureds, have to be devised prior to detariff. A plan for sharing of residual risk by market participants needs to be developed.

3.6. Strengthen Policy holder protection mechanism

With the advent of open market, plethora of products is expected to hit the market. Unless the consumers are insurance savvy they might not be in a position to compare policies and understand the subtle differences in the policy wordings, its impact of pricing and claims payment. As such the policyholder might be left with a policy which does not provide required cover, or pay more premium for a coverage that is not required or policy with restricting conditions. The insurance companies must be made aware of their responsibility in educating the customers about the insurance policy, its features, benefits, suitability of the product to the needs of customer. In the interest of the policyholders IRDA should formulate a policy guideline to create customer awareness, enable them to take informed decisions on purchasing insurance policy. Similarly IRDA should devise procedures to monitor the insurance companies' sales practices, products and its pricing and devise a suitable product disclosure mechanism to facilitate customer in making informed decision.

4. The new role for IRDA in de-tariff regime

With the file & use system of rating, the IRDA as approving authority needs to review filed actuarial documents, checking accuracy of calculations, actuarial projections, and compliance with standards prescribed. Prior to approval adequacy of data and appropriateness of models and rates filed have to be tested. It is recommended that rules related to reporting, filing documentation and procedures for submission, approval be devised keeping in mind, ease of use, speed of delivery, and process simplicity.

A monitoring mechanism to ensure that the insurance companies are adhering to the rating guidelines, underwriting practices, and to determine compliance to the regulations be established.

The process for appeal, process for initiating corrective actions against non compliant insurance organisation and related regulatory system needs to be announced prior to detariff.

A compliant mechanism to collect and resolve complaints from consumer representative, legislative and industry regarding insurance rates, and rating activities needs to be put forth.

5. Conclusion

To conclude, the proposed detariff presents exciting opportunities and challenges before Indian Insurance Industry.

There is the opportunity to improve profitability of the industry, by pricing efficiency, increase customer base and expand market by providing premium affordability for those who are outside the insurance net currently. It is also an opportunity to correct the inefficiency in the market, by charging price to commensurate with risk thereby motivating the high risk group to adopt loss prevention measures and bring down the loss cost. Untapped market potential in the insurance industry can be tapped by introduction of new products at affordable price and customers can obtain tailor made policies to suit their needs. The requirement for new skill sets brings in more opportunities to the insurance industry workforce and provides growth opportunities.

The challenge is in the assumptions carried, availability of relevant internal and external data, selecting the suitable rating models, and combining the necessary skills to come up with rating. With no prior experience available internally within company, a cautious approach is warranted.

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