INDIA INSURANCE SECTOR ASSISTANCE REVIEW

A. Objectives

USAID Mission in New Delhi conducted an in-house assessment of the impact of its technical assistance to India's insurance industry development from June 15 – 24, 2005. The objectives of the assessment are: (a) to assess the current status of India's insurance industry including the identification of major reform issues; (b) to measure the impact of USAID technical assistance program on the industry; and (c) identify any revisions to the scope or mode of the assistance program, if any.

This report is a result of the assessment undertaken by a three-member team consisting of Denise Lamaute of USAID/ Washington; Ashok Jha of USAID/ India and Aloke Gupta, an Indian insurance expert who was closely associated with the Indian government's policy reform initiatives and current health insurance related initiatives of the Insurance Regulatory and Development Authority (IRDA).

The Team conducted a wide range of interviews with key insurance sector leaders in the public and private sector (see Annexure I for the list). The discussions with the interviewees were supplemented with a review of several reports on the current state reform in the insurance industry.

This report identifies priority areas for continued USAID technical assistance and recommends intervention mechanisms and tools to make TA more result oriented.

B. India's Insurance Industry Reform

Insurance is the most effective risk mitigation mechanism to reduce the vulnerability of the people from the impacts of disease, disability, untimely death, and natural catastrophes. In a developing country like India the need for such a safety net is much greater, particular at the low income levels where vulnerability to risks is much greater and social security programs are not effective due to poor governance. Insurance reform is a prerequisite for reforms in social security, health care system and financial markets. In developed economies insurance companies and pension funds are major source of long-term capital and have dominant share (50 percent or more) in total financial assets. They provide funding for end-of-service indemnity, life insurance benefits, annuity and gratuity. They also increase the depth and liquidity in stock and bond markets, particularly in long-term bonds.

Prior to the opening of the insurance industry in 1999, the industry was underdeveloped and exhibited several major weaknesses:

- Insurance perceived as savings products not as risk-mitigation tools – little role in health care financing, disaster mitigation and agriculture;
- Absence of competition in the industry - only government-owned companies allowed to do business;
- Low penetration of insurance products- limited to middle and high income households in urban centers (Total insurance premiums: 1.93 percent of the Indian GDP compared to 8.61 percent in OECD countries and 7.38 percent in Asian countries);
- Lack of sophistication in the design, delivery and service of insurance products - limited range of products, absence of risk-based pricing, inefficient delivery channels and poor customer service;

- Inadequate mobilization and inefficient allocation of long-term funds by insurance companies - poor access to insurance funds by private corporate sector; and
- Conflict of interest in the supervision of insurance companies - the government was both the owner of the insurance companies and the regulator.

The underdeveloped state of India's insurance industry meant that nearly 90 percent of its 400 million working population did not have access to any mechanism to finance quality health care for the family members; over 90 percent of its 200 million households did not have any life insurance to protect against untimely death of their earning members; over 95 percent of its farmers did not any protection against floods, drought and natural calamities; and most importantly almost entire low-income and below the poverty population did not have any protection against risk arising out of sudden shocks such as crop failure, hospitalization and untimely death in the family. Clearly, the potential of the insurance industry to contribute to India's economic growth and mitigate risk faced by overwhelming section of its population was not being fully harnessed.

The Indian Government realized this and decided to reform the insurance industry as apart of its financial sector reform agenda. The enactment of the Insurance Regulatory and Development Authority (IRDA) Act by the Indian Parliament in 1999 opened the door for participation of private insurance companies and a limited participation of foreign insurance companies through joint ventures with Indian companies. The major policy and institutional initiatives that emerged from the law were:

- Establishment of an independent insurance regulator;
- Participation of private sector in insurance business;
- Minimum capital of US$ 23 million[1] for all types of insurance companies (life, non-life and health);
- Foreign insurance companies allowed to participate in the market through joint ventures with Indian companies - foreign equity in joint ventures capped at 26 percent;
- Minimum capital of US$ 46 million for reinsurance companies;
- Relatively liberalized guidelines for investment of funds by insurance companies; and
- Insurance companies mandated to do a certain percentage of their business in the rural and social sector.

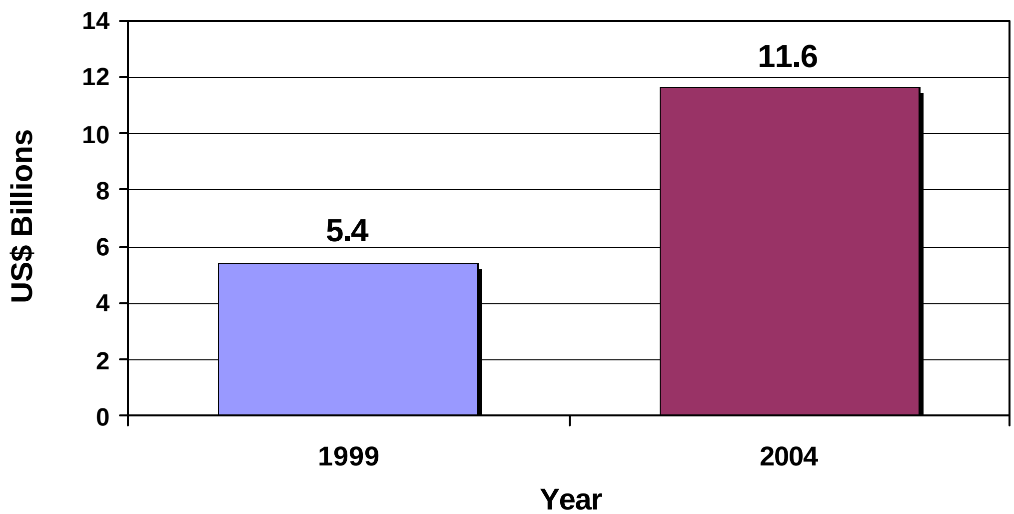
The results of liberalization are significant. Since 1999, IRDA has licensed 21 new private insurance companies, of which 19 insurance companies have foreign equity participation from well-known global insurance players. To date, the industry has attracted foreign direct investment of $235 million. Prior to 1999, there were only five insurance companies, all of them state-owned.

In terms of the market size, both life and non-life insurance markets have registered over 10 percent annual growth in real terms (India has recorded one of the best growths among Asian countries bettered only by Taiwan and Hong Kong). In 2004, Indian insurance companies mobilized over $21 billion, nearly three times as much as in 1999 ($8 billion). The contribution of insurance funds to household financial savings has increased from $5.4 billion in 1999 to $11.6 billion in 2004. The insurance penetration (premiums as percentage of GDP) has increased from less than 2 percent in 1999 to over 3 percent of the GDP, which has recorded annual growth of 6-8 percent in the past few years. The market is witnessing significant changes

[1] Exchange Rate – US$: Rs.43

in terms of types of products being offered and channels being used by insurance companies to reach out to underserved segments of population and geographical regions. New insurance products such as weather insurance, group health insurance for the poor, product liability insurance, life insurance with critical/terminal illness rider and SME package insurance have been introduced. Private insurers are also using banks, microfinance institutions and cooperatives to increase their market share and compete with well-entrenched state-owned insurance companies. The mandate with regard to rural and social sector is also driving innovations in product and distribution channels.

Figure 1: Share of Insurance in Household Savings



The industry has benefited significantly from the participation of global insurance giants (e.g. AIG, Allianz, Aviva, Sun Life, Chubb, Prudential, and New York Life) in terms of product innovation, distribution channels and 'best practices' in operations and claim settlement and managing operational efficiency. The institutional framework for the industry has expanded to include new trade associations such as life and non-life councils, brokers associations; third party administrators; underwriters; non-life actuaries and corporate brokers.

The insurance consumers have benefited immensely from the competition that has materialized in the last five years. A wide range of products, customer-friendly service and professional advice has become the mainstay of the industry and each insurer's strategy is centered on the Indian consumer. Advertising campaigns, seminars and workshops are increasingly contributing to customer awareness about risks – a critical factor in protecting incomes and assets.

Current Issues in Reform

Despite the progress, India's insurance market remains very small compared with some of the major emerging markets. India's share of global insurance market is less than 1%. Major emerging markets such as South Africa and South Korea with a fraction (one-twentieth) of India's population do twice as much insurance business as Indian companies did in 2004. Total assets of Indian insurance companies are $80 billion, while a typical medium-sized international insurance company will have assets of over $100 billion. The government continues to play major role in the industry through the state-owned insurance companies and high entry barriers for foreign insurance companies. Market share of private insurance companies remains low – in

10 to 15 percent range. Less than 10 percent of the Indian population has access to health care financing through risk pooling. Around 75 percent of India's non-life premiums are still generated under the administered pricing regime (called 'tariff'). Access to insurance funds by corporate sector and infrastructure projects remains inadequate as more than half of the insurance industry's financial assets are locked in government securities. In comparison, over two-thirds of financial assets of U.S. insurance companies are in corporate bonds and equities, municipal securities and commercial mortgages. If the insurance industry is to contribute to India's economic growth, it needs to address the following policy, regulatory and market infrastructure issues on a priority basis.

Infusion of Capital

Insurance is a capital-intensive industry. It is also a long-gestation business. In order to mobilize high rates of household savings the industry needs huge sums of capital to continue growing at rates seen in the past five years. The law provides for participation of global insurance firms in the Indian market only through joint ventures with Indian partners. FDI in these joint ventures can not exceed 26%. This means the Indian partner of a joint venture will have to bring in a minimum of 74% of additional capital required to do new business. On the other hand the foreign partner is unwilling to commit more capital and management resources as they have little say in shaping the business. There is also a strong case for raising the FDI cap in reinsurance and auxiliary insurance services such as brokerage and actuarial services. The FDI not only brings in capital but also insurance 'best practices' and new insurance products, and innovative distribution channels that help insurers reach a broader spectrum of the population.

India is highly prone to natural catastrophes. In the past decade, India and China accounted for one-fourth of the global economic losses from natural disasters. Less than one percent of the economic losses resulting from these disasters were insured. Insurance for natural catastrophes is almost negligible. Only an insurance market that has a strong capital base and ample provisions to handle the inherent risks of a major event can respond to the disaster mitigation needs. The raising of the FDI cap will go a long way in facilitating this.

Insurance Regulation and Supervision

Insurance is a contract where the purchaser of insurance pays premium upfront in return for a benefit which may not occur until many years in the future. The purchaser is entirely reliant on the expectation that the insurers will still be in business at that unspecified future date and that it will then have sufficient financial resources to discharge its obligations. Prior to 1999, the industry was a state-owned monopoly; the financial soundness of an insurance company was not much of an issue, as the government by virtue of its ownership of insurance companies was the insurer of the last resort.

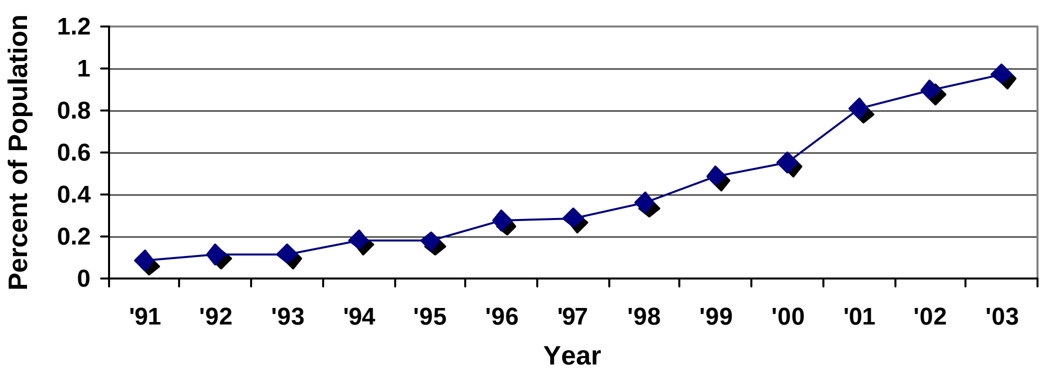
In a newly de-monopolized environment, IRDA will have to overcome key challenges which include building an insurance regulatory framework that is commensurate with international best practices, promoting market competition by eliminating regulatory forbearance towards state-owned insurance companies and lowering entry barriers, and raising public confidence in, and awareness of insurance products. This will require developing IRDA's institutional knowledge and expertise to make sure insurers have the financial resources required to pay all claims as they become due, invest their funds prudentially, develop technical and financial capability to offer health, agriculture and disaster mitigation insurance , and treat consumers in an equitable manner. It is also important that the standards of insurance professionals as agents, brokers, underwriters, and actuaries are maintained at high levels.

Health Insurance

India spends about 6 percent of GDP for health care, which compares favorably with countries with similar GDP per capita. However, public spending on health is under 1 percent of GDP, lower than all but five countries in the world. This means current financing (over 80 percent) of health care is largely from private "out-of-pocket". Clearly, there is a strong case for increasing the share of public expenditures on health care – particularly for lower and middle income households. The reality is that this is not going to happen in foreseeable future, and the out-of-pocket will continue to be the major financing source for health care.

The high share of 'out-of-pocket' financing combined with ever rising cost of medical care, overwhelming size of the informal sector, and low penetration of health insurance means that over 90 percent of the population faces very high or potentially crippling burden of health care expenditures without any access to risk pooling through health insurance or managed care. The challenge facing India is how to create a policy and institutional framework that allows the vulnerable population to shift from private 'out-of-pocket' health financing to risk pooling mechanisms.

Figure 2: Percentage of the Indian Population with Private Health Insurance



Currently, privately financed health insurance reaches out to about one percent of the Indian population. The available health insurance plans are of indemnity type, mostly offered by non-life insurance companies. These plans are characterized by 'one-size-fits-all' approach to product design, limited coverage (only hospitalization), stringent exclusions especially on account of pre-existing conditions, poor quality of service by insurers such as delays in claims settlement and disallowance, and lack of standardization in treatment protocols and cost. Some life insurance companies also offer critical illness riders to their life policies.

Unlike other forms of insurance, health insurance transcends the insurance industry and involves the healthcare providers and medical community which are not regulated by the IRDA. The absence of an appropriate regulatory framework for the healthcare providers that enforces a minimum level of service and hygiene standards has been a major impediment to the growth of health insurance in India. The lack of standardized data from health care providers and on claims hampers the ability of insurers to price their health insurance products difficult. It is not surprising that despite opening up of the insurance sector and IRDA's best intentions, not a single dedicated health insurance company is among the 21 new private insurance companies licensed since 1999. Clearly, the IRDA and the Ministry of Health need to work in tandem to address the impediments described. The issue of high entry barriers in the form of higher capital requirement ($21 million) and low FDI cap (26 percent) will also have to be addressed by the

Ministry of Finance and the IRDA, if the market is to attract specialized global players in health insurance.

Market Infrastructure
India's insurance market, though with a long history, is still a fledgling in many respects. Data is the lifeline of an insurance market. Comprehensive mortality and morbidity data facilitate risk-based pricing of life and health insurance products. Similarly claims data on auto insurance and other types of casualty and property insurance are critical to ensuring financial soundness of insurers. With the exception of mortality data, India's insurance industry doses not have any data warehousing and data mining infrastructure to offer varied insurance products needed by a vast segment of the population. Only the availability of reliable data on economic losses arising out of natural disasters together with a well-capitalized industry to absorb risk transferred from households will lead to the development of a functioning natural catastrophe insurance market in the country.

Apart from a lack relevant information and data, restricted availability of qualified and well-trained insurance professionals such as underwriters, actuaries and brokers is also a major impediment to the robust growth of the market. The industry does not have any institutional infrastructure for testing, certification and licensing of underwriters and brokers. The absence of functioning trade associations practicing basic self-regulatory principles such as a code-of-conduct for their members and a mechanism for identification and elimination of market conduct malpractices that cause serious damage to industry's reputation is also not helping the industry realize its huge potential.

Administered Pricing in the non-life Insurance Market
Continued tariff-based pricing of non-life insurance products has resulted in unprofitable underwriting, cross-subsidization across different lines of business and distortions in the market. This has impeded the growth of non-life insurance market. It is not surprising that the non-life insurance premium as percentage of GDP for India is among the lowest in emerging markets (less than one percent). India needs to deregulate the insurance pricing to make sure that the access to insurance by underserved population increase significantly.

Disaster Mitigation and Agriculture Insurance
India is prone to natural catastrophes. Between 1994 and 2003, India together with China accounted for 25 percent of the global economic losses from natural catastrophes and for 31 percent of fatalities. In comparison, insurance compensation arising from these adverse events was minimal, amounting to less than 1 percent of global insurance losses. It is clear that India like other Asian countries has not been a serious participant in the global market for disaster loss risk transfer. The insurance industry has played a relatively insignificant role in funding disaster losses, despite having been in existence for many decades. In developed countries disaster loss is typically funded through a combination of private insurance arrangements and an efficient public finance system. In India's case the disaster loss funding has mainly come from central and state exchequers and assistance from international donors. Given the poor health of public finances in India, the existing pattern of disaster funding pose a serious threat to its economic growth. The industry needs to develop appropriate infrastructure for pooling all catastrophes related risks and increase its reinsurance capacity.

The existing crop insurance in India covers only about 10 percent of sown area and have a high claims to premium ratio. It is managed by state-owned insurance a company and subsidized by the central and state governments. Recently, some private insurers have begun implementing rainfall insurance on pilot basis. But the share of private sector in agriculture insurance remains insignificant. The reasons for low penetration of agriculture insurance are: (a) administered pricing and high levels of subsidization leading to market distortion; (b) lack of availability of mechanism for transfer and sharing of systemic risk; and (c) lack of accuracy and timeliness of crop estimation methods.

Insurance for the Poor (Micro insurance)
The penetration of insurance products among the poor is insignificant. The focus of the Indian microfinance institutions has been on delivery of cost-effective credit and savings products to the poor. Insurance has been restricted to protecting loss of the asset that is being financed. The poor need life insurance, asset insurance, disability insurance and most importantly health insurance which is a major cause of indebtedness in low income households. Studies show that on an average, the average Indian spends 60 percent of the annual income towards medical costs for single episode of hospitalization. Around 40 percent of hospitalized Indians are forced to sell their properties or borrow at high interest rates. This results in a good 25 percent falling below the poverty line.

The insignificant penetration of insurance can be attributed to (a) lack of awareness about the benefits of insurance; and (b) reluctance of insurers to sell insurance to the poor due to high delivery costs. The law that opened the insurance industry to private sector charged insurers to make available insurance services to the huge segment of the population that are vulnerable and not part of the formal economy. The translation of the intent of the law into reality is going to be most formidable task for the IRDA, policy makers, insurers, NGOs and MFIs alike. Micro insurance will require a regulatory framework that is flexible enough to allow insurers, NGOs and solidarity groups to innovate in product design and delivery models to make insurance affordable to the poor and yet be economically viable.

C. USAID Support of the Insurance Reform

In response to a request from the Government of India, USAID designed a multi-year technical assistance program to strengthen the insurance industry. The international consulting firm Bearing Point began implementing this four-year $10 million program in June 2003.

The program is primarily focused on building the institutional capacity of IRDA to help align local regulations to international best practices, guide the market towards a more liberal regime with fewer entry barriers, reduced micro-management, better level-playing field, and more efficient investment of funds by insurance companies. The program also supports IRDA in raising the standards of insurance professionals and in the development of enabling regulatory and institutional environments for health insurance and insurance for the poor.

The program just completed two years. It has had the following significant impact on the industry:

Regulation and Supervision
The program is assisting IRDA in the development of a supervisory system that makes sure insurance companies are solvent at all times, promotes efficient use of capital, eliminates avoidable micro-management of business practices and promotes actuarially sound pricing of insurance products. The program helped

- Develop inspection manuals for financial condition and market conduct examination of insurance companies. Provided training to IRDA staff in the use of the manuals.
- Develop an IT-enabled early warning system to track financial soundness of insurance companies.
- Conduct training workshops for IRDA staff in areas such as risk-based capital, examination re-insurance treaties and early warning solvency ratios.
- Develop draft regulations on micro-insurance and organized round tables with NGOs and MFIs to promote consensus on approach to micro-insurance. IRDA is the first regulator anywhere in the world to develop micro-insurance regulation.
- Develop a detailed roadmap for transition to market-based pricing for non-life insurance products. The transition to the new pricing regime is expected to be completed by the end of 2006.

Health Insurance

The program is assisting IRDA in the development of an institutional and regulatory framework necessary for the development of private health insurance market in India. It helped:

- Develop standards for collection of using WHO's International Classification of Diseases (ICD). All private health insurance programs have been mandated to collect data according to the new standards from April 1, 2006. This would allow health insurance companies and managed health care programs to price their products, realistically.
- Develop regulatory parameters to promote licensing and operation of dedicated health insurance companies, of which none exists today. The parameters include minimum capital for health insurance companies, permissible FDI and application of risk-based capital approach to solvency.
- The Healing Field Foundation, a USAID grantee, which is implementing a pilot model to deliver cashless health insurance to the poor households in sorting out implementation related problems.
- Training in actuarial application health actuaries.

Market Infrastructure

USAID assistance in this area is focused on building the institutional capacity of trade associations and professional bodies (brokers, loss adjusters and underwriters) to increase insurance consumer confidence and industry's reputation. The program helped:

- The life and general insurance councils organize themselves into functioning trade associations. Helped develop membership codes of ethics and rules on market conduct and enforcement mechanism for such codes of ethics and rules for their members.
- Reviewed the existing system of grievances redress mechanisms such as insurance ombudsman and consumer courts and made recommendations to improve their effectiveness and efficiency.

[2] Exchange Rate – US$1 : Rs.43

[3] Exchange Rate – US$: Rs.43

[4] Insurance Penetration – Insurance Premium as a Percentage of GDP

[5] Insurance Density – Premium Per Capita (in US$)

[6] Population penetration – percentage of population covered under private health insurance

[7] Exchange Rate – US$: Rs.43

[8] NSSO – National Sample Survey Organization

[9] Mediclaim – is a health insurance policy that reimburses in-patient medical expenses.