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INTERNATIONAL ACTUARIAL ASSOCIATION



Institute of Actuaries of India



13th Global Conference of Actuaries 2011

Emerging Risks... Daring Solutions

India Insurance: Industry outlook and developing best-in-class risk capability

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India

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Naveen Tahilyani is a Partner with McKinsey & Co. and is based in India.

- Naveen is the leader of the Financial Service practice in India. Since joining the firm, he has worked on several engagements in the financial sector across strategy formulation, organisation and operations. He has served clients in India, Europe, South East Asia and the Middle East.
- He has worked with leading life insurers in India on topics of agency transformation, growth plans, cementing Banca partnerships, improving persistence and redesigning operating models
- Naveen holds an MBA from Indian Institute of Management, Ahmedabad and a Bachelor of Technology from Indian Institute of Technology, Madras.

Naveen- Please edit your profile



Content

Global Insurance – Emergence of Asia as a 'Global Insurance Powerhouse'

India Insurance – Getting ready for the new era

Building best-in-class risk management capability



Key global trends in the Insurance sector



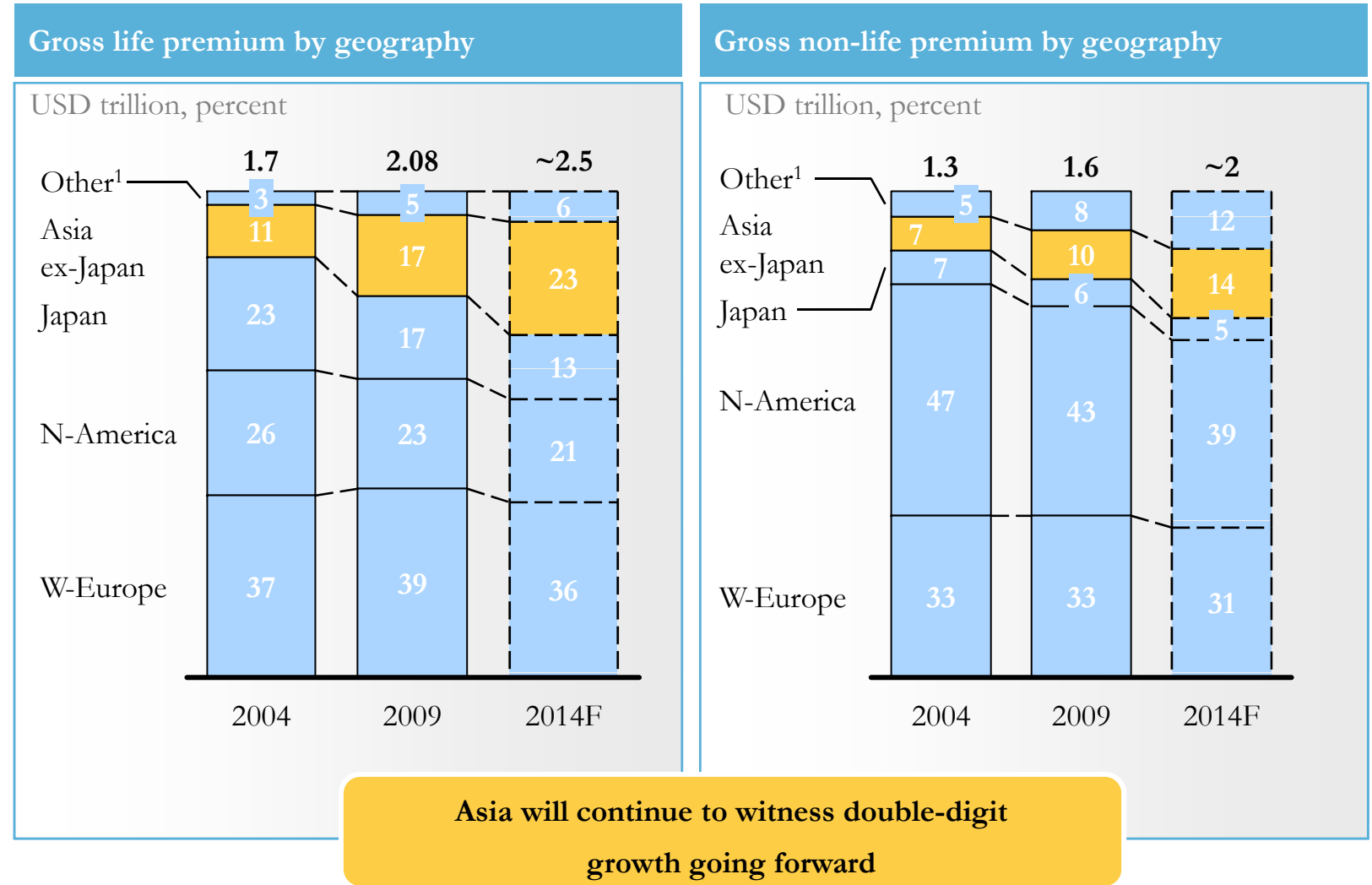
1 Insurance industry in Europe and US is recovering slowly from aftermath of the financial crisis, and is still to reach pre-crisis levels in terms of profitability and value

2 Asia has emerged as the 'global powerhouse' for insurers (both life and P&C), contributing to majority of the growth in the sector


3 Regulatory interventions have heightened significantly across regions, with higher capital requirements resulting in falling RoEs


SOURCE: McKinsey analysis


2 Asia has emerged as a major ‘powerhouse’ for insurers, contributing to majority of the growth in the sector



SOURCE: McKinsey analysis


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Content

Global Insurance – Emergence of Asia as a 'Global Insurance Powerhouse'

India Insurance – Getting ready for the new era

- **Life insurance**
- General insurance

Building best-in-class risk management capability



India Life Insurance – Key messages

1

Life insurance market in India has seen rapid growth in the past decade and has emerged as a top 10 market in world

2

However, beneath the surface, growth has been driven by short-term investment-oriented products where customer has not been fully aware of underlying risks. As a result, the industry has not been able to meet core objectives of providing long term savings and protection

3

Further, business models which players have adopted have significant structural challenges, constraining full potential of value creation

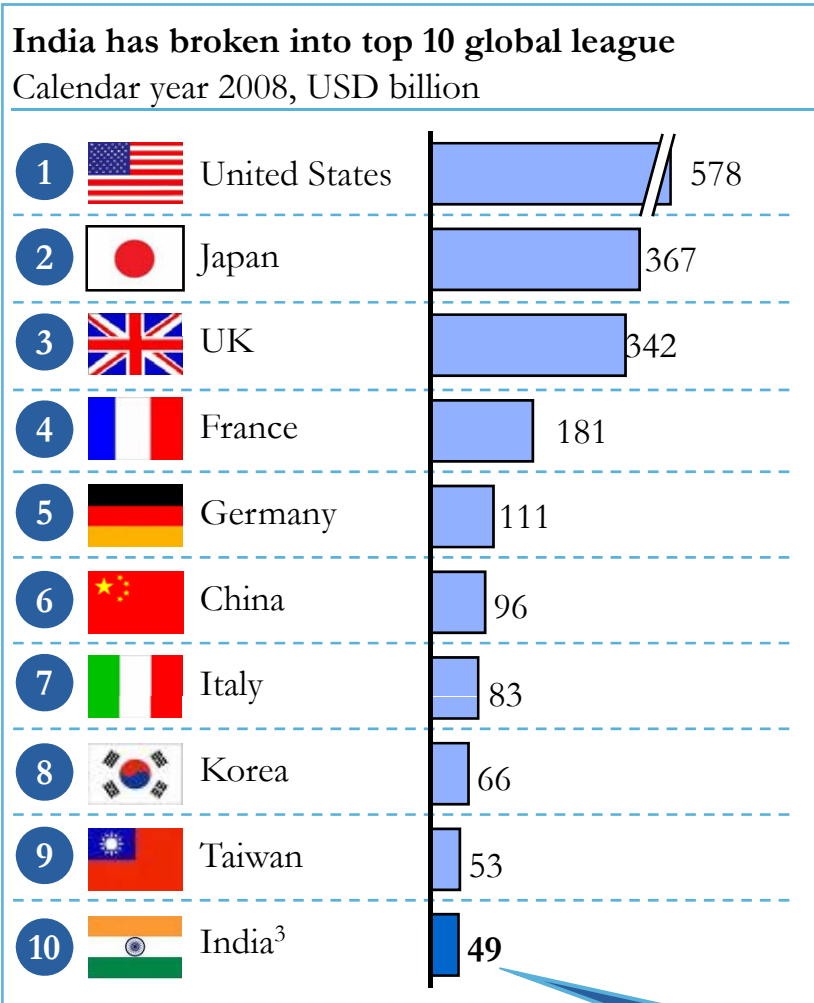
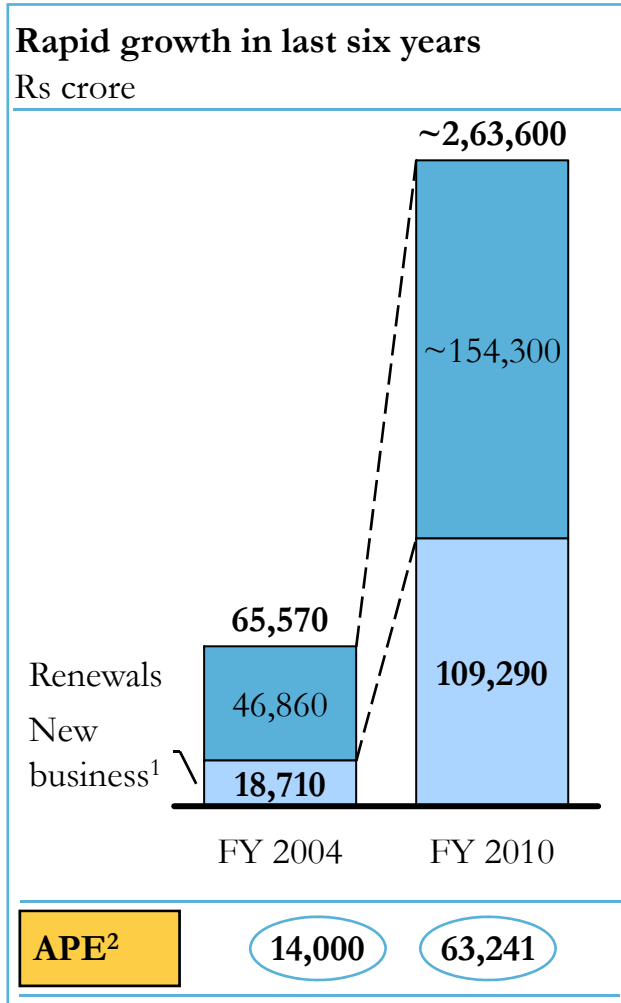
4

For the industry to meet core objectives of long-term savings and protection while evolving to balanced and vibrant structure, the interplay among and action taken by three sets of stakeholders is critical:

- ◎ **Manufacturers:** Innovating business models and products
- ◎ **Regulators:** Ensuring appropriate oversight to balance objectives
- ◎ **Distributors:** Creating access and consumer education



1 Indian life insurance market has grown rapidly in the last few years and is now the tenth largest market globally



~USD 58 bn in FY 2010

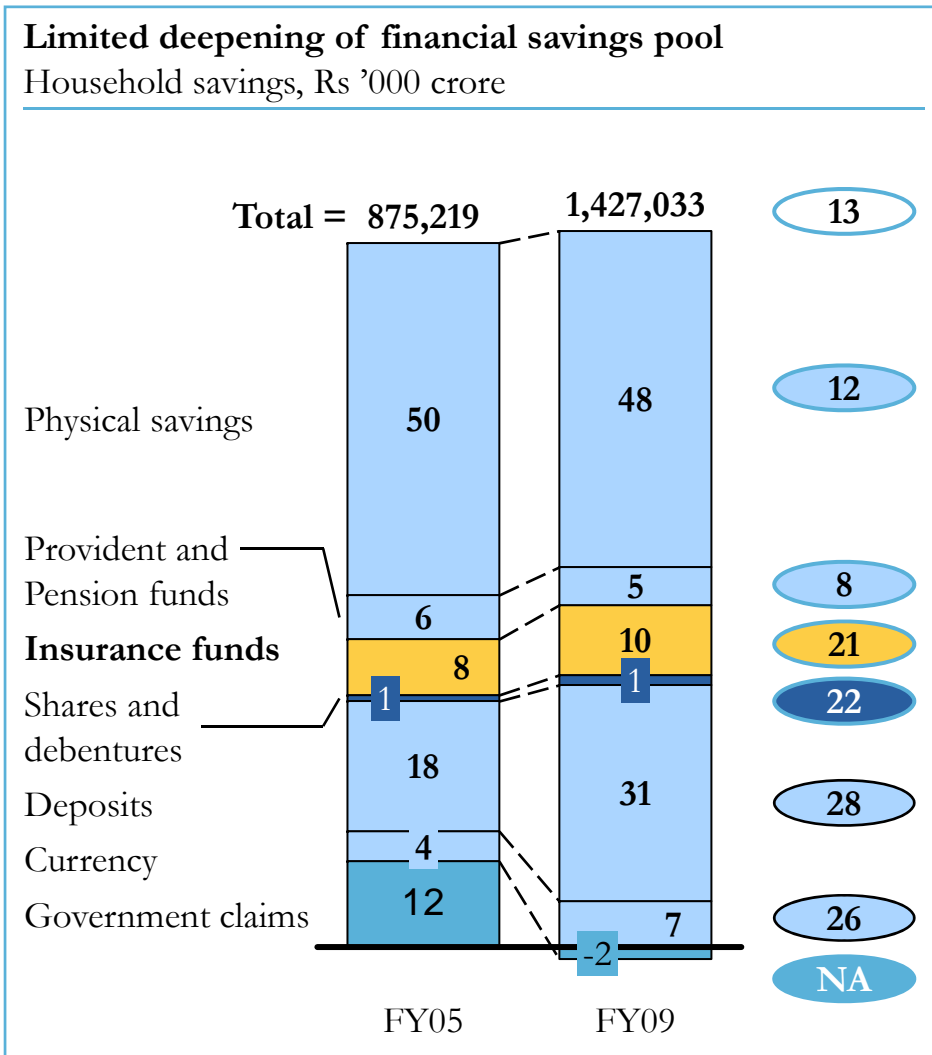
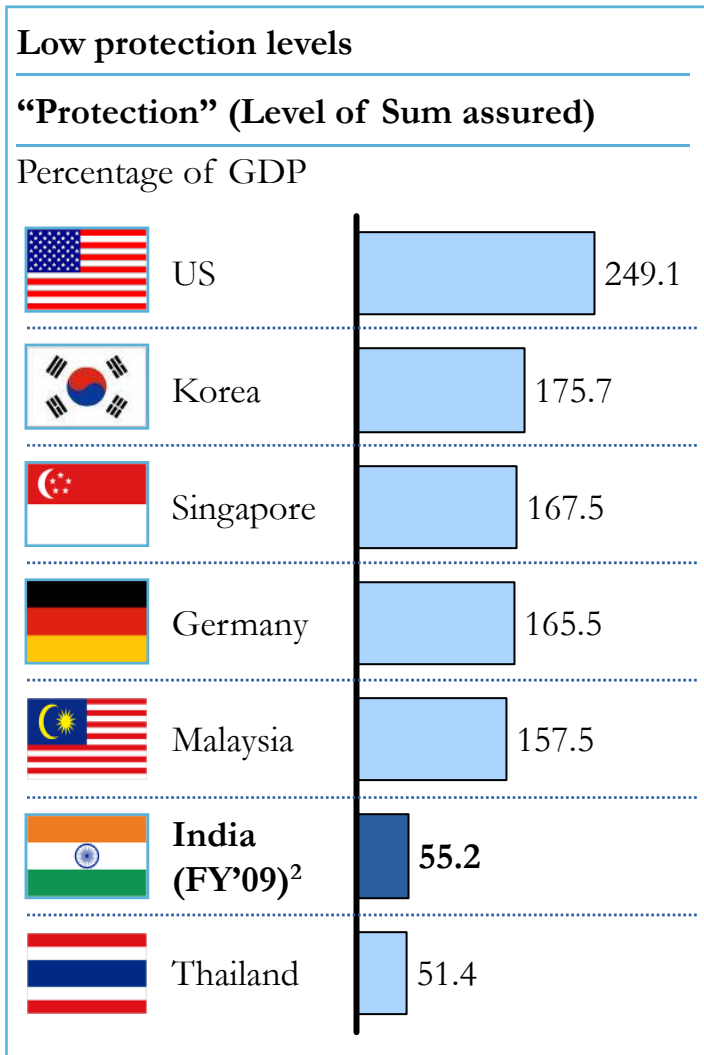
1 Calculated taking 100% credit for regular single premium
 2 Calculate taking 100% credit for regular premium and 10% credit for single premiums
 3 Financial year ending March 2009
 SOURCE: IRDA; Swiss Re Sigma;

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2 While the premium size is high, the protection levels remain low, with life yet to achieve objective of deepening savings pool



1 Estimated for 2009 by taking same persistency as 2008

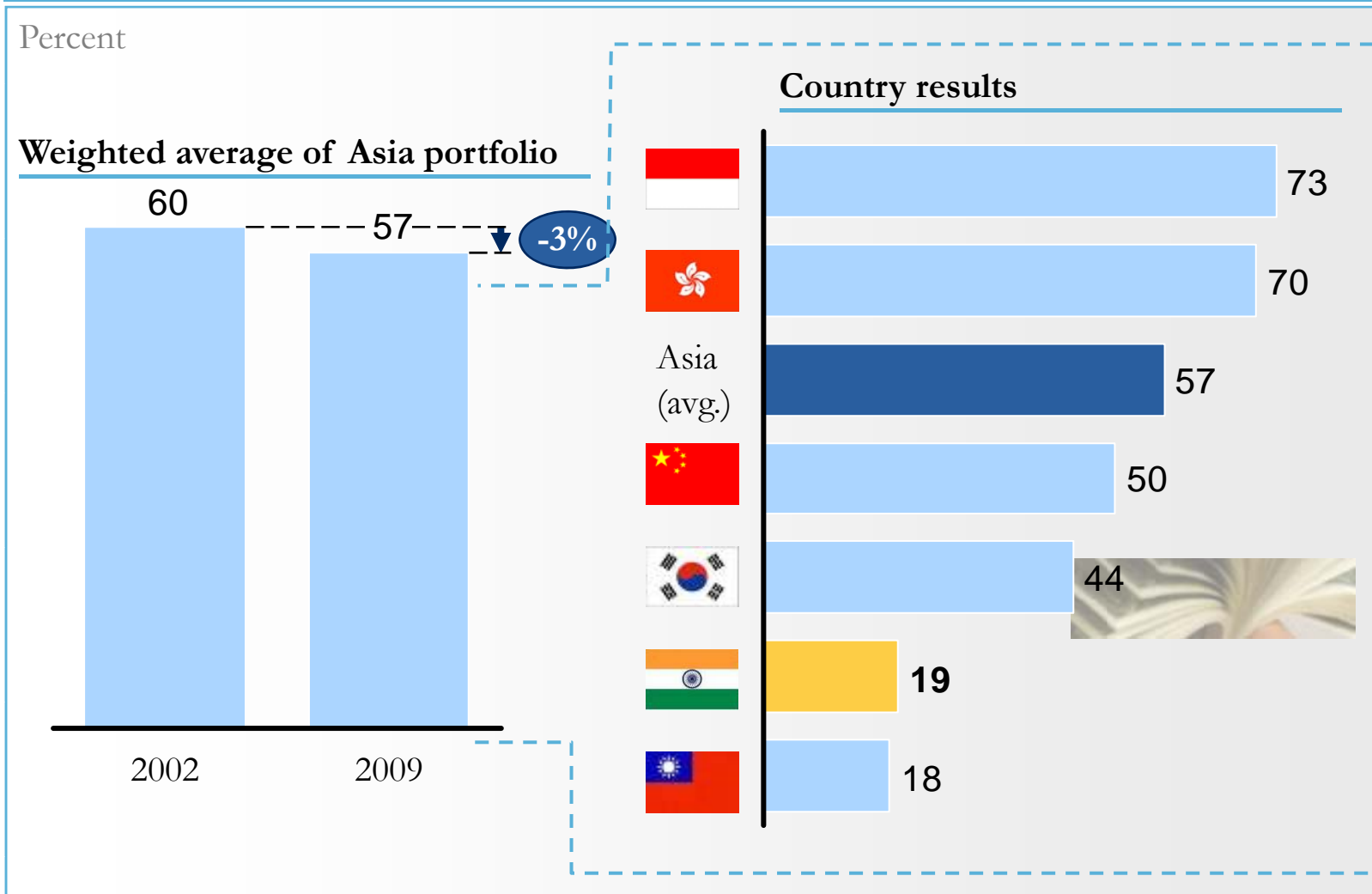
2 Estimated the Sum Assured by keeping the ratio of Sum assured – GWP to sum assured -NBP same as of 2008

SOURCE: Global Insight; ICI World Factbook, 2008, IRDA; Swiss Re; Country Insurance handbook,

3 India is significantly less profitable compared with other Asian markets

LARGE ASIAN
PLAYER EXAMPLE

New business margin as a percentage of APE

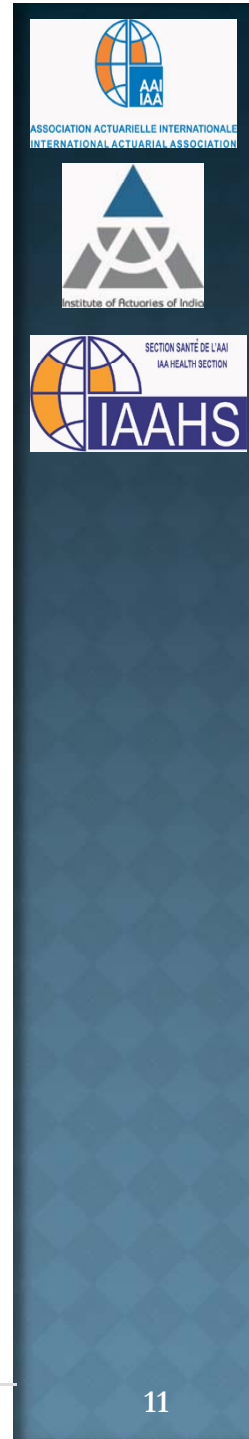


SOURCE: Company annual reports

3 This is primarily driven by the economically unviable distribution models

	Typical Cost ratios ¹ Percent of APE	Estimated Cost overruns (over breakeven costs) (Percent of APE)	Key challenges faced
Agency channel	50-100	20-75%	<ul style="list-style-type: none"> High UM attrition (75%+) Low economic incentives for agents resulting in low activation rates (20-25%) High fixed cost infrastructure
Third-party banca channel	55-65	25-40%	<ul style="list-style-type: none"> Significant product / training support and upfront commission sharing with the bank Products not customised
Captive banca channel	35-45	5-20%	<ul style="list-style-type: none"> Lack of integrated product development and operations





1. Includes commissions and Opex
SOURCE: McKinsey analysis



3 Also the interventions by regulator are unprecedented in their intensity and pace of implementation impacting economics

In India the recent regulatory interventions are unprecedented in their scope

Regulatory announcements in UK comes closest

Country	Cap on charges ¹	Cap on surrender charges	Minimum sum assured	Minimum lock-in period	Minimum guaranteed return ²
 India	✓	✓	✓	✓	✓
 China	⋯	✗	✗	✗	✗
 UK (effective 2012)	⋯	✗	✗	✗	✗
 US	✗	✗	✗	✗	✗

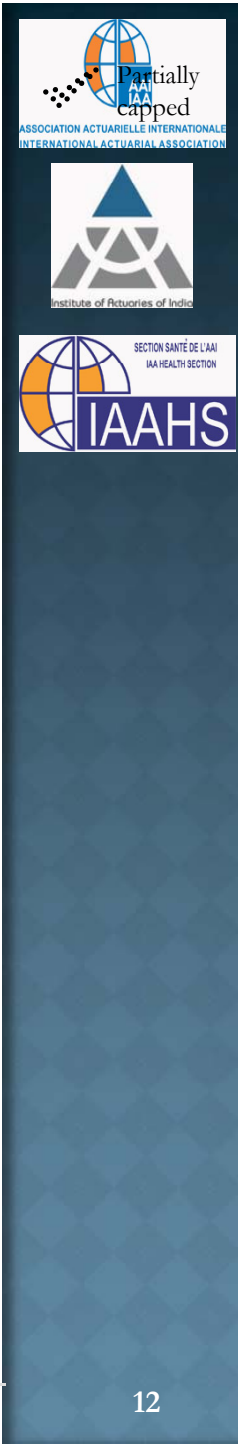
Recent RDR regulation (announced in 2008) will create another discontinuity in market (effective 2012)

- Mandates truly independent IFAs to receive only fees from customers
- No upfront commission for any other category of advisors
- Raised qualification standards

However the UK regulator has given players four years to realign their operating model

In India, players have been given just three months to align their business and operating model

1. Includes allocation, fund management and other charges
 2 Only for pension products;
 SOURCE: Local regulatory sources

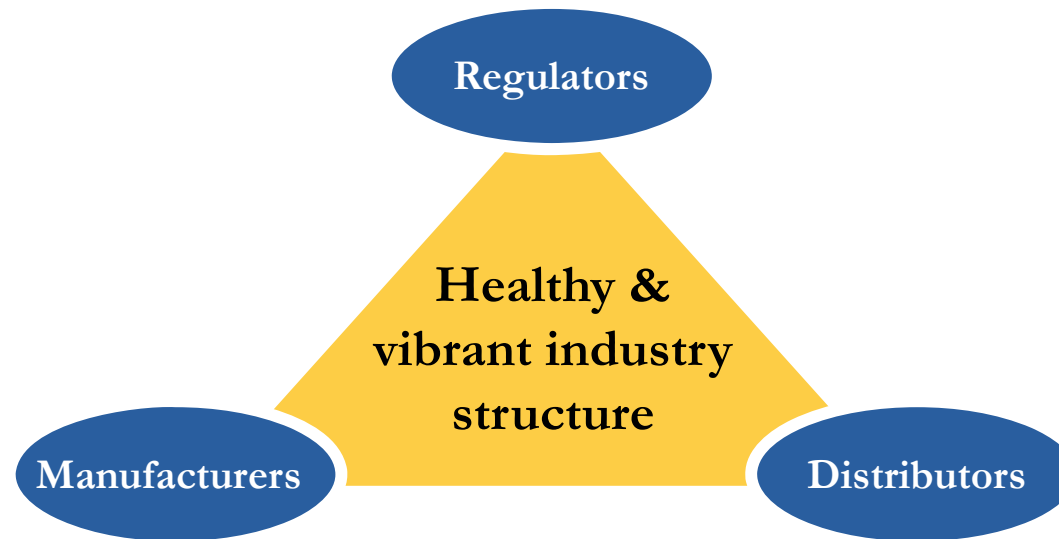


4 Creating a healthy life insurance industry structure would require interplay among actions taken by 3 sets of stakeholders

Over-arching objectives for the industry

- ◉ Long term savings and protection
- ◉ Protection of consumer interests
- ◉ Creation of economic value for shareholders

- ◉ Mechanism and incentives for deepening long term savings pool
- ◉ Appropriate regulatory oversight



- ◉ Efficient and sustainable business models
- ◉ Investing in consumer education

- ◉ Enhancing access to products
- ◉ Driving awareness

Content

Global Insurance – Emergence of Asia as a 'Global Insurance Powerhouse'

India Insurance – Getting ready for the new era

- Life insurance
- **General insurance**

Building best-in-class risk management capability

India General Insurance – Summary of key messages

1

Although the general insurance market has grown rapidly since deregulation (~15%), penetration levels remain flat and have not increased in past few years

2

Industry profitability has been driven entirely with investment income, with players continuing to make large underwriting losses. This has been a result of significant price deterioration since detariffication and under-developed business models

3

Looking ahead, there are 4 different evolution paths for the industry based on interplay of macro-economic environment and player actions. Each of these paths will have dramatically different outcomes

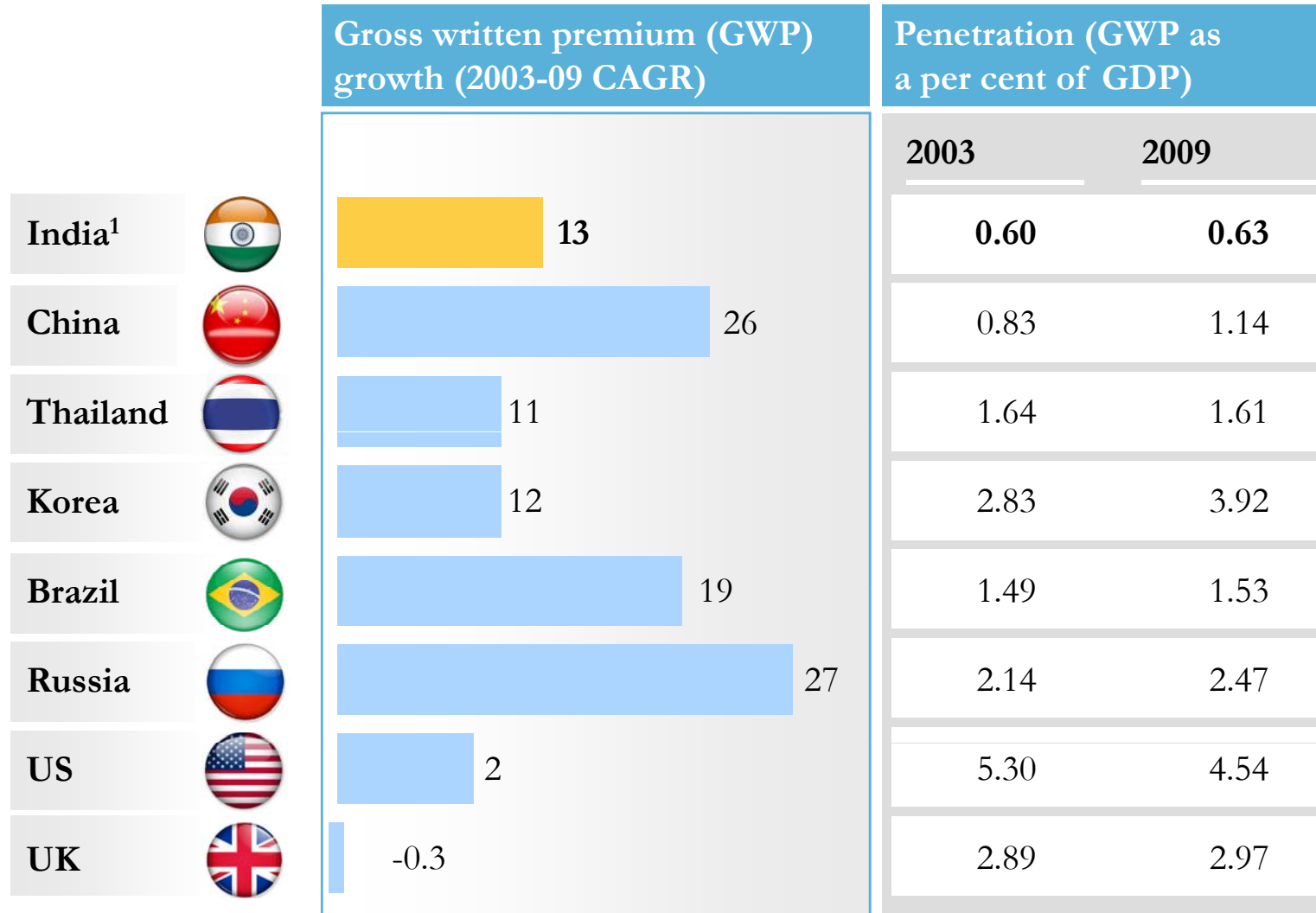
4

Moving to a high performing industry structure and performance will require an integrated set of actions from both industry players and the regulator



1 Penetration levels in India remain extremely low compared to other P&C markets and has not increased over time

Percent



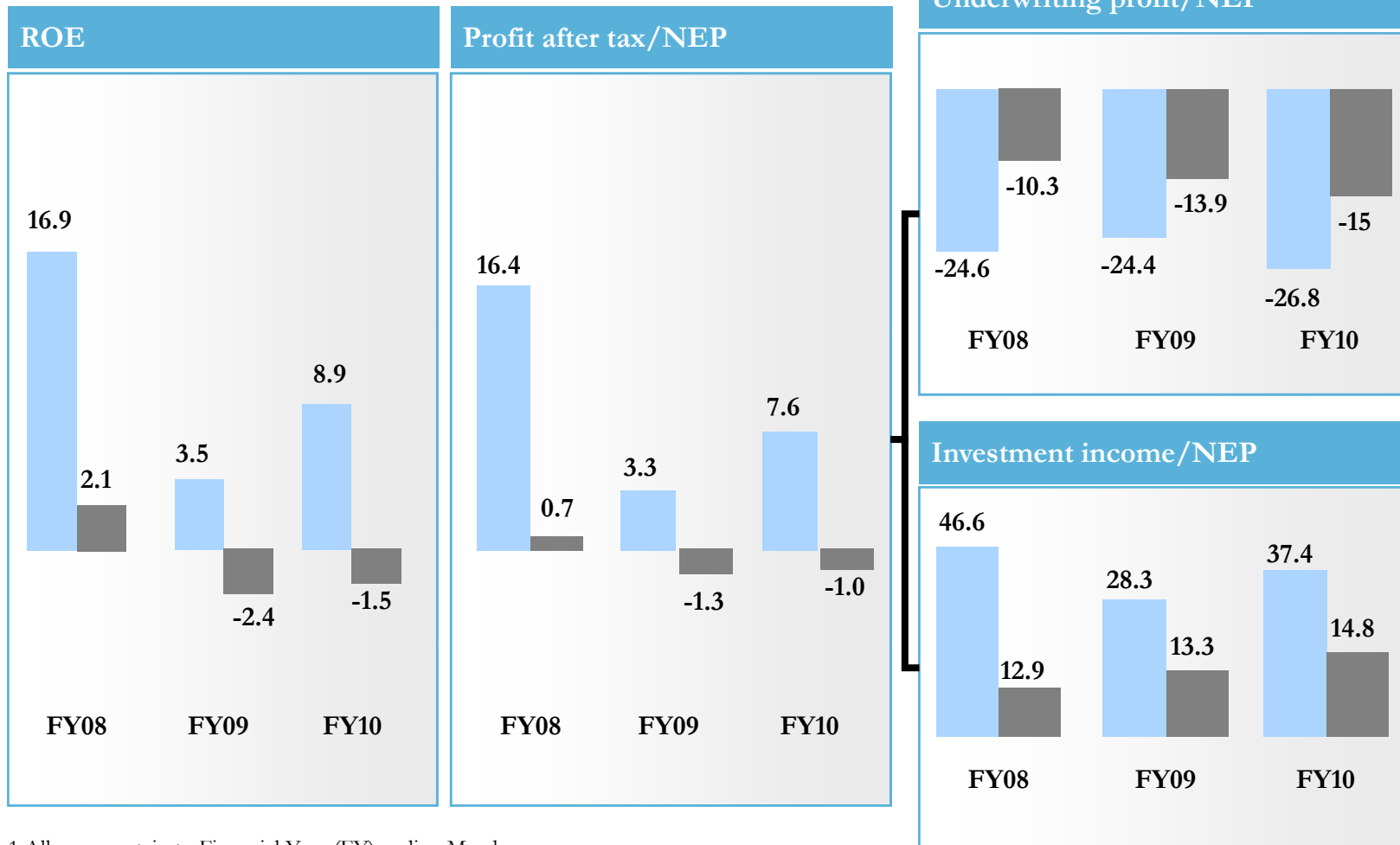
¹ Financial year 2003-04 and 2008-09 respectively
 SOURCE: IRDA journals; IRDA annual reports; Swiss Re Sigma



2 Players continue to make large underwriting losses, with profitability being driven entirely by investment income

Percent

PSU
Private



1 All years pertain to Financial Year (FY) ending March

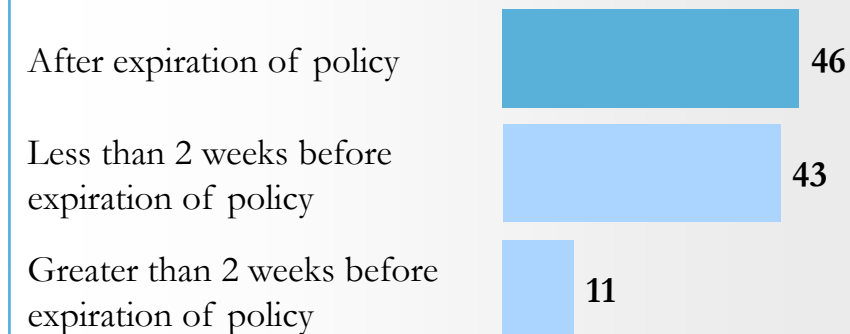
SOURCE: IRDA; General insurance council; annual reports; McKinsey analysis

2 Consumer involvement is low and lacks buying sophistication and maturity

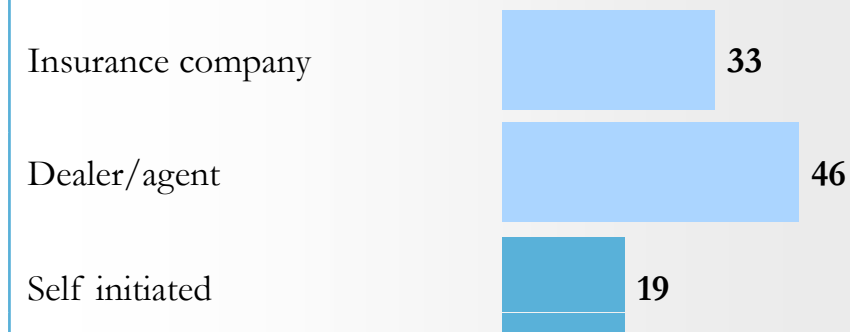
MOTOR EXAMPLE

Very high push and low involvement in the buying process ...

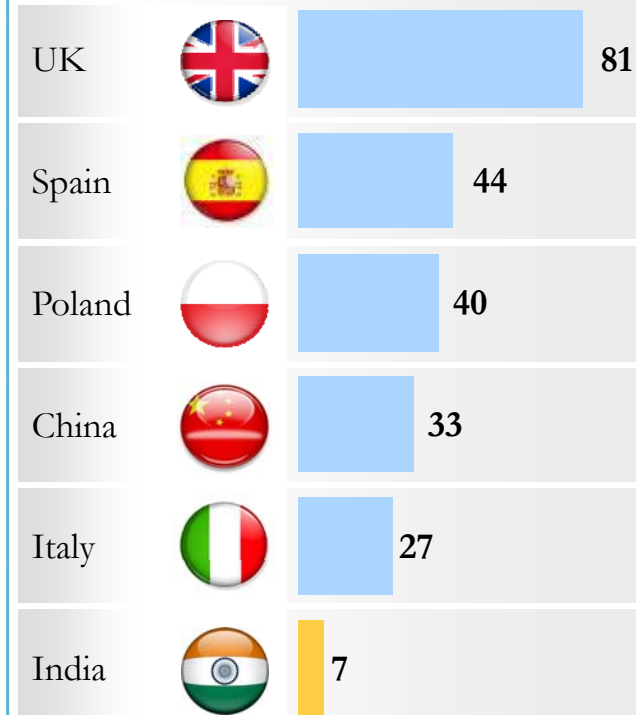
When did you start renewal process for the insurance
(per cent of respondent; n = 834)



Who initiated process of renewal
(percent of respondent; n = 834)



... resulting in consumer not 'actively' exercising choice



Active shopping has not been prominent but will improve as market sophistication increases

SOURCE: McKinsey analysis

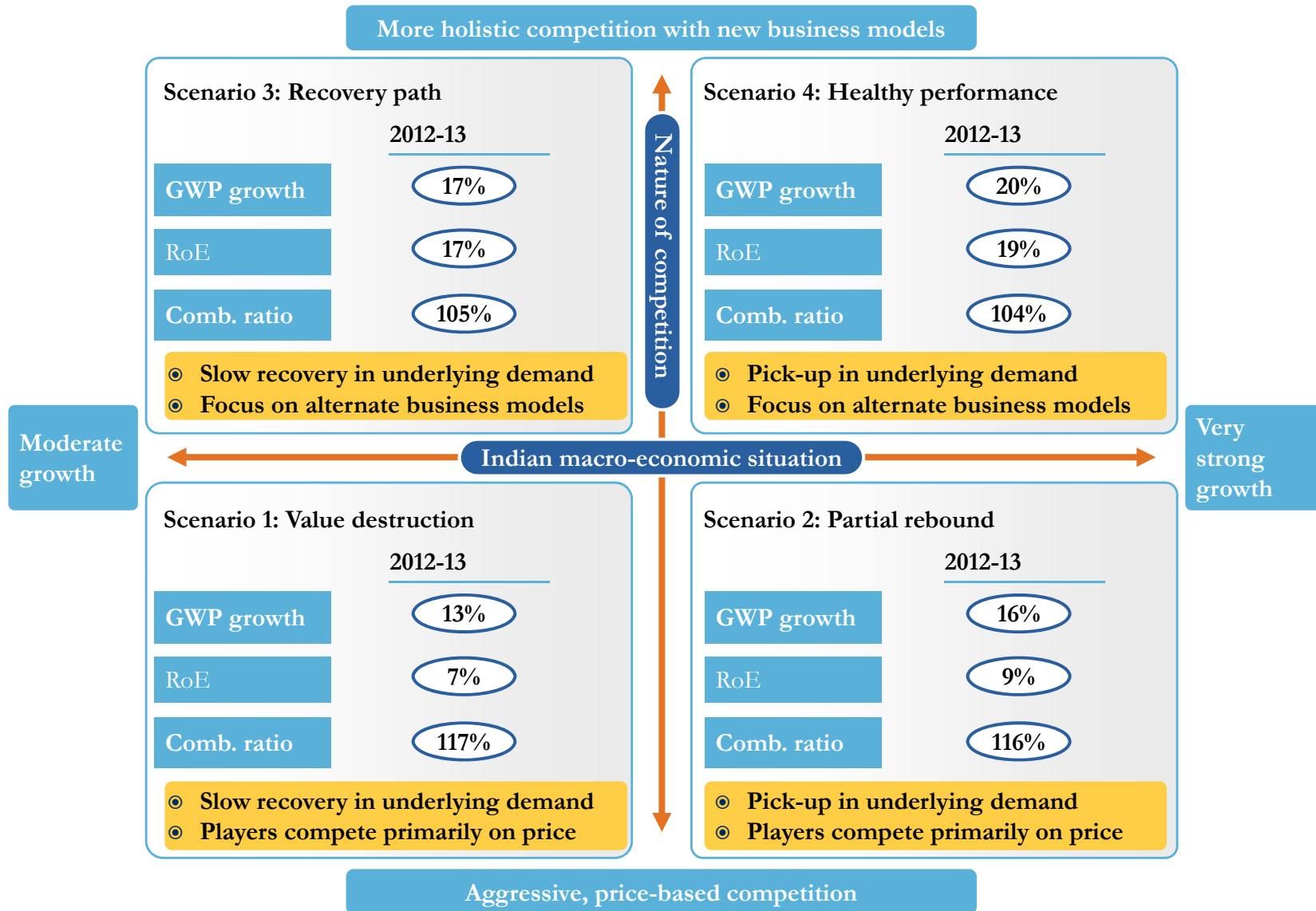


3 There have been varied experiences from other markets in terms of evolution post liberalization

	Examples
1 Sustained price-war resulting in worsening of market economics	<ul style="list-style-type: none">Germany China (on-going) 
2 Partial recovery driven by combination of player and regulatory actions	<ul style="list-style-type: none">Korea 
3 Stable and healthy market due to largely rational competitive actions	<ul style="list-style-type: none">Poland Czech Republic 

SOURCE: McKinsey analysis

3 There are 4 evolution paths for the market looking ahead, with dramatically different outcomes

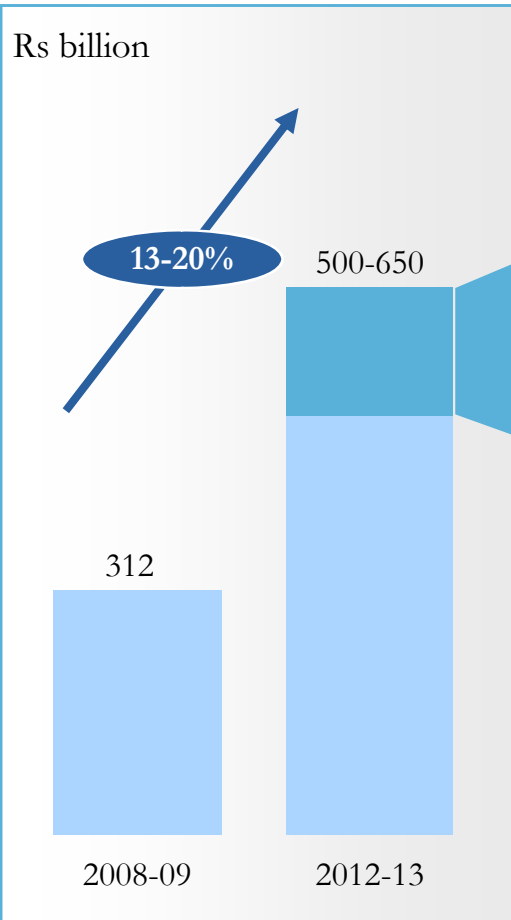


SOURCE: McKinsey analysis



3 Across scenarios, Health and SME will grow rapidly; motor to remain the largest line

P&C premiums likely to grow by 15-22% across the four scenarios



Health and SME likely to show strongest growth

	Growth, 2008-09 to 2012-13 Percent	Share of market	
		2009	2013
Motor	6-17	~43	33-36
Health	25-30	~22	30-32
Large commercial	8-11	~16	14-15
SME	16-22	~6	7-8
Specialty commercial	14-16	~7	6-7
Other personal and rural	~20	~6	6-7

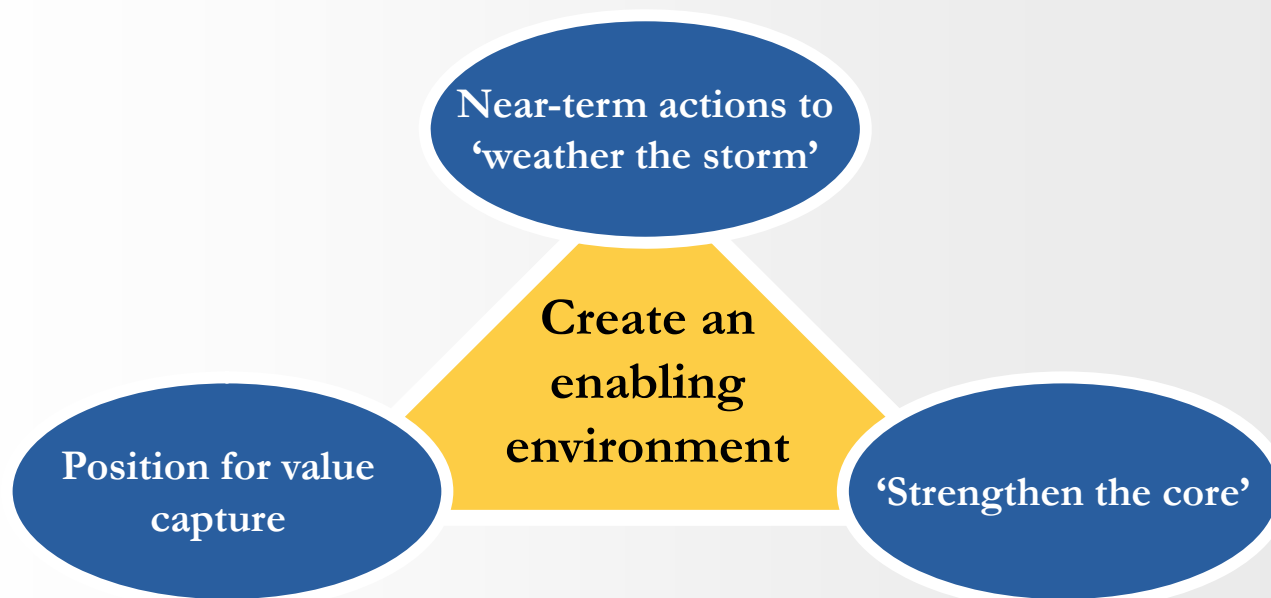
1 Exchange rate: USD 1 = Rs. 45

2 Includes aviation, liability, credit insurance, special risks

SOURCE: McKinsey analysis

4 Key imperatives for the industry players

- ⦿ Reduce operating and non-operating expenses through various levers
- ⦿ Control leakages in claims process
- ⦿ Bring more discipline in pricing



- ⦿ Develop **consumer centric approach** (i.e. tailored offerings for different segments, customer experience)
- ⦿ **Revamp traditional channels** (e.g., agency, brokers) and **innovate on new channels** to tap new opportunities (e.g., direct, retailers)
- ⦿ Build a **strong claims organisation** and embed transactional excellence
- ⦿ Enhance **underwriting capability**
- ⦿ Build better product management capabilities
- ⦿ Strengthen financial discipline, performance and talent management

SOURCE: McKinsey analysis

Content

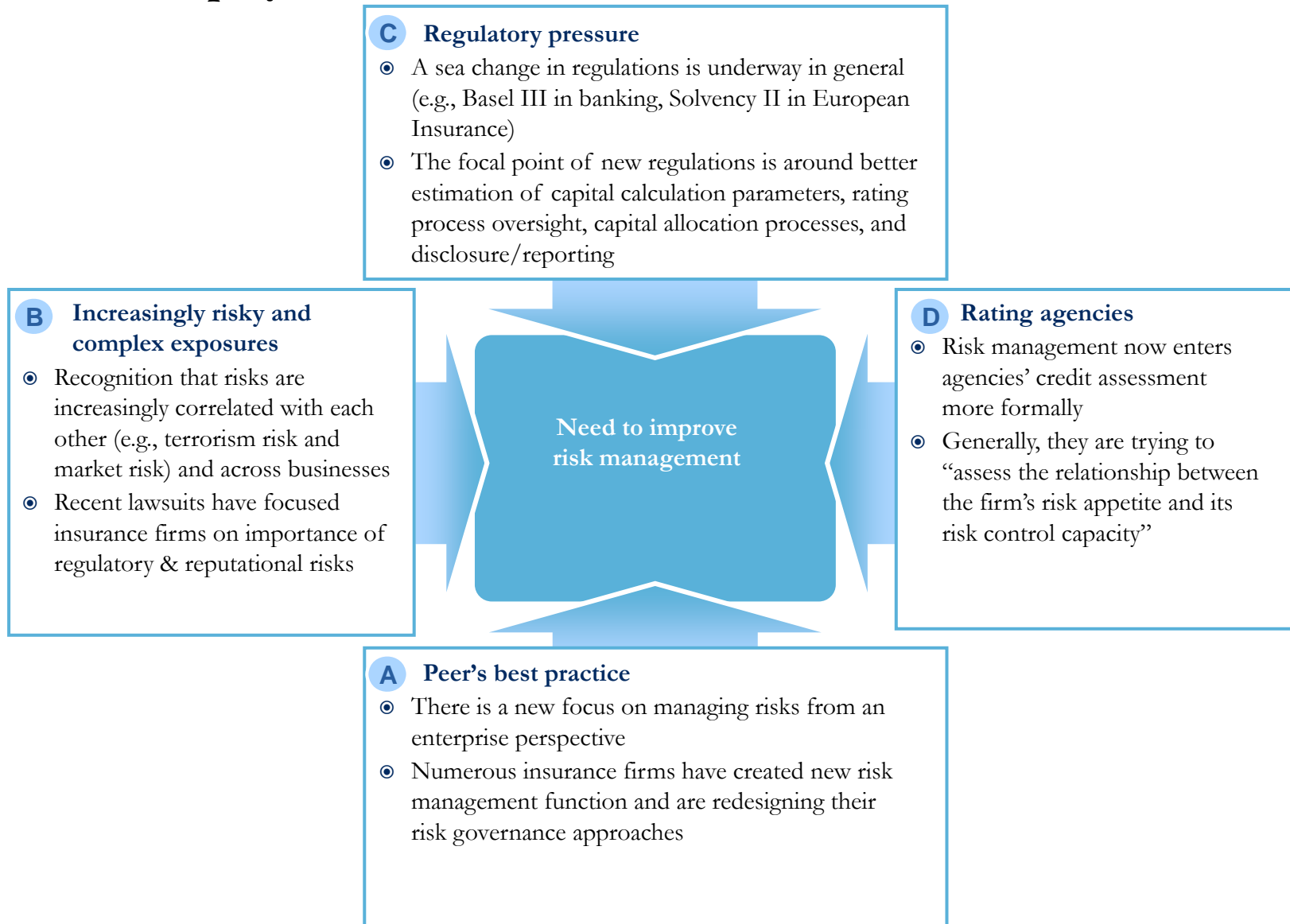
Global Insurance – Emergence of Asia as a
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**Building best-in-class risk management
capability**



4 main forces at work to raise the bar on risk management for insurance players



SOURCE: McKinsey analysis



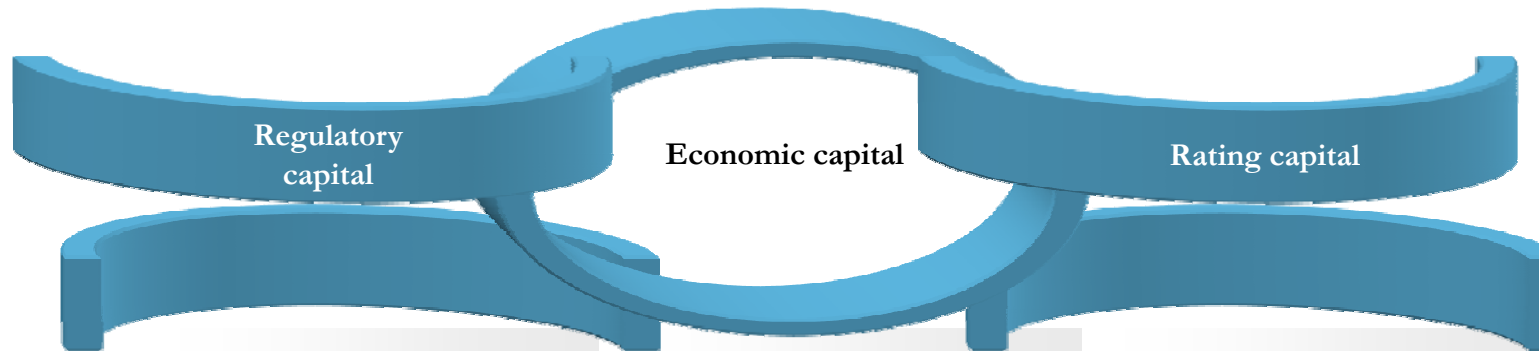
Risk management in insurance involves several key areas, of which financial risk management is a critical element

 Focus of discussion

Strategic risk management	<ul style="list-style-type: none"> ⊙ Enterprise risk management (ERM) ⊙ Re-insurance
Financial risk management	<ol style="list-style-type: none"> 1 Capital management 2 Rating advisory 3 ALM/treasury
Portfolio & investment management	<ul style="list-style-type: none"> ⊙ Investment portfolio optimization
Commercial risk management	<ul style="list-style-type: none"> ⊙ Risk-based pricing
Operational risk management	<ul style="list-style-type: none"> ⊙ Operational risk management ⊙ Reputational risk management
Regulation	<ul style="list-style-type: none"> ⊙ Solvency II
Organization and governance	<ul style="list-style-type: none"> ⊙ Risk organizational design ⊙ Risk diagnostic



1 Capital management has to keep an integrated view on 3 different capital definitions



Stakeholder	• Regulator	• Management	• Rating agencies
Source/Scope	• Externally imposed, it affects all legal subs and group	• Internal imposed, it reflects all sources of risks in the company	• Externally imposed, it affects rated entities and group
Key objectives	• Maintain minimum required regulatory solvency	• Maximize risk-adjusted returns and minimize cost of capital	• Achieve/maintain rating target and financial strength
Impact of failures	• Very high, loss control or legal insolvency	• No significant financial penalty if restriction is exceeded	• Very high, significant financial impact of downgrade
Internal level of consideration	• Not always directly monitored as part of risk management	• Primary measure of risk/capital in internal discussions	• Viewed as the most binding constraint for insurers
Status/development	• With Solvency II, regulatory capital will tend to converge toward a more economic view	• Majority of insurers use internal capital models, with different level of development	• Rating capital assessment and risk-based Solvency II models will tend to converge
Impact/relevance in the financial crisis	• Very high, as insurers' financial strength/solvency is the key priority for survival	• Secondary in the short-term, more focus on risk-capital integration in the medium-term	• Very high, as insurers' financial strength/solvency is the key priority for survival

Source: Team analysis

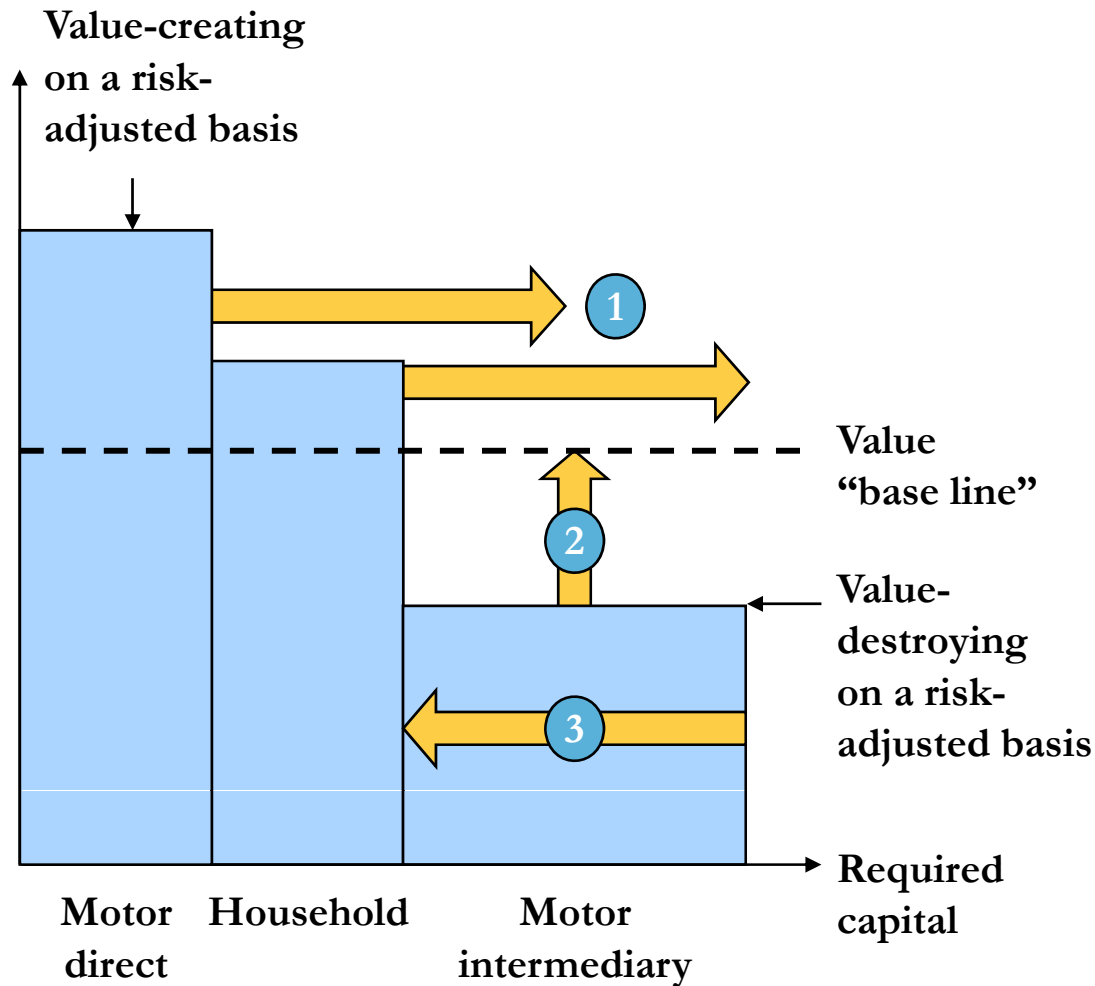
1 There are 3 main reasons why insurers should embed capital management into all aspects of their business operations

Support to business decisions	<ul style="list-style-type: none">○ Several key business decisions benefit from a detailed view of risk-based capital, such as:<ul style="list-style-type: none">■ Allocation of resources across business lines■ Target-setting by line of business■ Reinsurance purchasing
Regulatory/ rating agency requirements	<ul style="list-style-type: none">○ Regulators and rating agencies increasingly require companies to have a view on risk and capital requirements, and they will penalize insurers that do not do so
Financial market requirements	<ul style="list-style-type: none">○ Financial markets increasingly require active capital management<ul style="list-style-type: none">■ Over-capitalized companies face pressure to return capital■ Under-capitalized companies find it difficult to raise funds or even stay in business



1 Capital allocation: risk-adjusted returns can help identify segments to target, to scale down and to turn around

Operational planning example: Risk-adjusted performance of business units

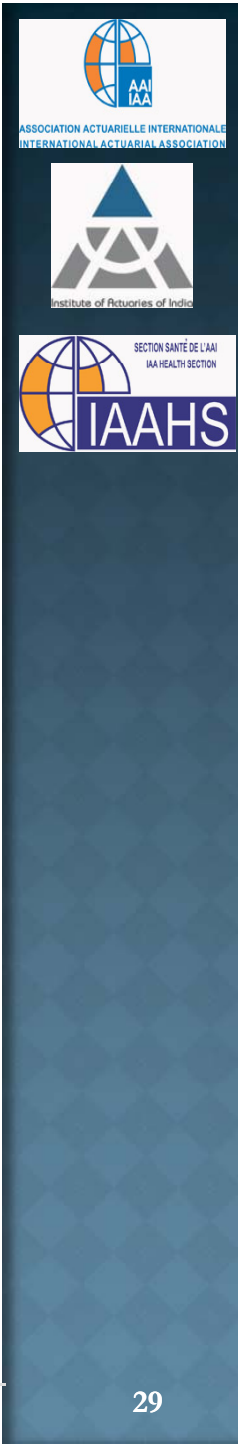
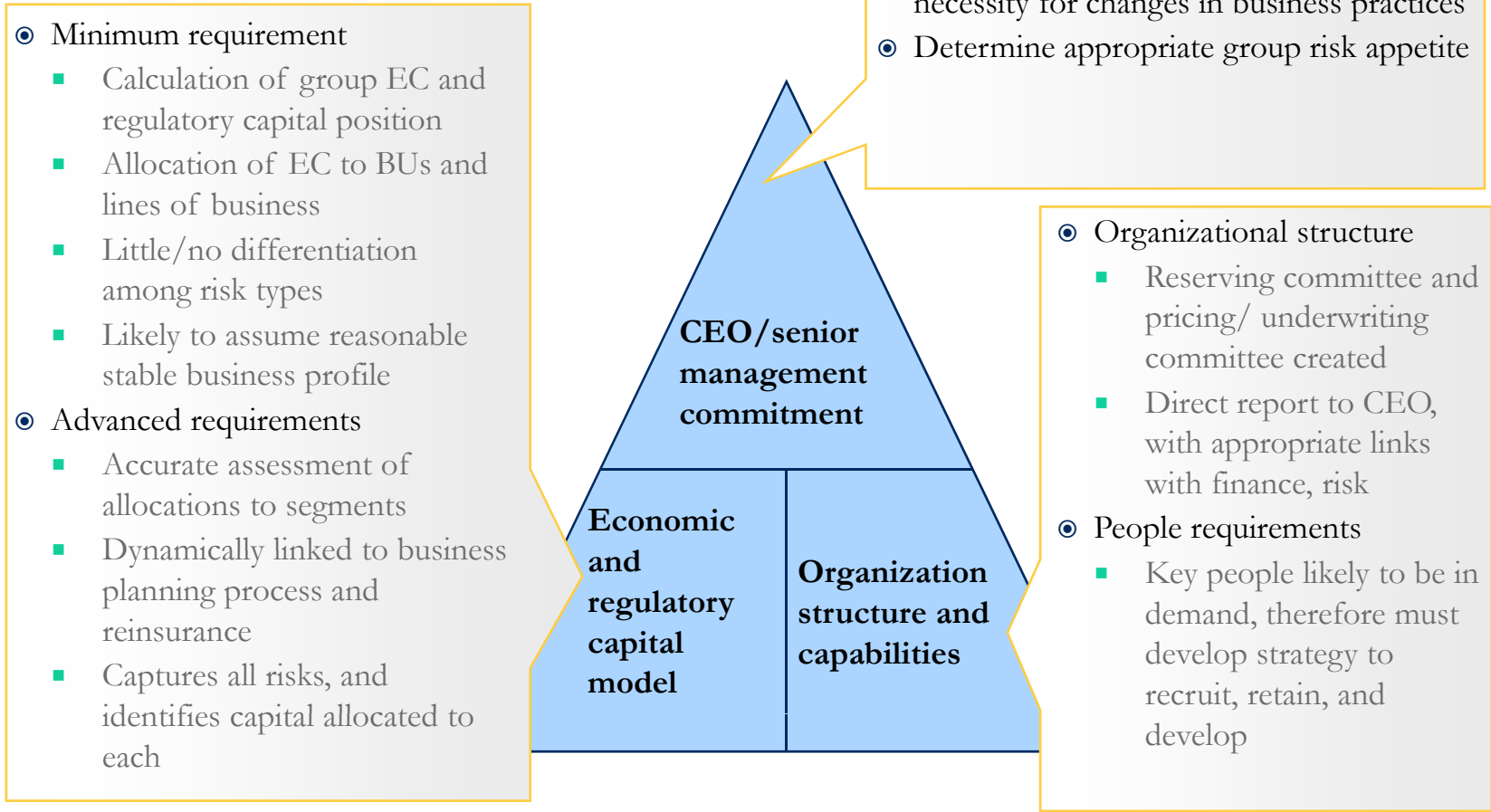


Insurers can enhance profitability by:

- 1 Reallocating capital to businesses with higher returns on economic capital (business units 1 and 2)
- 2 Increase profitability of business unit 3 (e.g., increase pricing) to reflect capital consumed
- 3 Reduce amount of risk capital invested in business (e.g., scale down or exit business)

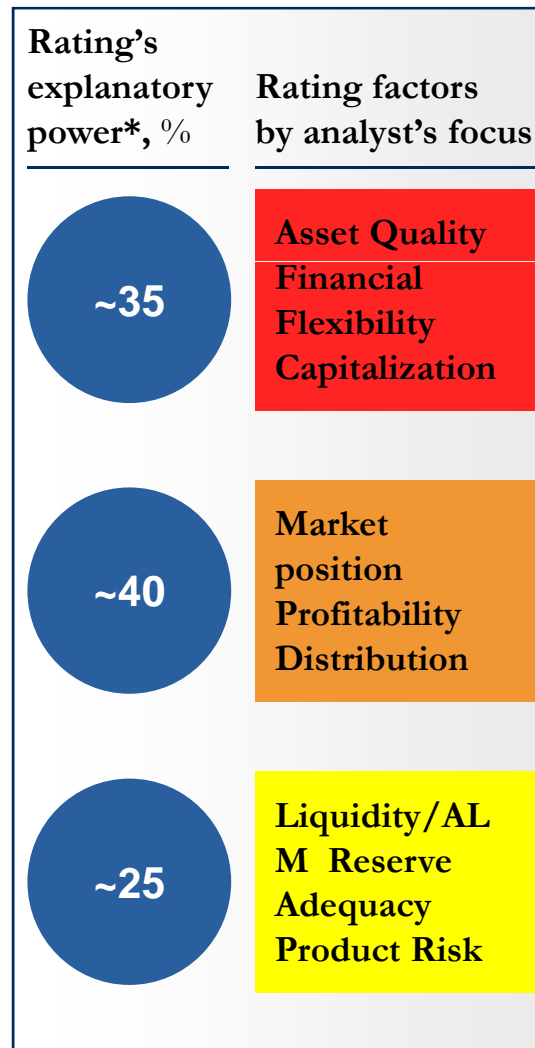
1 The three fundamental building blocks to successful risk and capital management

Building blocks of successful capital management




2 A clear understanding of a communication plan around rating factors of rating agency can improve rating position

- Very reactive to events
- Medium reactive to events
- Low reactive to events




Summary rating card			
Company XYZ			
Computed rating card			
Key factor	Scorecard quantitative result	Scorecard rating	Default weightings, %
Market position and brand	3.50	Aa3	20
Distribution	7.50	Baa1	8
Product focus and diversification	3.75	Aa3	12
Asset quality	2.80	Aa2	5
Capital adequacy	6.00	A2	12
Profitability	6.50	A3	15
Liquidity and ALM	1.00	Aaa	5
Reserve adequacy	3.00	Aa2	5
Financial flexibility	3.00	Aa2	18
Final rating	4.33	Aa3	100


Source: The Firm's rating advisory tools



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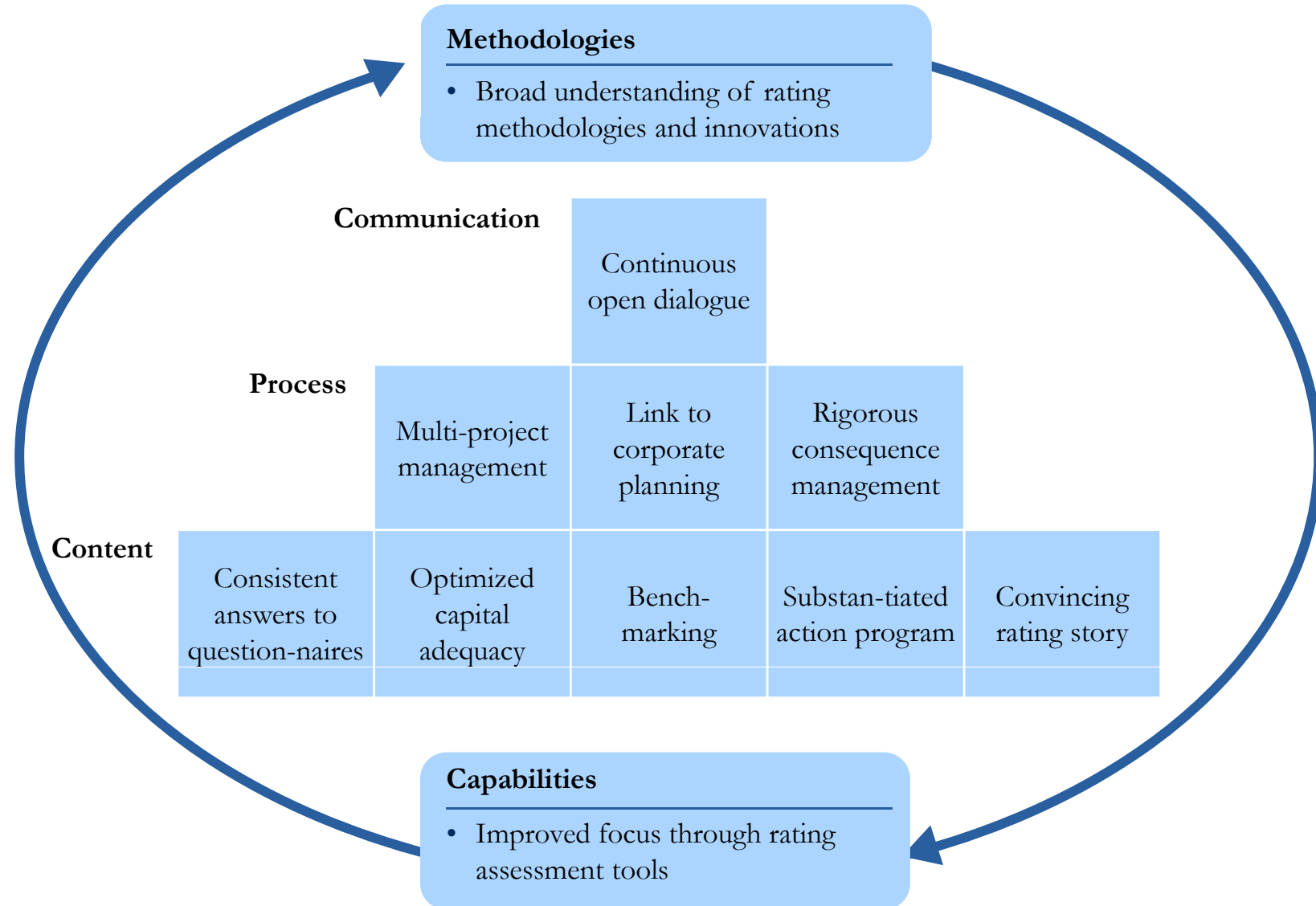
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2 Advanced rating management should be based on a profound understanding of rating methodologies and advanced capabilities, as well as effective dialogue



2 Rating assessment tools are highly effective to build capabilities to guide the dialogue with rating agencies and the impact of strategic changes

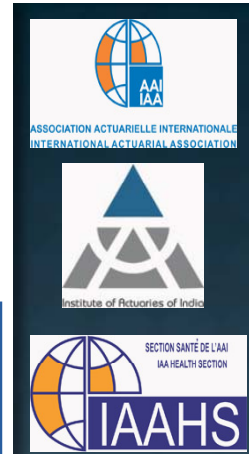
EXAMPLE

■ Detailed



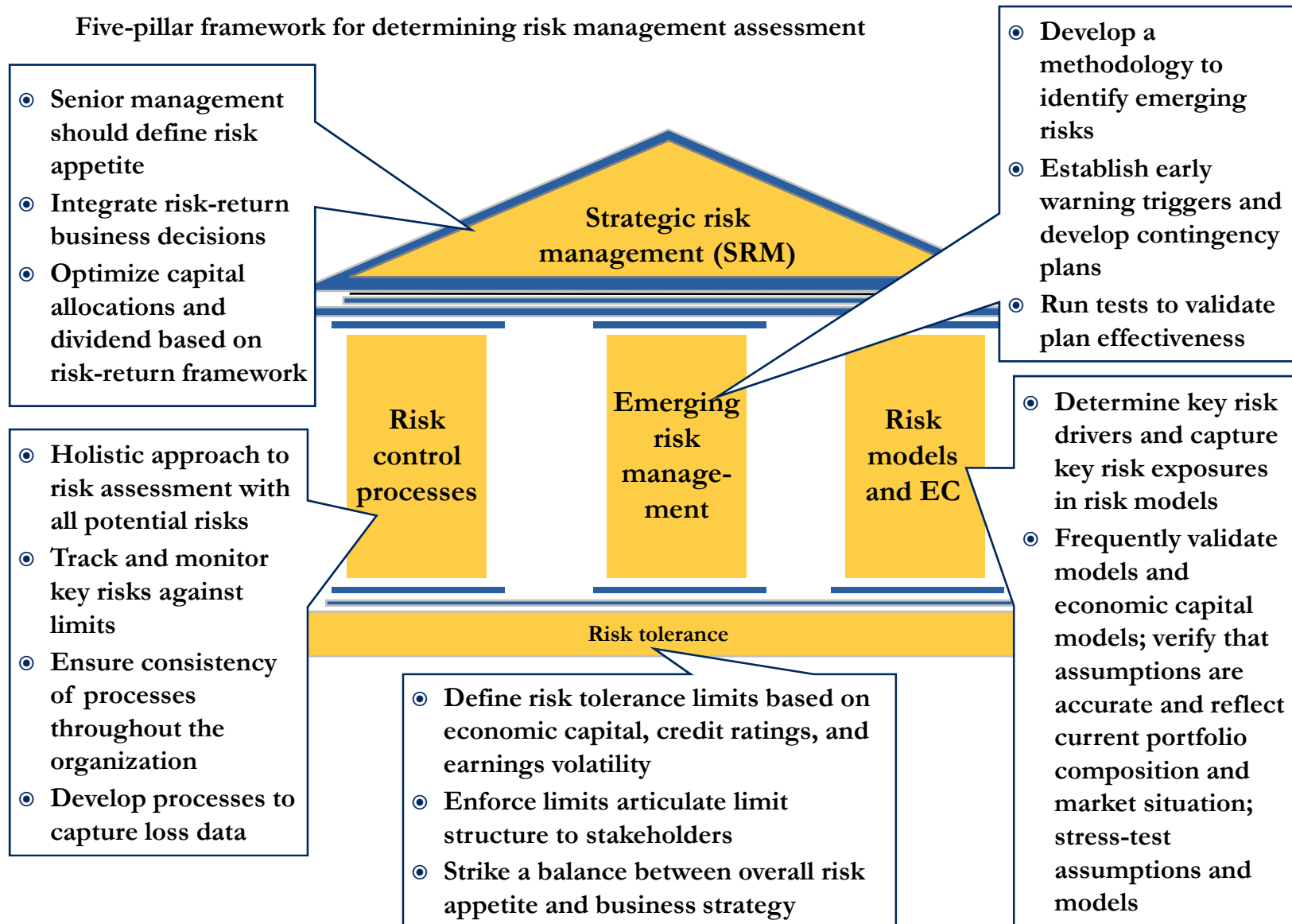
- Anticipate likely agency ratings (based on selected financials)
- Identify core financial drivers (strengths/weaknesses) of current ratings
- Understand potential rating impact of alternative budget plans (scenario analysis)

	2007	2006	2005	2004	2003	2002	2001	Adjusted Rating Card	
Leverage								Discussed Rating	Assigned Weights
REPORTED FINANCIAL LEVERAGE	23.2%	24.3%	26.7%	35.6%	37.3%	43.1%	18.8%	Aaa	20
ADJUSTED FINANCIAL LEVERAGE	27.4%	29.3%	35.8%	42.9%	45.0%	50.0%	27.5%	Aa1	8
EARNINGS COVERAGE (1 Year)	10.5x	9.5x	6.5x	4.6x	3.6x	0.4x	2.3x	Aa2	12
REPORTED EARNINGS COVERAGE (1 Year)	17.1x	15.4x	11.6x	8.4x	6.2x	0.1x	3.6x	Aa3	5
EARNINGS COVERAGE (5 Year Average)	6.9x	4.9x	3.5x	-	-	-	-	Aa3	12
Equity								A2	15
EQUITY (NOT FOR LEVERAGE)	10,276	11,378	9,420	7,538	7,392	5,998	9,803	Aaa	5
ADJUSTED SHAREHOLDERS EQUITY FOR LE	10,537	11,486	9,319	7,559	7,275	5,919	9,706	Aa2	5
Pensions								A1	18
Total Debt Adjustment	(1,049)	(1,278)	(1,774)	(1,426)	(1,233)	(1,170)	(1,192)	Aa2	100
Equity adjustment	(224)	(376)	(480)	(225)	(138)	(96)	(97)		
Operating Leases									
Annual Lease Charge x 6	306	306	378	336	355	222	216		
Rating assignment									
Market Share Ratio	9.7%	9.7%	0.0%	0.0%	0.0%	0.0%	0.0%		
Relative Market Share Ratio	4.8x	4.8x	0.0x	0.0x	0.0x	0.0x	0.0x		
Distribution Control	Aaa								
Diversity of Distribution	Aa								
P&C Product Risk	Aa								
Life Product Risk	Aa								
Product Diversification	Aaaa								
Geographic Diversification	Aa								
High Risk Assets % of Invested Assets	22.8%	25.4%	21.6%	18.8%	17.9%	18.9%	24.3%		
Reinsurance Recoverables % Equity	27.2%	31.7%	43.9%	55.9%	64.4%	89.7%	59.9%		
Goodwill % Equity	24.2%	21.1%	25.5%	31.0%	33.5%	46.0%	25.8%		
Capital % Total Assets	4.8%	5.4%	4.8%	4.8%	3.9%	3.5%	5.2%		
Return on Average Equity (1 year)	16.2%	15.6%	12.6%	7.7%	10.7%	-4.4%	4.8%		
Return on Average Equity (5 yr Avg)	12.6%	8.5%	6.3%	-	-	-	-		
Sharpe Ratio of Growth in Net Income (5 yr	-21.1%	-41.3%	-	-	-	-	-		
Liquid Assets % Policyholder Reserves	95.4%	91.3%	89.4%	80.2%	100.6%	97.2%	118.0%		



2 A risk management assessment consistent with the rating agencies' risk management best practices is also crucial

Five-pillar framework for determining risk management assessment



Source: Team analysis

3 Investment and ALM reports are essential to allow a proper monitoring of risk and investment management

ILLUSTRATIVE
EXAMPLE

Investment Management dashboard

Objectives

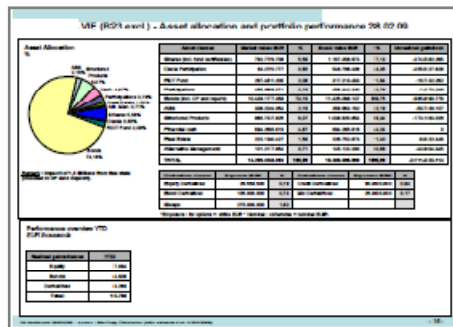
- Provide synthetic overview of assets portfolio investment performance
- Enable effective discussion within the risk and investment governance on the steering of the investment function

Periodicity

- Monthly

Primary recipients

- Investment committee, risk committee

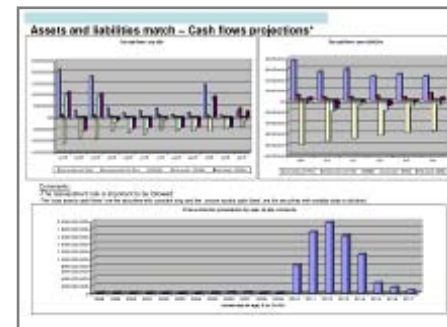


ALM dashboard

- Provide synthetic overview of Assets and Liabilities match, as well as solvency and liquidity measures
- Enable effective ALM risk monitoring
- Provide asset and liability cash-flow schedule

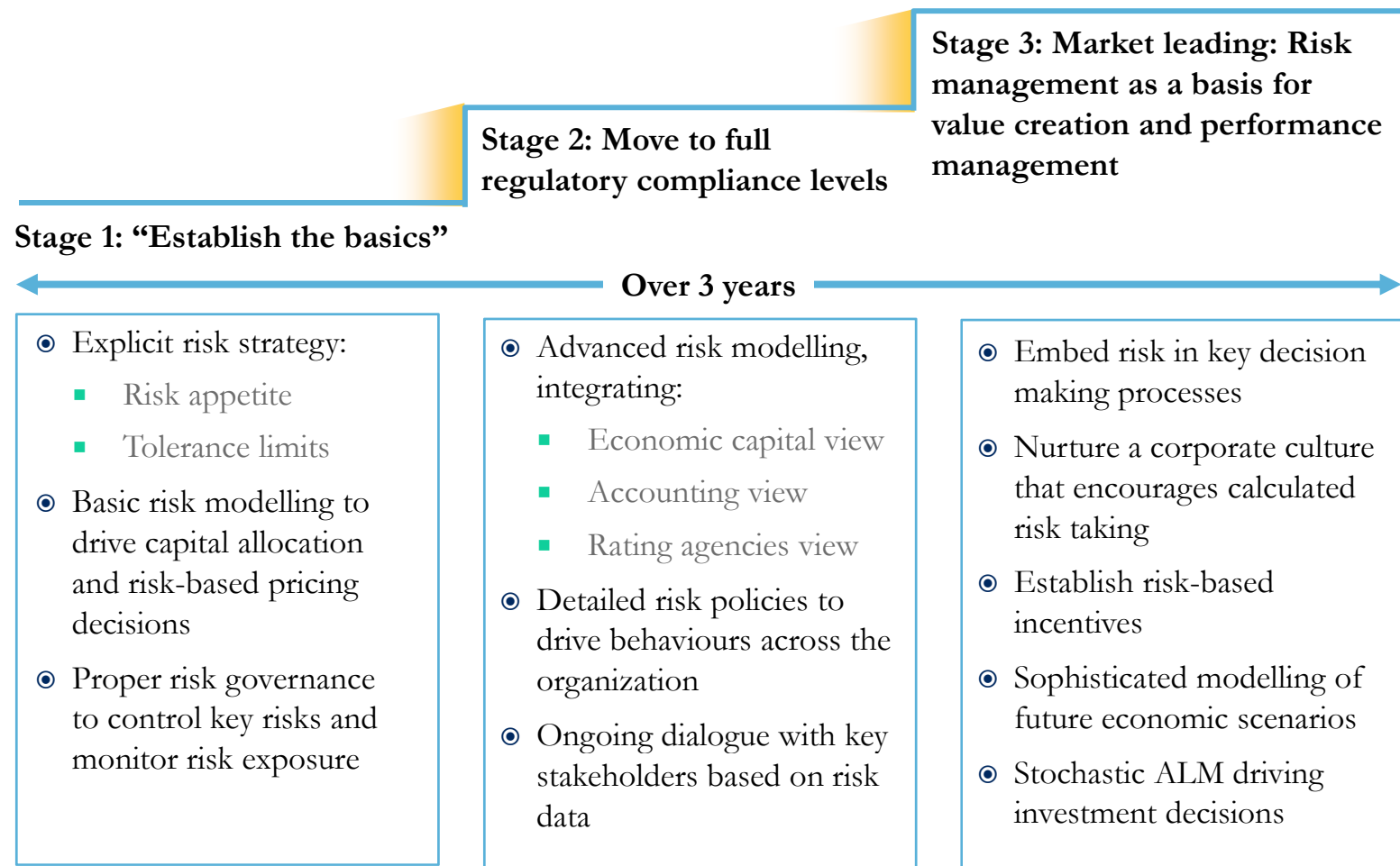
- Quarterly

- Risk committee



Our global experience indicates that risk management capability building is a multi-year journey with different levels of maturity

NOT EXHAUSTIVE







- Overall time-frame will depend upon current starting position, ability to accelerate change
- For different elements, effort & timing to move to “market-leading” could be different


SOURCE: McKinsey analysis




Successful implementation we will require focus on behavioural shifts

		From to
	Under-writing	<ul style="list-style-type: none"> ⊙ Hiding impact of bad underwriting decisions 	<ul style="list-style-type: none"> ⊙ . . . supporting cross-divisional risk learning by sharing negative experience
	Actuarial	<ul style="list-style-type: none"> ⊙ Being incentivised to be highly conservative 	<ul style="list-style-type: none"> ⊙ . . . aligning incentives with business
	Marketing	<ul style="list-style-type: none"> ⊙ Being passive in sourcing information 	<ul style="list-style-type: none"> ⊙ . . . proactively sourcing key data about risks being underwritten
	Finance	<ul style="list-style-type: none"> ⊙ Inadequate understanding of risk-return characteristics of asset classes 	<ul style="list-style-type: none"> ⊙ . . . fully understanding the risk-return trade-off at transactional level
		A silo approach to a cross enterprise view


SOURCE: Outside in assessment through interviews, McKinsey analysis



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