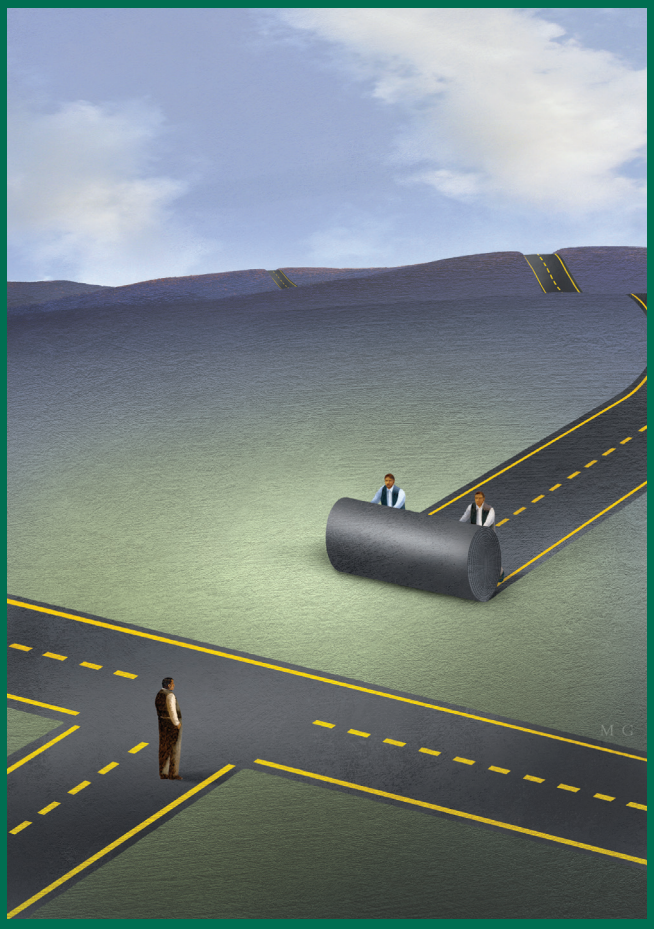
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India Insurance

Turning 10, Going on 20

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Executive Summary

Insurance is a Critical Part of Any Economy

It contributes to economic development on four key dimensions. First, by pooling risks and smoothing incomes, it helps avoid excessive and costly bankruptcies and facilitates lending to businesses. Second, the availability of insurance enables individuals and entrepreneurs to undertake activities with higher risk and higher return than they would otherwise consider, thus promoting higher productivity and growth. Third, due to the long–term nature of their liabilities, with predictable premiums, life insurers also serve another important function, acting as providers of capital to infrastructure and other long–term investments. Finally, insurance has a big role to play in providing support to the poorer sections of the society. In the absence of risk–pooling mechanisms, setbacks in incomes can permanently damage a poor family's prospects. Insurance can help prevent these setbacks and provide support to the society.

The Insurance Industry in India has Come a Long Way

Since the opening up of the sector in 2001, the industry has undergone a major transformation. There is enhanced penetration, increased coverage of lives / property, more customer–friendly products, rapid growth of multiple channels (agency, bancassurance, broking, direct, corporate agency, etc.), enhanced reach, and increasing competitiveness of the market.

The total penetration of insurance (premium as percentage of GDP) has increased from 2.3 percent in 2001 to 5.2 percent in 2011. In addition there has been a vast increase in the coverage of insurance. The number of life policies in force has increased nearly 12–fold over the past decade and health nearly 25–fold. This progress has been aided by the dramatic shift in the availability of products, for example: better term, ULIPs, whole life, maximum NAV guarantee, auto assistance, auto pay per km insurance, disease management, wellness, etc.

Similar progress has been made on the channel front with the emergence of five distinct channels — bancassurance, broking, corporate agency, direct and auto dealers to complement the existing third party agency and in–house salaried sales force. Along with the emergence of multiple channels, the distribution reach has increased manifold, nearly 6–fold for life, and 1.5 times for non–life.

During the same time, the Indian market has evolved from a monopoly to a truly competitive market. The market has moved from 5 incumbents (1 life, 4 non–life) to nearly 45 today (across life and non–life).

Currently, the Insurance Industry is Facing Challenging Times

While the industry has come a long way over the past decade, the big challenge with the industry is profitability. Private life insurers have accumulated losses of over ₹16,000 crores till March 2010. Similarly, the non–life industry has cumulative underwriting losses of nearly ₹30,000 crores. There are multiple elements that contribute to this profitability challenge for insurers:

- Agency is looking for the elusive profitable operating model, for both life and non–life insurers.
- Economics of all other channels are also challenged, be it bancassurance, brokers, auto dealers, corporate

agency or in–house salaried sales force.

- Insurers' fascination for top line growth at any cost has resulted in inefficient operating models and hence inferior opex ratios as compared to global benchmarks, in both life and non–life.
- The claims cost in the case of non–life are very high arising from four key reasons — third party liability claims, health loss ratios (group health cross subsidy), fraud in the case of auto and health and lack of supplier (hospital/garage) management by insurers.
- There is limited focus on the end customer and the intermediary is being given a more prominent position by insurers, with insufficient focus on maximizing value from existing customer.
- Lastly, the recent regulatory changes on commission caps, caps on surrender changes and minimum guarantee return for pension products have turned the world upside down and tightened insurer margins.

However, the India Growth Story Expected to Continue Unabated

Inspite of all the recent upheaval, BCG expects the insurance industry to continue outpacing the rapid economic growth. The insurance industry will be ~US $350–400 billion in premium income by 2020, making India a top 3 life insurance market and a top 15 non–life insurance market by 2020.

Insurers and Regulator / Government Will Have to Work in Tandem to Ensure a Sustainable and Healthy Industry

BCG has defined a six point action agenda for the life insurers journey ahead:

- Fix the agency operating model
- Build strategic, long term non agency partnership
- Incubate, experiment and develop alternative channels
- Develop a customer centric operating model
- Target customer / product white spaces
- Go lean — "lean is in"

Similarly, for non–life insurers, BCG has also defined a six point agenda for the path to a sustainable profitable business:

- Create optimal product portfolio
- Innovate to target product/customer white spaces
- Move towards risk based pricing
- Develop next generation claims management processes
- Go direct — build alternate channels for retail products
- Define and enhance agency sales force operating model

Lastly, in addition to the insurers, the regulator / government has a huge role to play in enabling the journey of the insurance industry to sustained profitability. The regulatory / government agenda will need to cover:

- Relax ownership norms
- Define IPO norms
- Enhance banca distribution through multi tie–ups
- Enable "direct" channel
- Refine outsourcing guidelines
- Enable electronic statements of insurance
- Refine investment norms
- Define flexible norms to enable Indian insurers to go international
- Build depth in debt / bond / derivative market
- Ensure appropriate taxation policies

Insurance

Critical to the Economy

The Merriam–Webster dictionary defines insurance as: "(a) the business of insuring persons or property; (b) coverage by contract, whereby one party undertakes to indemnify or guarantee another against loss by a specified contingency or peril." In the modern economy, however, insurance means a lot more than what the above standard definition describes and, in fact, insurance contributes significantly to the development of the economy.

Role of Insurance in Economic Development

Evidence suggests that insurance contributes materially to economic growth by improving the investment climate and promoting a more efficient mix of activities than would be undertaken in the absence of risk–management instruments. Insurance serves a number of valuable economic functions that are largely distinct from the functions served by other types of financial intermediaries. This contribution is amplified by the complementary development of banking and other financial systems.

Insurance contributes to economic development on four key dimensions:

1. Facilitate lending to businesses

The indemnification and risk–pooling properties of insurance facilitate commercial transactions and the provision of credit by mitigating losses as well as measuring and managing non–diversifiable risk more generally. Typically, insurance contracts involve small periodic payments in return for protection against uncertain, but potentially severe, losses. Among other things, this income–smoothing effect helps to avoid excessive and costly bankruptcies and facilitates lending to businesses.

This is one of the reasons most banks encourage, and, on occasions, even insist on small and medium size enterprises buying fire and property insurance to protect against uncertain, but severe, losses. Without insurance, the higher potential risk of bankruptcy would increase credit pricing and make business growth more difficult.

2. Promote higher productivity and growth by enabling risk averse individuals to take higher risk

Fundamentally, the availability of insurance enables risk–averse individuals and entrepreneurs to undertake activities with higher risk and higher return than they would otherwise consider, thus promoting higher productivity and growth. The management of risk is a fundamental aspect of entrepreneurial activity. Entrepreneurs manage the risk of accidental loss by weighing the costs and benefits of each alternative.

In a structured risk management process, this involves:

- Identifying the exposures to accidental loss
- Evaluating alternative techniques for treating each loss exposure
- Choosing the best alternative
- Monitoring the results to refine the choices

Even those who do not apply a structured process make decisions about risk, although by default rather than by design.

The scope of an economy's insurance market affects both the range of available alternatives and the quality of information to support decisions. For example, a manufacturer might produce only for the local market, forgoing more lucrative opportunities in distant markets, to avoid the risk of losing goods in shipment. Transport insurance can mitigate this loss exposure and enable the manufacturer to expand his business. Such expansion provides larger scale and additional stability for the business. Thus, insurance products clearly enable stronger and more robust businesses.

Similarly, to avoid the risk of total loss from drought, a commercial farmer may keep half his seeds in reserve. Instead of incurring the cost of holding half the seeds in reserve, the farmer could buy crop insurance for a small premium, protect himself against drought, and plant all his seeds. Therefore, public policies that encourage insurance operations improve the economy's productivity by broadening the range of investments.

Insurers also have an incentive to control losses. By offering discounts for seat belts, smoke detectors, or other measures that reduce the frequency or severity of losses, they lower their eventual claims costs. In the process, they help save lives and reduce injuries, thus offering a significant social benefit.

3. Provide capital for long–term needs such as infrastructure

On the investment side, the long–term nature of their liabilities, sizable reserves, and predictable premiums allow life insurance providers to serve an important function as institutional investors. Apart from providing capital, they can also provide professional oversight to infrastructure and other long–term investments. Of course, these benefits are fully realized only in markets where insurance providers invest a substantial portion of their portfolios in the domestic market.

India has an extremely large and critical need for investments in infrastructure. The demand for infrastructure funding and debt is estimated to increase from the existing about 6 lakh crores to about 20 lakh crores by 2015 and about 45 lakh crores by 2020. The tenure of funding for these infrastructure projects normally ranges from 10 to 15 years. The insurance industry needs to be one of the primary sources for these funds.

An analysis of the financial savings pool in India, and specifically household financial savings, shows that insurance funds can be the long–term savings pool that can fuel infrastructure growth. As Exhibit 1.1 illustrates, the only money pools with a longer tenure than life insurance savings are the provident fund and pension money, and these are already directed by the government.

Life insurance funds have tenure greater than 7 years and would be the closest fit with the approximate tenure requirement of 10 to 15 years for infrastructure projects. In fact, infrastructure investments are ideal for asset–liability matching for life insurance companies given their long–term liability profile.

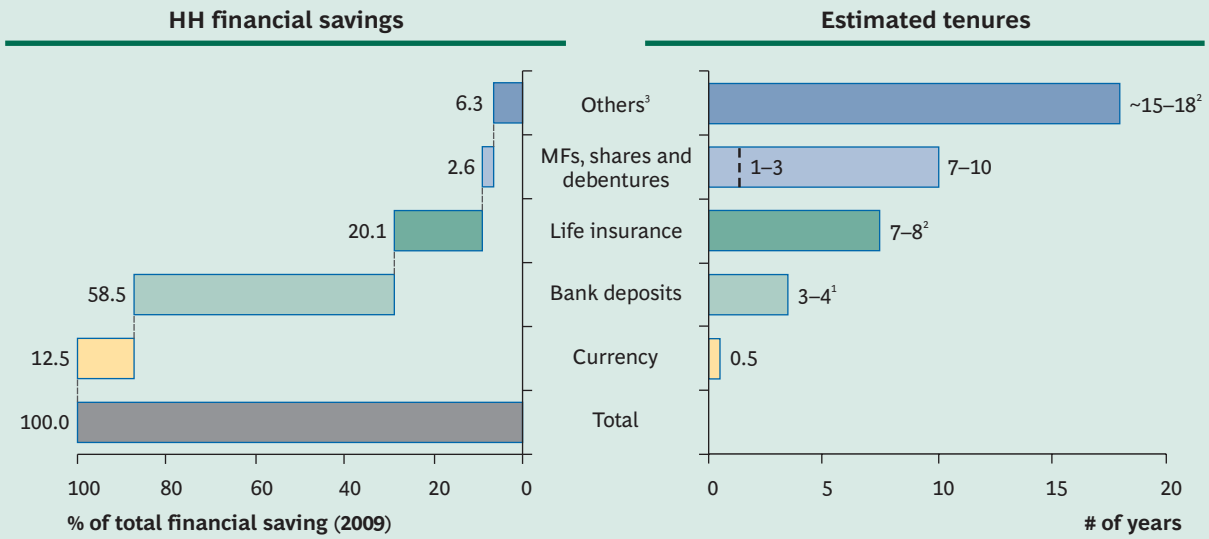
4. Offer societal support for poorer sections of the society to continue development

Insurance has a big role to play in providing support to the poorer sections of the society. In the absence of risk–pooling mechanisms, a sudden drop in incomes due to death, disability, or adverse agricultural outcomes often translates into substantial decreases in consumption and investment that can permanently set back a poor family's ability to better their lives. When drought or floods lead to low agricultural yields, critical health interventions could be delayed, education of the younger members of a household could be put on hold indefinitely, and land, livestock, or equipment could be permanently forfeited. Insurance can help prevent these setbacks and thus offers support to the society.

Due to the catastrophic consequence of such losses, and in the absence of formal insurance, there is extensive evidence that suggests that poor households and communities attempt to "self–insure" through a combination of asset building and diversification of income sources. The most likely result is investment in a set of lower–risk but also lower–return activities, and even this degree of self–insurance is highly incomplete.

As explained above, insurance has a critical role to play in the economic development of a country. In that context, it is only appropriate to look at the insurance industry in India through the same lens. The following chapters focus on the decade gone by and the evolution of the insurance industry in India, the challenges facing the industry, and the journey ahead, especially in terms of the agenda for the industry.

Exhibit 1.1: Household financial savings share



Source: RBI; BCG analysis.
Note: Data pertains to FY 2009.
[1]Based on bank portfolio of deposits.
[2]Industry estimate.
[3]Others include provident and pension funds, investment in government securities, investment in small savings, etc.

The Past

The Decade Gone By: FY 2001 – FY 2011

A decade after the insurance industry was opened up, a remarkable transformation has taken place. The changes may go unnoticed from month to month, or even year to year, but if one takes a step back and compares the industry landscape of 2001 to that of 2011, the difference is more than striking.

In the last decade, the insurance industry has moved forward on multiple fronts. There has been progress in terms of enhanced penetration, increased coverage of lives / property, more customer–friendly products, a rapid growth of distribution channels (agency, bancassurance, broking, direct, corporate agency), enhanced reach, and increasing competitiveness of the market.

Customers — "Going Wide and Deep"

The total penetration of insurance, measured by premium as a percentage of GDP, has increased from 2.3 percent in 2001 to 5.2 percent today. While there has been a substantial jump in penetration in the past decade, all of it has come from life insurance (increasing from 1.8 percent in 2001 to 4.6 percent in 2010). Non–life insurance penetration has remained more or less flat, increasing marginally from 0.5 percent in 2001 to 0.6 percent in 2010. As a result, life insurance in India compares favorably with the rest of the world (United States 3.5 percent; United Kingdom 10 percent; France 7.2 percent; Germany 3.3 percent; Japan 7.5 percent; Brazil 1.6 percent; China 2.3 percent). Non–life insurance in India is still significantly under–penetrated, and has some way to go (United States 4.5 percent; United Kingdom 3 percent; France 3.1 percent; Germany 3.7 percent; Japan 2.1 percent; Brazil 1.5 percent; China 1.1 percent).

Along with the increase in penetration, there has been a massive increase in the number of people covered. In life insurance, the number of policies in force has increase from approximately 20 million in 2001 to approximately 230 million in 2010, a nearly 12–fold increase. The other big increase in coverage is in the health insurance space. The number of lives covered through health insurance has increased from just 2 million in 2001 to nearly 55 million in 2010, a nearly 25–fold increase.

Product — "From a Seller's Market to a Buyer's Market"

There has been a remarkable shift in the availability of products over the past decade as well. Products that were hardly known or not available earlier are now quite popular as they offer real value to customers.

Take life insurance for example. Term insurance, which was never pushed by the channel earlier, is now an extremely attractive product for both customers and insurers. The change in pricing of the term product over the past few years illustrates the product's attractiveness and the manner in which the market has evolved.

For a 30–year–old, non–smoking male, for example, the premium for a 25–year term has come down drastically from about 70 bps in 2001 to about 20 bps today – an almost 70 percent reduction in price for the customer. Add to that the plethora of Unit–Linked Insurance Policies (ULIPs), whole–life products, and maximum Net–Asset Value (NAV) guarantee products and the movement to a buyer's market is clear.

Similarly, for other insurance products, the options for customers have gone up dramatically. For example, the

auto insurance market has moved away from a standard commodity product and is now offering products with assistance services, such as replacement vehicles, towing services, and emergency support services. Some companies are also exploring innovative products such as pay–per–kilometer offerings. The same is true in the case of health insurance. From offering hospitalization reimbursement as the only product — and that too with a low cap on the total quantum covered — the health insurance industry has progressed enough to have many products with large caps, including outpatient department and dental coverage, as well as disease management and wellness offerings.

Distribution — "From Agency Alone to Multichannel"

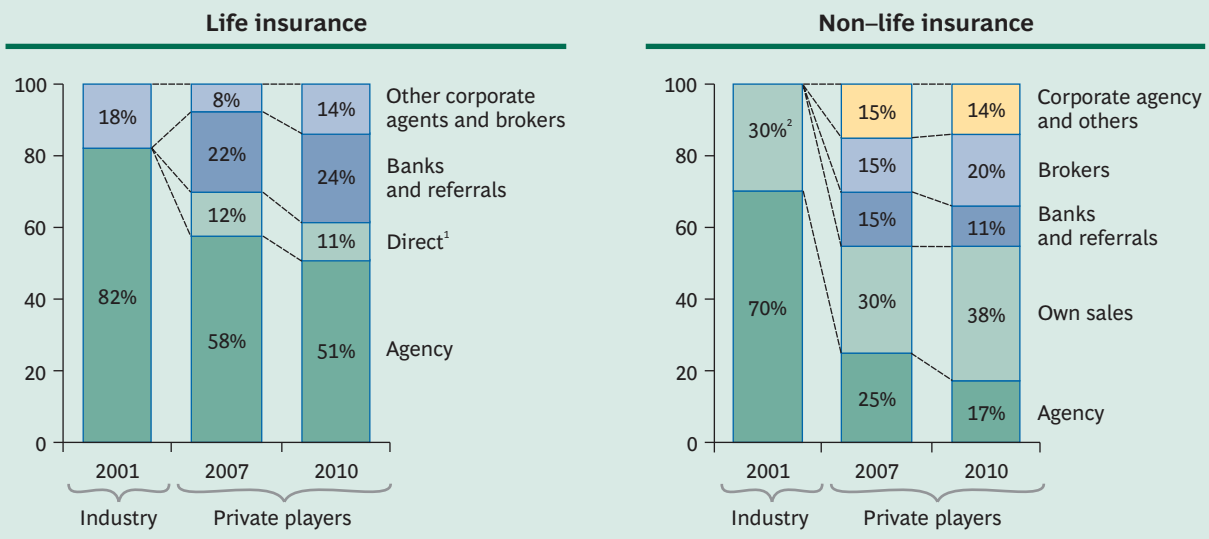
Distribution is the most critical element of the insurance value chain from the customer experience point of view, and the Indian market has evolved dramatically over the past few years along this dimension. Before 2001, in the pre–privatization phase of the insurance industry, there were only two channels of distribution — third–party agency and direct (in–house salaried sales force.) Third–party agency accounted for more than 80 percent of the sales in life insurance and approximately 75 percent in non–life insurance.

The last decade has seen the emergence of five distinct channels to complement the existing two – agency and direct (as shown in Exhibit 2.1):

I. **Bancassurance:** A distribution channel that has been extremely large in European countries for a long time, bancassurance has now also become substantial in the Indian market over the last few years. In fact, the bank channel now contributes approximately 25 percent of the new business for private companies in life insurance, and approximately 15 percent of the Gross Written Premium (GWP) for private companies in non–life insurance (bank plus some corporate agency). The primary value that banks bring to the insurance business is customer trust and a wide reach.

II. **Broking:** This is a very large channel for non–life insurance globally. This channel's proposition to the customers is that brokers represent the customers, not the insurance company, and will advise them on

Exhibit 2.1: Channel mix (2001–2011)



Source: IRDA, Company public disclosures.
[1]Including own sales force, tele and online.
[2]Including all other channels.

the best product / solution to meet their requirements. While India has seen growth in this channel, India has a long way to go in this dimension. So far, the biggest selling point for brokers in India has been their ability to negotiate discounted rates based on the volume of business. They have now begun to move to a full advisory role. Brokers today account for approximately 20 percent of the GWP for non–life insurance and just about 3 percent of the life insurance new business.

III. **Corporate agency:** This includes two categories of channels: outsourced agency, at times also known as MLM (Multilevel Marketers); and existing distribution networks. The second category offers a lot of opportunity and value for the economy. The idea here is to leverage existing distribution channels, push more through the same channel infrastructure and hence improve efficiency, just as in the case of bancassurance. For private companies, this channel has already become significant, accounting for about 10 percent of the new business for private companies in both life and non–life insurance.

IV. **"Direct":** This includes sales through the internet and call centers. Products that lend themselves to easy comparison are easier to sell through such channels and hence term insurance, auto insurance, and health insurance are the products currently being sold through the internet and phone channels.

V. **Auto–dealer channel:** This is a point–of–sales channel that has become substantial in the past few years. Auto dealers leverage the opportunity when customers walk into their dealerships to buy cars to offer auto insurance as well. Auto dealers started with new cars and, realizing the value at stake, many of the larger dealers have now started outbound calling to increase renewals. The auto–dealer channel now accounts for nearly 10 to 15 percent of auto insurance and approximately 5 to 6 percent of total non–life insurance. This is, however, recorded as premium under the agency / corporate agency heads as shown in Exhibit 2.1.

The evolution of these five new distribution channels has been rapid. These channels had zero share of business in 2001, and have grown remarkably, to now account for approximately 35 percent of new business for private companies in life insurance and approximately 45 percent of the business for private companies in non–life (as shown in Exhibit 2.1).

Reach — "Multiplying the Reach 3–5x"

Along with the emergence of the multiple channels described above, came the rapid expansion of distribution reach. As private companies rolled out their businesses, with limited or no regulatory controls on the opening of outlets, the number of office / branches multiplied. This was especially true for life insurance, where insurers built comprehensive office networks to stake out a position in the market. The number of offices / branches increased 6–fold in the past nine years, going up from about 2,200 in 2001 to more than 12,000 in 2010 (as shown in Exhibit 2.2).

At the same time, the growth in the number of agents kept pace, increasing from about 0.6 million in 2001 to about 3 million in 2010. Last year, after some regulatory changes, more than 1,000 branches were shut down and over 400,000 agents were released by private companies to manage the economics of the agency channel.

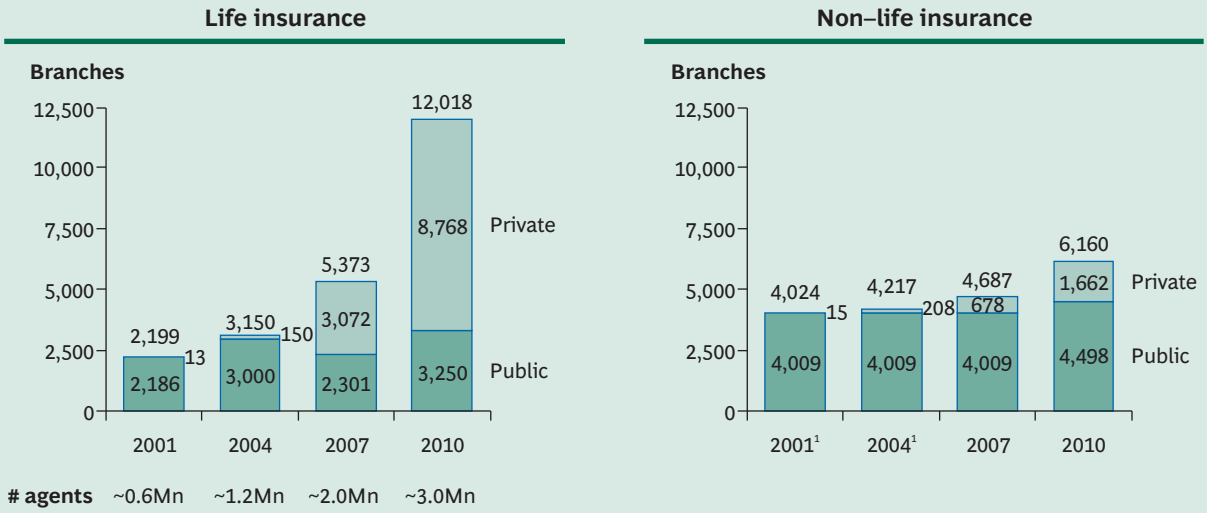
Similarly, there has been an expansion in reach in non–life insurance too, though nowhere to the same extent as in life. This is because even though the agency channel is large in non–life, a large part of that agency operations is actually on–site. This holds true, for example, in the auto insurance market, with the auto dealers accounting for a large part of the business. The number of offices / branches has increased from approximately 4,700 in 2001 to approximately 6,200 in 2010.

Competition — "From a Monopoly to a Competitive Market"

The Indian insurance market has evolved from a monopoly to a truly competitive market. As the industry opened up after 2001, the market saw the entry of 12 companies in life insurance and 8 in non–life insurance in the first 2 years, making a total of 20 new companies and 5 incumbents. The "success" of many first–generation entrants attracted the second generation of competitors, most of them in 2007 and 2008, leading to a total of 45 insurers, including life and non–life, in India, with a few more still keen to enter (as shown in Exhibit 2.3).

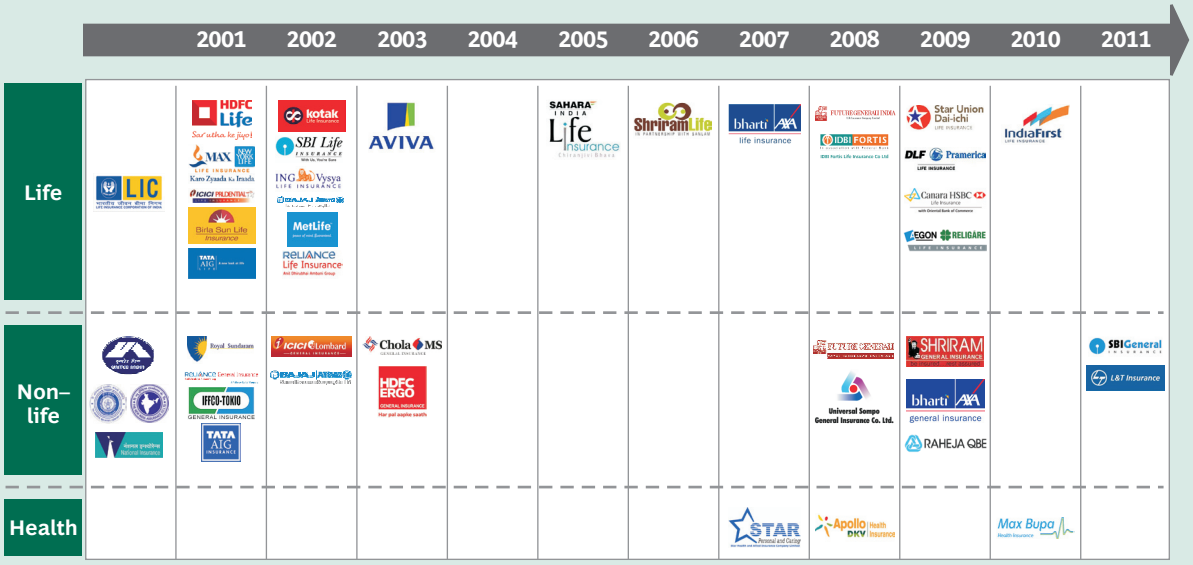
Over time, the new entrants have been taking share away

Exhibit 2.2: Insurer's reach (2001–2011)



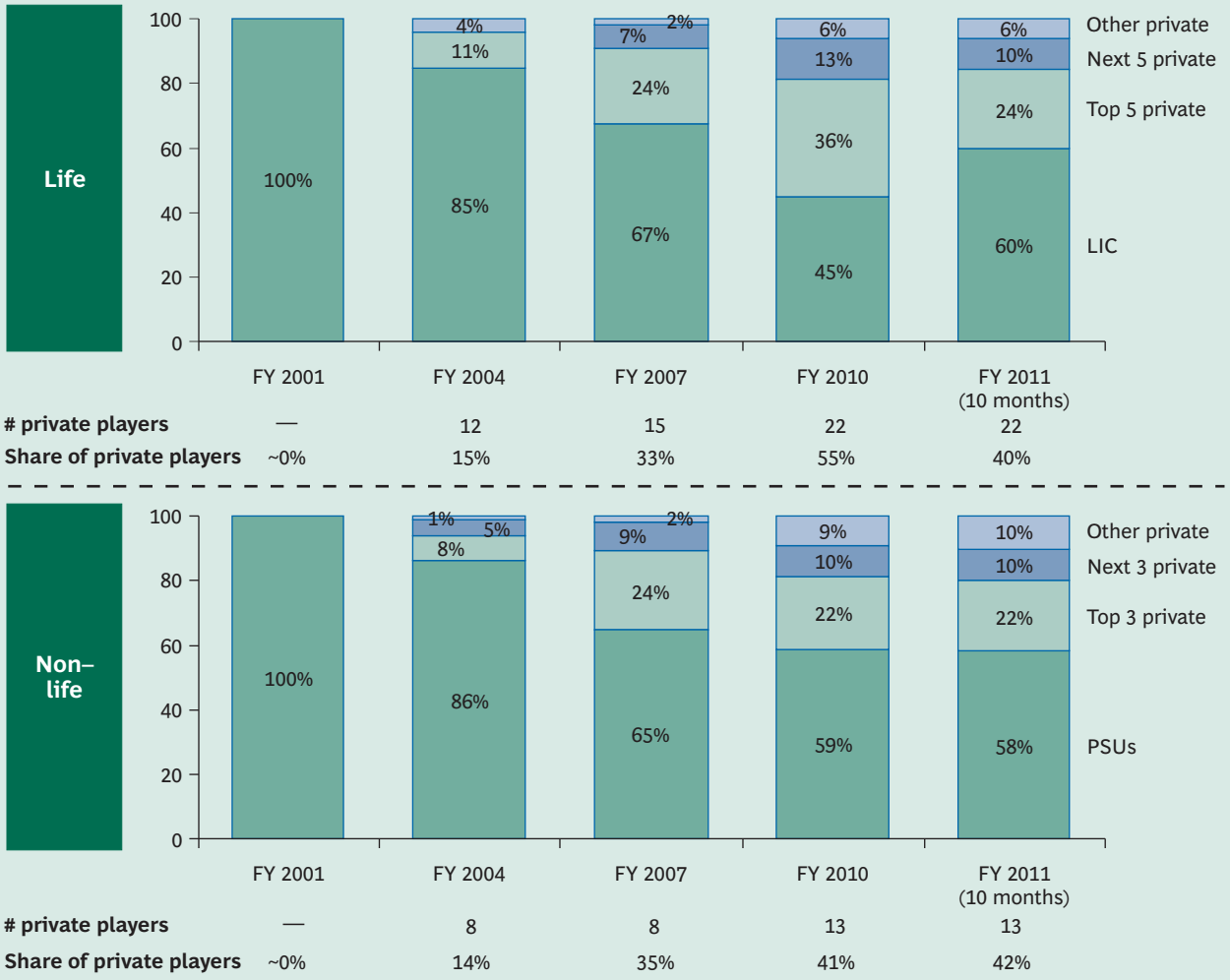
Source: IRDA; Company web sites.
[1]Estimated.

Exhibit 2.3: Increasing competitive intensity (2001–2011)



Source: IRDA.

Exhibit 2.4: Share of life insurance ANBP and non–life insurance GWP (2001–2011)



Source: IRDA.

from the incumbents, as one would expect. In the case of life insurance, as shown in Exhibit 2.4, the share of private companies has increased from virtually zero in 2001 to about 55 percent of Annualised New Business Premium (ANBP) in 2010. However, recent regulatory changes have had a big positive impact for Life Insurance Corporation of India (LIC), which has resulted in the share of private companies falling to 40 percent for the first 10 months of 2010–2011. Interestingly, the biggest loss in market share has been for the top five private companies, with their share coming down from about 36 percent to about 24 percent. The smaller companies have not lost as much market share.

Similarly, as can be seen in Exhibit 2.4, the share of private companies in non–life insurance has increased from nothing in 2001 to 42 percent in 2011. There is large concentration in market share among the 13 private companies, with the top three private companies accounting for about 22 percent share, the next three accounting for about 10 percent share, and the remaining seven accounting for the last 10 percent.

As is obvious, the insurance market has come a long way in the past decade, transforming along all dimensions, be it products, channels, customer, distribution reach, or competition.

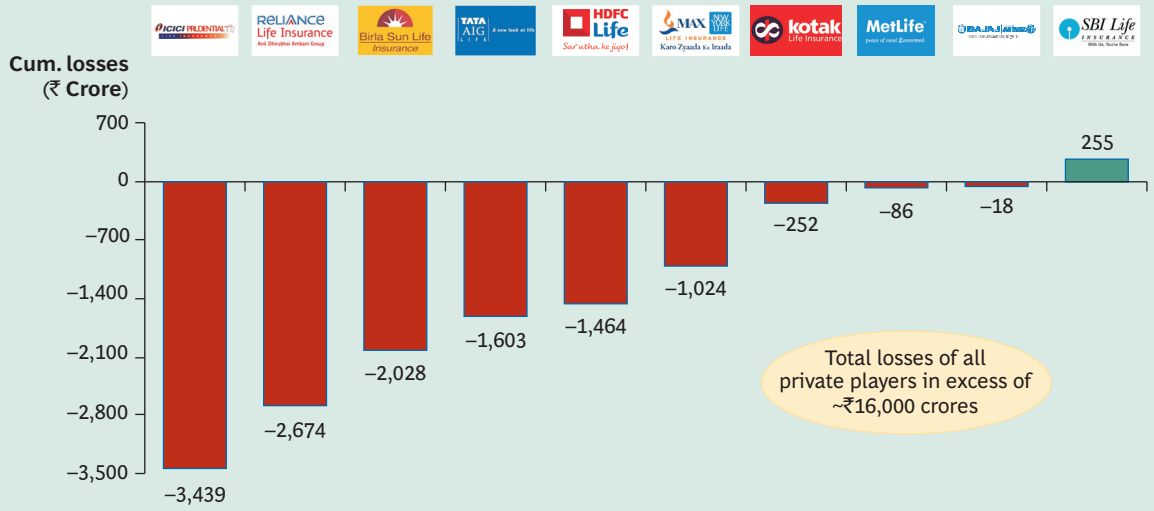
The Current

Insurance Industry Facing Challenging Times

The big challenge before the Indian insurance industry today is profitability. The industry was privatized a decade ago, but profitability/returns are still tough for most insurers, both in life and non–life. The life insurance industry has been struggling to achieve profitability in the face of high operating losses. Cumulative losses for private companies in life insurance are in excess of ₹16,000 crores, as shown in Exhibit 3.1. Almost 75 to 80 percent of the capital requirement has been to fund operating losses and not for solvency requirements. Increasing pressure from shareholders to limit additional capital contribution, has forced the industry to change its focus to enhancing profitability. Tightening regulation has further increased this pressure.

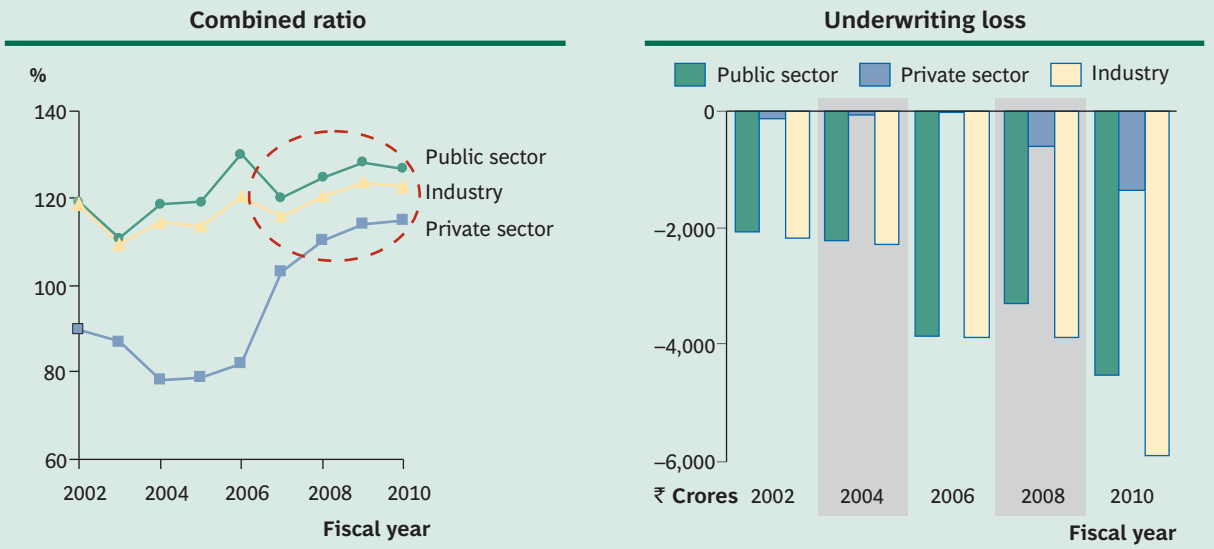
Non–life companies in India face a similar challenge. The combined ratio (operating expenses + claims + commissions as a percentage of net earned premiums) of all the non–life insurance companies for the past five years has been around 120 percent (refer to Exhibit 3.2). The cumulative underwriting losses of the industry, since

Exhibit 3.1: Cumulative losses of top 10 private players (2001–1010)



Source: IRDA annual reports; company disclosures; BCG analysis.

Exhibit 3.2: Non–life insurer profitability



Source: IRDA; BCG analysis.
Note 1: Companies included are: Private non–life insurers = Royal Sundaram, Bajaj Allianz, Tata AIG, Reliance, IFFCO Tokio, ICICI Lombard, Cholamandalam, HDFC Ergo, Future Generali, Universal Sompo, Shriram, Bharti Axa, Raheja QBE; Public Non–life Insurers = New India Assurance, Oriental Insurance, National Insurance, United India Insurance.

2001, totals to more than ₹30,000 crores. Further, the underwriting losses for the industry have grown at around 13 percent CAGR in the past five years. In fiscal year 2010, the underwriting losses stood at a staggering ₹5,900 crores. The companies are dependent on their investment income to break even, which is not sustainable in the long term. This is a critical challenge that the industry needs to address in the coming years for the long–term viability of the sector. There are many factors behind the profitability challenge, as discussed below:

"Agency is looking for the elusive profitable operating model"

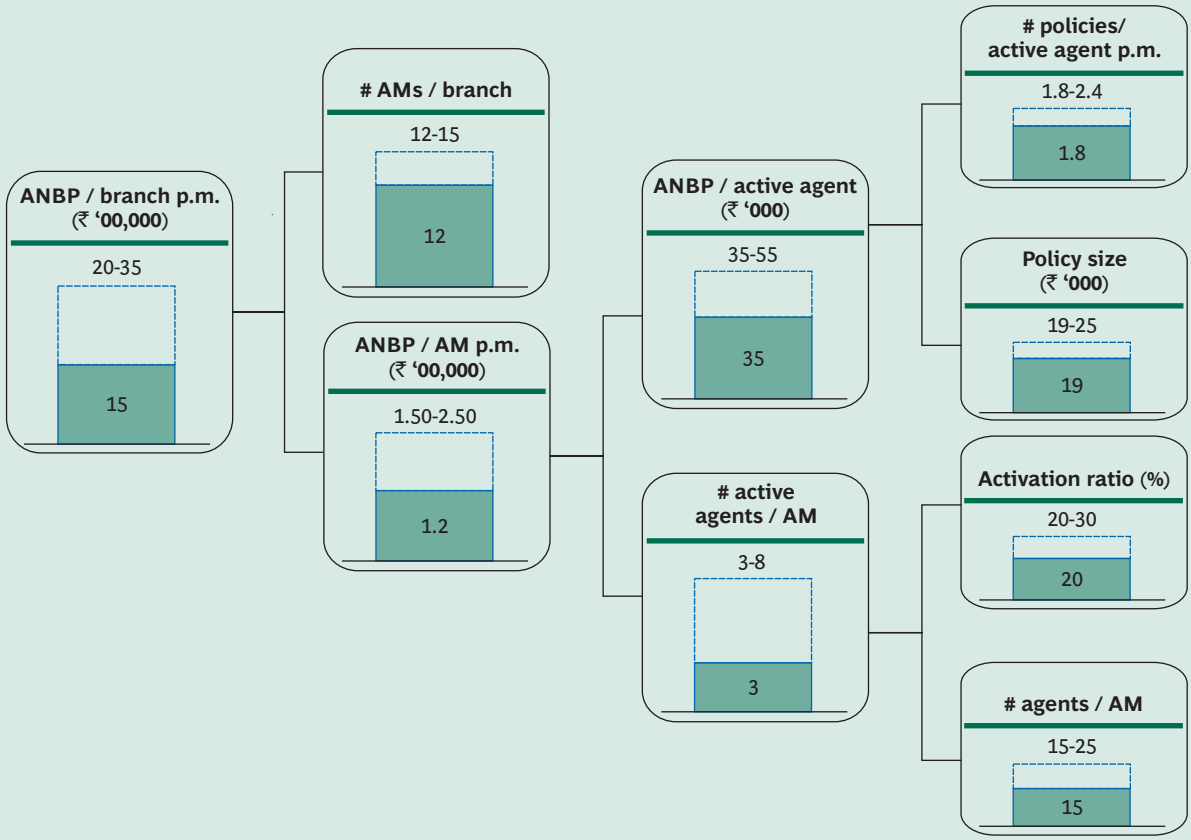
The viability of the agency channel in the case of both life and non–life is challenged. For life insurers, the agency channel has been plagued by high expense ratios, primarily because of fixed compensation for agency managers. This is a unique situation, and India is one of the few countries, if not the only country, to have such a large fixed cost in part–time agency. Elsewhere in the world, agency compensation is variable rather than fixed. This situation is an outcome of the "agency manager as an employee with fixed costs model", and now the industry is stuck in a rut. With all the existing 25 insurers employing the same model, it is impossible for any one or two insurers to try and change the model to a truly variable compensation model.

The high fixed cost of agency management pushes up the break–even volume for insurers. To cover costs, the average monthly ANBP per agency manager has to be in the range of ₹200,000. In reality, the average productivity of an agency manager is significantly below this threshold at ₹125,000–150,000 per month (as shown in Exhibit 3.3).

If one looks at agency economics, even considering the part–time nature of agency, what stands out is the activation ratio of approximately 20 percent. There is a critical need to start focusing on enhancing the productivity of the channel. While structural changes will take time to implement, there is need for rationalization and professionalization of the agency channel for all insurers.

This has significant implications for all life insurance companies, especially in terms of how to set up agency networks. The Boston Consulting Group has carried out

Exhibit 3.3: Life insurance agency economics tree (2010)

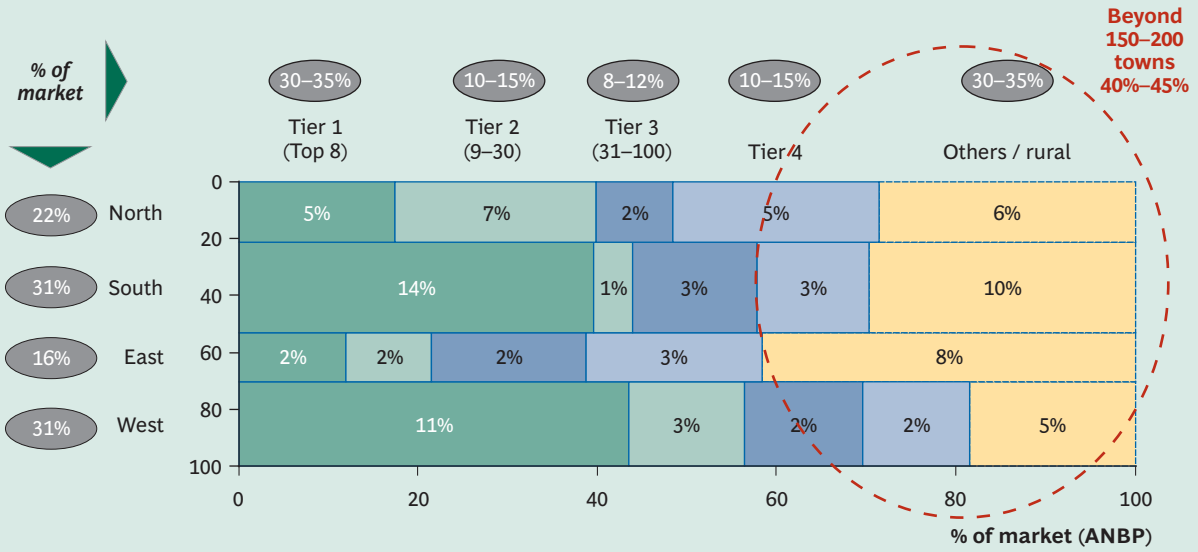


Source: Industry interviews, press searches, BCG analysis.
Note 1: Industry benchmarks – lower limit is quintile–1 branches of top 10 players; Upper limit is quintile 1 branches of top 5 players.
Note 2: Industry numbers represent the typical performance across several competitors' branches as per industry interviews.
Note 3: AM = Agency Manager.

detailed analyses of the life insurance market in the top 1,000 towns. Based on this study's forecast for life insurance (2015 and 2020) by town, and the bare minimum fixed costs associated with establishing a branch (infrastructure, branch manager, and agency managers costs), it is clear that owned branch infrastructure beyond the top 150 to 200 towns is unlikely to be viable, even if one makes aggressive market share assumptions. At the same time, nearly 40 to 45 percent of the life insurance market is beyond these 150 to 200 towns (as shown in Exhibit 3.4) and hence, targeting these locations will require innovation – companies will need to leverage partner assets and / or alternative channels.

In the case of non–life insurance, the agency model is challenged even further. The biggest challenge for the non–life industry is that agents do not find the compensation lucrative enough to work full time. On average, annual agent productivity is around ₹5 lakhs to ₹10 lakhs, which translates to a commission of only ₹4,000 to ₹8,000 per month. This is further made difficult by the nature of the sale – low pull from customers, small ticket size, etc. Typical ticket size for auto, health, or homeowners insurance is approximately ₹5,000 to ₹8,000. Even to achieve a target of ₹10 lakhs of premium, an agent would have to sell about 100 to 150 policies per annum (or 8 to 12 per month). Hence, many agents find selling life

Exhibit 3.4: Life insurance market by region (2010)



Note: Each cell represents a particular tier of a particular region; size of the cell represents the percentage of market corresponding to the same.
Source: Bank Statistical Returns – RBI; MOSPI GDP growth estimates; BCG analysis.

insurance or other financial services products more lucrative than non–life.

Economics of all Other Channels are Also Challenged

Economics of all the other channels are also tight. For example, bancassurance provided a very good and profitable model in the early years. Once banks realized their value and clout, they renegotiated more attractive terms for themselves, making the economics for insurers less favorable. The Axis Bank — Max New York life deal is a good example of the tightening of terms. This has triggered a wave of similar expectations with Punjab National Bank, Syndicate Bank, Punjab and Sind Bank, Corporation Bank, and Indian Bank, among others, now exploring such an optimal deal for themselves.

In–house salaried sales forces built by life insurers also face challenging economics with most companies struggling to raise productivity per sales manager beyond ₹100,000 per month, clearly not enough to cover costs. In fact, BCG estimates break–even premiums at ₹2 to ₹3 lakhs per month, depending on the operating model.

Broking is another fast–growing channel in the non–life industry. However, unlike most developed markets, in India, this channel is very fragmented, with few large and organized brokers. Most brokers do not provide sufficient value–addition to the client and hence, end up as glorified and more expensive agents. In fact, even when brokers participate, they only play the role of an effective reverse auctioneer and play–off insurers against each other, hence reducing margins for the insurers.

Corporate agents are of two types. The small ones, typically, deliver poor–quality customers (low persistency) and are a potential brand risk. The larger ones (like banks) have realized their value and insist on high payouts, which have made corporate agency less profitable. While current regulation is forcing a move toward lower commission payouts on ULIPs — the economics for insurers continue to be challenging. For example, non–linked products capturing a higher share of business continue to receive high commissions.

Auto dealers are an important and growing channel for non–life insurance companies. Many Original Equipment Manufacturers (OEMs) and their dealerships have

realized that selling insurance can be a very attractive proposition. Not only does it provide them additional income while selling new cars, it also works as a good way to drive volumes for their service and repair business. However, this is a very expensive channel for insurance companies. They end up paying a very large commission up–front (to the tune of 25 to 30 percent on the higher side) to these dealerships. Claims losses are also high as the cost of repairs in OEM dealerships is very high. Most insurance companies find this channel to be unviable.

Insurance Missing its Uncle Scrooge!

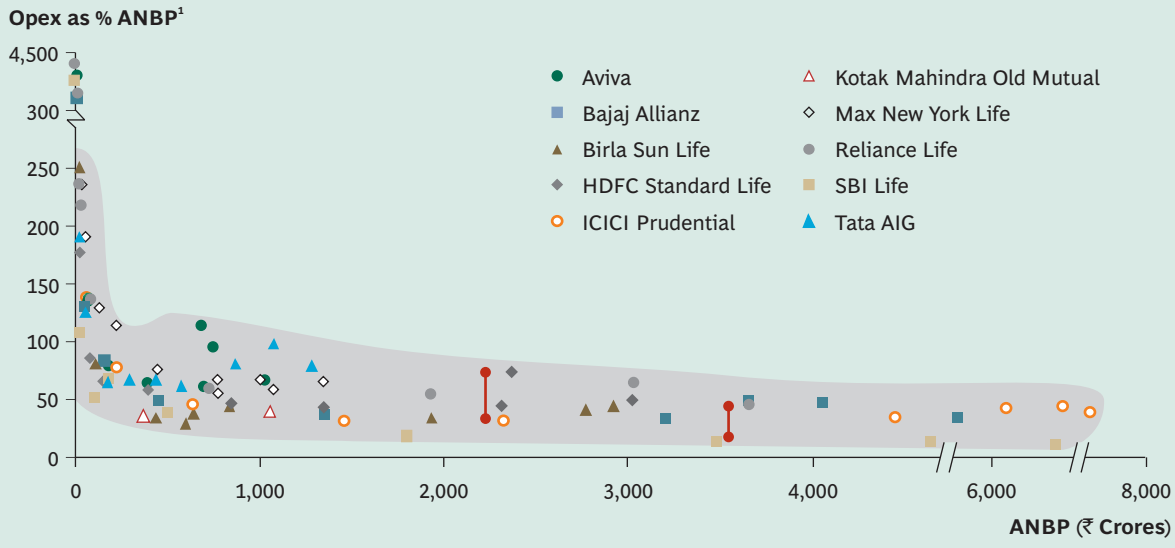
The third key challenge in the Indian insurance market has been the fascination for top–line growth at any cost. Insurers appear to have forgotten the clichéd phrase "Topline is vanity; bottom–line is sanity". This lack of profit focus within the insurance industry, until recently, has contributed to significant inefficiency in operating models. This, for example, results in large branch offices resembling those of banks despite the fact that life insurance branches are inherently agent–servicing locations. How else do you explain insurers maintaining more than 4,000 sq. ft. ground floor, main–road–facing branches in prime locations with expensive infrastructure, or having more than 10 branches in tier 2 cities? Given the smaller size of these markets, a large number of the branches in small urban / semi–urban centers are struggling to break even – with volumes insufficient to justify branches covering more than 1,000 sq. ft. The limited attention to lean staffing and variable compensation models further inflates costs.

Not surprisingly, cost ratios for most Indian life insurers are inferior to those of global peers. Opex ratios (defined as operating expenditure / total premium) for the top 10 Indian life insurers are in the 15 to 30 percent range, compared with international benchmarks of 10 to 15 percent. The smaller companies are much worse. With an average cost ratio of 25 percent, Indian companies are a long way off from meeting international norms.

Additionally, there are significant differences in the cost positions of various companies even within India (as shown in Exhibit 3.5). Two points stand out:

1. There are huge benefits of scale–up to a premium income of about ₹1,500 crores to ₹2,000 crores and the

Exhibit 3.5: Opex ratios for top 10 private life insurers (2001–2011)



Source: IRDA; Analyst reports; BCG analysis.
Note: ANBP = Annualized New Business Premium.
[1]Single premiums have been taken as 1/10th for their annualized value.

opex cost ratio drops dramatically from more than 100 percent to 30 to 50 percent.

Operating model choices make a significant difference. For example, even at the same scale of operations, there is a significant difference in the opex cost ratios, with the difference being as stark as x–2x / 3x. This is the difference between break–even in year 7 and break–even in year 10, and could mean an extra ₹1,000 crores of capital.

A similar trend can be seen in non–life insurance as well. The operating expenses as a percentage of Net Earned Premiums (NEP) for the industry is more than 32 percent. This is higher than the global average of 15 to 20 percent. Further, there is high variability in the opex ratio of different companies. It varies from 25 to 30 percent for the large private sector companies and from 40 to 50 percent for the smaller companies. This poses a significant challenge to new entrants in terms of their choice of business model to keep operating expenses under control. The value of scale is evident in Exhibit 3.6. Doubling NEP reduces opex cost ratio by approximately 25 percent.

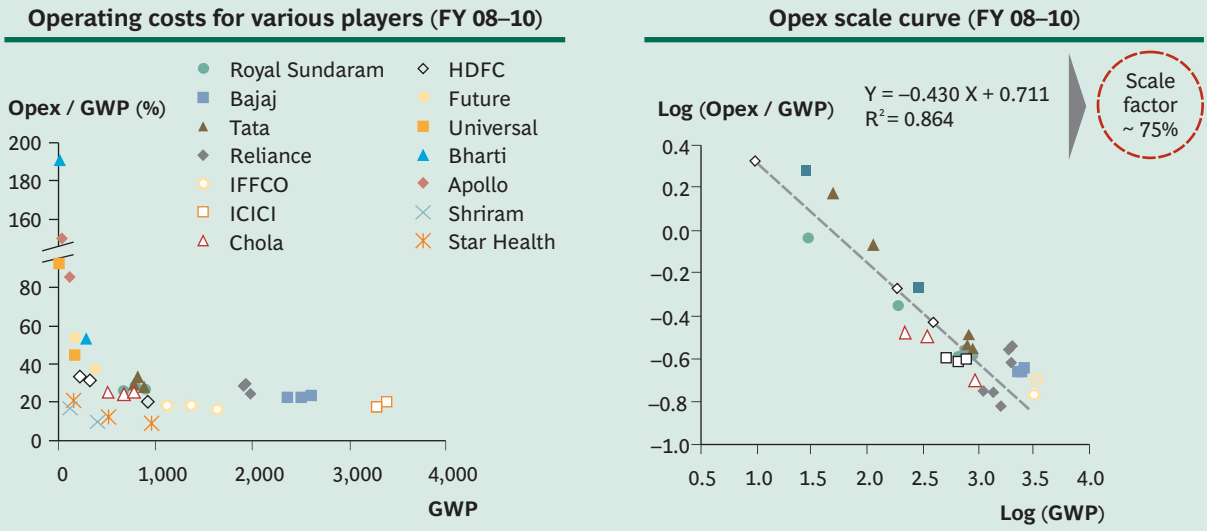
While a continued focus on growth for scale is critical, focus on opex management is a necessary step. Companies will need to adopt a set of appropriate practices to build a lean operating model. Greater regulatory flexibility could help them develop new operating models — for example, through outsourcing — and improve their performance.

"High, Higher, Highest" Claims Costs

High claims costs in the non–life sector is the main reason the industry still has underwriting losses. The claims ratio in the Indian non–life industry in the last five years has ranged from 80 to 85 percent. The ratio for public sector companies is even higher at around 90 percent. This means that for every ₹100 of premium that the industry earns, it gives back ₹85 to the policyholders in the form of claims, leaving only ₹15 for commissions and operating expenses, which is clearly not enough. The international benchmark of claims ratio is 60 to 70 percent.

There are several factors for the high claims ratio. One of the biggest reasons for the high claims for the industry is auto Third–Party (TP) claims. TP liability cover is

Exhibit 3.6: Opex ratios for private non–life insurers



Source: IRDA, BCG analysis.
Note: Companies included are ICICI Lombard, Bajaj Allianz, IFFCO–Tokio, Tata AIG, Royal Sundaram, Cholamandalam, HDFC Ergo, Reliance, Future Generali, Universal Sompo, Bharti Axa, Apollo Munich. Shriram and Star Health excluded due to extremely distinct operating model.

mandatory for all vehicles in India. The challenges for TP insurance include:

- The cover is for unlimited liability.
- The prices of commercial vehicle TP are still controlled by the regulator and are kept artificially low due to pressure from the truckers lobby.
- TP has a very long tail of many years, making provisioning very difficult.
- Industry is chronically plagued by large–scale fraud.
- The claims settlement process is extremely cumbersome and time–consuming.
- The loss ratio for the commercial vehicle TP is estimated to be around 150 percent, and has been in excess of this number for the past few years.

The second key reason for the high loss ratio is health. The health loss ratio for the industry is more than 100 percent and has been so for many years. The key reason for high losses is group health covers. Group health covers are given to employees and dependents of large companies. The pricing for group health was low in the tariffed world because it was used as a discount for the more profitable fire and engineering business from corporates. Despite de–tariffing, when fire and engineering rates have fallen, insurers still find it difficult to increase the prices of group health because of the bargaining power of the large corporates and the large premiums involved. This results in huge losses.

Another key reason for high claims costs are high payouts per claim event. This is a function both of the extent of fraud in the industry and the lack of supplier management (hospitals / garages) by the insurance companies. The extent of fraud is to be seen to be believed. For example, in the case of health, many people have experienced different rates being charged by clinics / doctors / hospitals for those with and without an insurance policy. In fact, data shows that the difference between cashless (insured) and non–cashless settlements (both insured and uninsured) is more than 40 percent. If this is not enough, in the case of auto, there exist garages with apparatus to simulate accidents for enhancing claims. (For example, some have two solid poles to create damage on either side of the vehicle.)

Post de–tariffing, insurance companies are facing intense pricing pressure for all products, ranging from private cars to fire / engineering policies. The key to improving claims ratio will be the ability to impose risk–based pricing, ensure superior claims management, and manage suppliers pro–actively.

Where the Intermediary is the Customer and the End Customer is Forgotten

Life and non–life insurers have failed to maximize the value from their existing customer base. On average, less than 10 percent of their customers have bought more than one policy from the same company. Furthermore, most of their customers have less than adequate insurance. The focus has been on pure "land grab". However, of late, few companies have started focusing on the life–cycle value of the customers.

The industry is inherently intermediary–centric and limited attention has been given, so far, to customer engagement. In fact, basic customer information is often not tracked and mined. A few examples highlight this problem. In the case of health insurers, it is remarkable that the entire customer data is with TPAs and, in some cases, the insurers do not even have the full data set.

In auto insurance, basic data such as age of the owner that can have a large relevance for pricing, is not even asked for, forget about using it for pricing. While many companies have started collecting more data in the last few years, the quality of data capture is suspect, and the lack of historical data delays usage for pricing.

Channel and internal sales organizations are not geared to focus on upselling / cross–selling – even persistency management has traditionally been less than an active part of channel management and organizational systems. As a result, cross–selling ratios continue to be low, and low persistency is a challenge for most companies.

Regulatory Changes Turning the World Upside Down

A lot of regulatory changes have been implemented in the past two years. 2010 was the year of the product. The key changes included commission caps for channels for ULIPs, caps on surrender charges, and minimum guaranteed returns for pension products.

These regulatory changes, introduced since September 2010, have significantly reduced new business margins for ULIPs. Companies have been forced to reduce

commission payouts (agency commissions, for example, have fallen to about 5 to 6 percent) and explore means to reduce operating expenses. Minimum stipulated returns on pension products have affected sales.

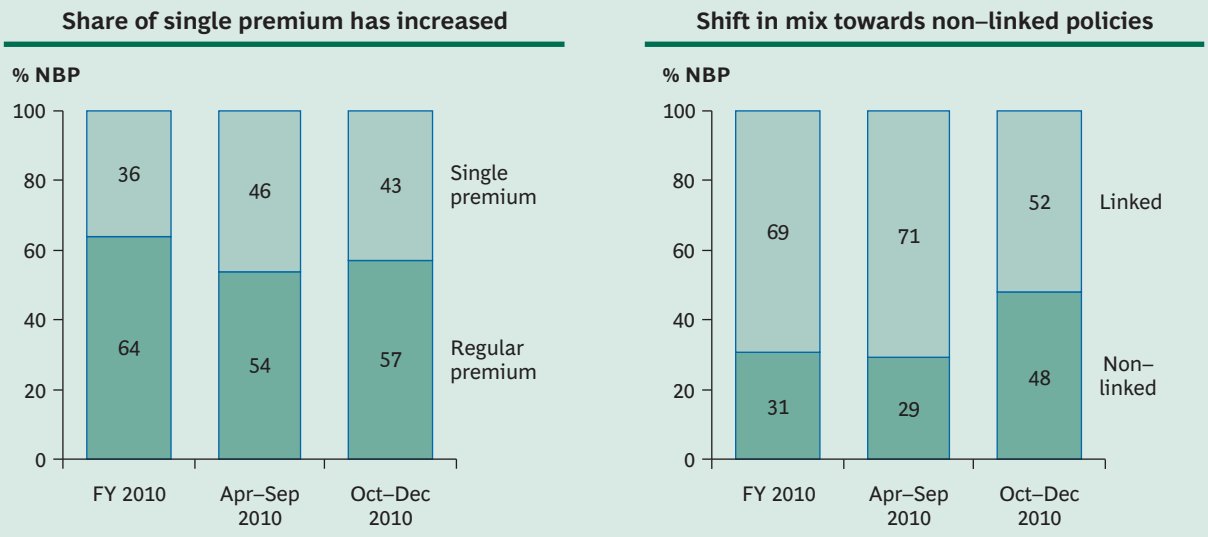
The regulatory changes appear to be in the right direction and are forcing insurers to focus on customer value and operating efficiency. There is, however, a key question: Are the regulatory changes "too much, too quick?". The intensity and extent of changes appear to be steep and the transition time short. The short time to transition has led to a sharp decline in sales and a period of uncertainty as companies struggle to quickly adapt a large part of their portfolios and overhaul their operating models.

The immediate impact, in the short term, has been a shift toward sales of single premium and non–linked products (as shown in Exhibit 3.7). These products have been increasing their share of the market in the past six months. This will continue, given the regulatory impact on ULIP margins. Over time, ULIPs can be expected to recapture a part of this loss as the product economics improve, the anomaly between traditional products and ULIPs is corrected (after all, a traditional product is nothing but a non–transparent debt ULIP), and increased customer transparency creates demand pull from customers.

The second big shift has been the shift in focus on the part of insurers toward a leaner, more productive distribution network. Tightening regulations have "forced" companies to move from an unorganized, mostly part–time agency force with very low productivity to a leaner, more professional channel with a growing focus on key productivity metrics and profitability. A number of private insurers have already started rationalizing their agency force with closing and / or merging branches and by targeting marginally active or inactive agents for release. It is estimated that insurers have shut about 1,000 branches and released about 400,000 inactive agents in the past six months, after the regulatory changes on September 1, 2010.

The industry will also see a move away from a multitude of very small distributors, with inefficient sales models supported by high commission structures, to large distributors that are becoming larger as they transform their business models and shed their inefficiencies.

Exhibit 3.7: Product mix (2010–2011)



Source: IRDA journals, annual reports; analyst reports; BCG analysis.

The Future

Crystal Ball Gazing: "Going Through the Teens"

As discussed earlier, insurance is critical for the development of the Indian economy. It has, in fact, come a long way in the past decade and the transformation is incredible. The industry has changed significantly along many dimensions — enhanced penetration, increasing coverage, rapid growth of multiple channels, and more customer–friendly products.

However, at the same time, the industry is faced with many challenges as described previously. These include the economics of agency, the economics of other channels, the unhealthy focus on top line with limited attention to costs, really high level of claims, lack of customer centricity, and the tightening of regulations. The overarching challenge is to chart a path to profitability.

India Insurance — A Continued Growth Story: "From Fast to Faster Growth"

The good news is that as one looks to the future, the crystal ball shows rapid growth. Historically, the life insurance market has grown around 20 percent per annum but it suffered a dip in FY 2009 because of the downturn (as shown in Exhibit 4.1). This trend was mirrored by non–life insurance, which saw a momentary reduction in growth rate in FY 2008 and FY 2009 due to the double impact of de–tariffing and the economic downturn. However, as is seen in the growth rates for FY 2010, the sector was back on its way to resuming the historic growth rates in the high teens / early twenties. FY 2011 has been different, and growth has been impacted negatively by the massive regulatory upheaval.

However, 2011 is an aberration and BCG estimates high–growth to continue in both life and non–life insurance. By FY 2020, the life insurance market could be six to eight times the FY 2010 market, growing at the rate of around 20 to 22 percent per annum. Similarly, by FY 2020, non–life insurance market could be five to six times the FY 2010 market, growing at a rate of around 18 to 20 percent per annum (as shown in Exhibit 4.2).

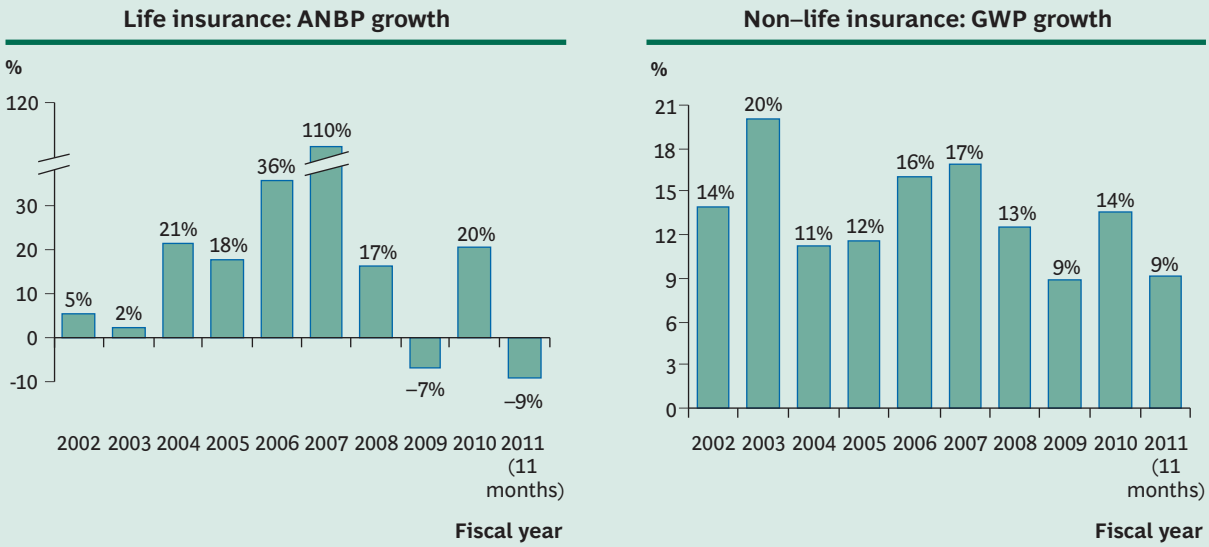
BCG estimates the total insurance premium at approximately ₹17 lakh crores to ₹22 lakh crores in 2020 (with life being ₹15 lakh crores to ₹20 lakh crores). That would make it, in U.S. dollar terms, an approximately $350–400 billion industry. This massive growth will have a significant impact on India's ranking in the global insurance industry. In life insurance, India, with a current total premium of about ₹2,60,000 crores (FY 2010), ranks tenth after South Korea and Taiwan. By FY 2020, India is likely to be one of the top three insurance markets, behind only China and the United States. This would mean that the Indian life insurance market will overtake the Japanese, British, French, and German markets, among others.

Similarly, in non–life insurance, India with GWP of about ₹35,000 crores (FY 2010) is currently ranked twenty–eighth after Turkey and Sweden. By FY 2020, India can be one of the top 15 markets. This would make the Indian non–life insurance market potentially larger than the Swiss, Argentinean, Belgian, and Austrian markets. This rapid growth is based on strong fundamentals

Strong GDP growth, savings growth, and financial savings growth

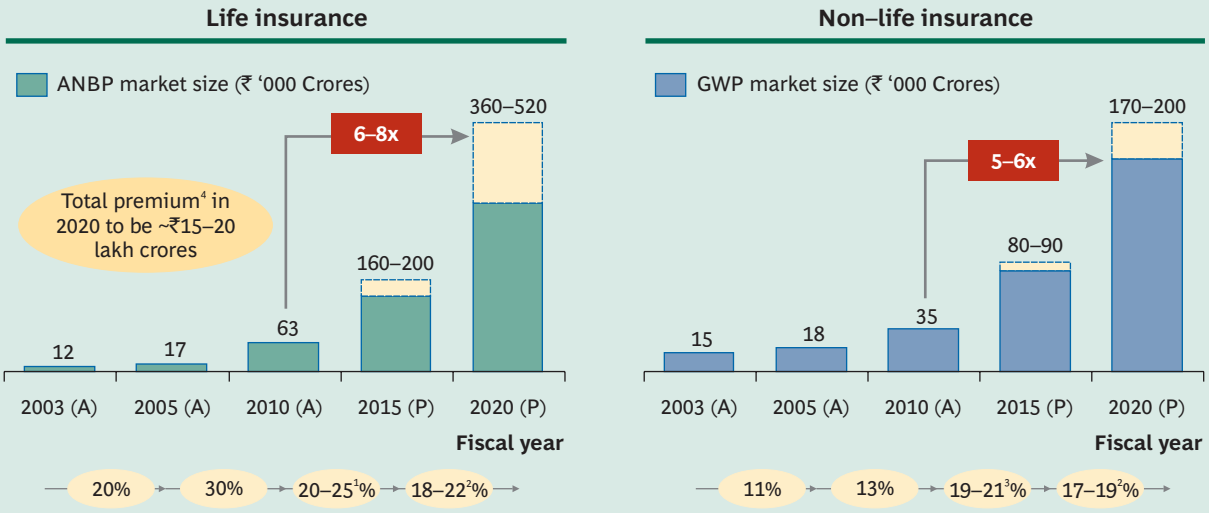
Looking at GDP growth forecasts, India is expected to figure at the top of the charts and is expected to be the fastest–growing economy, even among the rapidly growing BRIC (Brazil, Russia, India, and China) group.

Exhibit 4.1: Insurance growth (2002–2011)



Source: IRDA; BCG analysis.
Note: ANBP = Annualised New Business Premium; GWP = Gross Written Premium.

Exhibit 4.2: 2020 insurance market estimate



Source: IRDA; RBI (for inflation and GDP estimates); BCG analysis.
Note: ANBP = Annualised New Business Premium; GWP = Gross Written Premium; (A) = Actual; (P) = Projected.
[1]Implied multiple of nominal GDP growth rate = 1.5 (low) and 1.7 (high).
[2]Assuming 2015–2020 growth is at same multiple to real GDP as 2015.
[3]Implied multiple of nominal GDP growth rate = 1.3 (low) and 1.6 (high).
[4]Ratio of total premium to ANBP assumed to remain more or less constant at about 4.

Add to that the fact that the savings rate in India is increasing. In fact, household savings has risen from mid–20 percent in 2000 to approximately 33 percent today. And if this was not enough, financial savings as a percentage of total savings has grown from approximately 40 percent in 2000 to approximately 50 percent today, and is expected to continue to increase to approximately 60 percent by 2020.

New customers will come into the insurance fold, resulting in higher penetration

India has highly favorable demographics. Penetration of both life and non–life insurance is correlated to GDP per capita. As GDP per capita increases, penetration of insurance premium as a percentage of GDP also increases (as shown in Exhibit 4.3). For example, premium volume as a percentage of India's real GDP is just 0.6 percent for non–life; Asia is 1.67 percent, Europe is 3.1 percent, and North America is 4.92 percent.

This trend will be supported by the rising income levels of India's young population. In fact, approximately 40 percent of population is currently between 20 to 49 years of age, and this number is expected to grow to 45 percent by FY 2020. Low social security cover, coupled with increasing life expectancy — average of 66 years in 2010 against average of 60 to 61 years in 2000 — will also fuel a need for insurance. As the level of education increases, general awareness about insurance and its benefits will also increase, providing further fillip to the demand.

Significant under–penetration in the commercial segment of non–life

The penetration of Small and Medium Enterprises (SMEs) in the case of non–life is low and that of Small Enterprises (SEs) is negligible. As one looks at the maturing of these SME / SE businesses, it is clear that their needs and hence, penetration will multiply manifold.

New products will be developed to capture unmet needs

Going forward, Indian consumers will witness significant changes in their insurance needs. The cost of living is likely to rise with inflationary pressures. Life expectancy is also likely to continue to increase for the Indian consumer. Both these trends require Indian customers to plan actively for future sources of income to sustain a desired standard of living. Consequently, Indian customers require innovative wealth management, protection, and retirement solutions.

Similarly, Indian corporates are getting increasingly sophisticated in their business operations. For example, India's international trade is growing at almost 14 percent against world trade, which is growing at about 6.7 percent. Also, the number of large corporates (companies with revenues greater than ₹5,000 crores) has increased from 24 in FY 2000 to 114 in FY 2010. Along with this increased sophistication and complexity of business comes the need for innovative and sophisticated insurance products.

There are also certain segments like rural / micro / FI that have unmet needs. Product innovation will capture these needs and drive growth.

Further, there is significant opportunity to increase distribution reach

Bancassurance, brokers, and other alternative channels (tele sales and online) are still nascent in India, and their growth will bring in new customers and drive higher share of spending on insurance products by existing customers.

Existing customers will allocate higher corpus to insurance

Even for people who are insured, there is significant undercoverage. For example, in the case of life insurance, the global thumb rule is that people should insure themselves for 5 to 6 times their annual income. Very few, if any, Indians would have such a quantum of insurance. Increasing savings rate and a shift in the mix of savings instruments away from traditional savings instruments will result in growth of allocation to life insurance.

The Indian Insurance Market in 2020

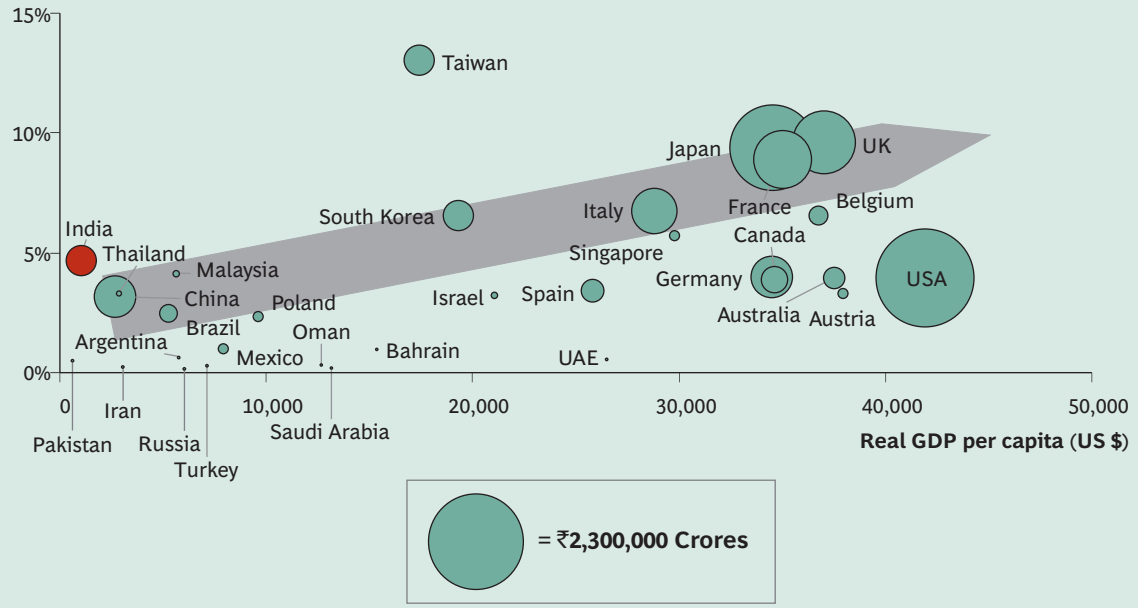
As one looks to the future (2020), it is clear that the next decade will be just as transformational as the past decade has been. Massive changes are expected in product mix, customer mix, channel mix / penetration mix, products / services offered, pricing, etc.

Product mix — "Health emerging as the clear blockbuster"

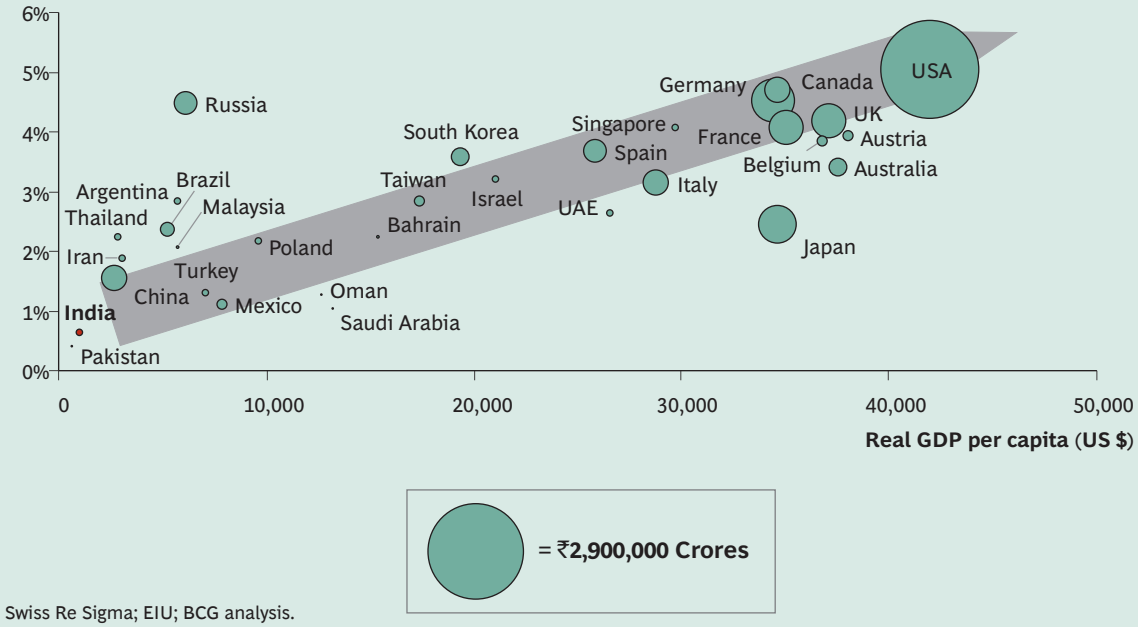
In the life insurance space, regulatory changes are likely to shift the product mix – with single premium and non–linked products likely to grow (This was described

Exhibit 4.3: Global insurance penetration (2009)

Life insurance penetration and GDP per capita (2009)



Non–life insurance premium / real GDP (2009)



Source: Swiss Re Sigma; EIU; BCG analysis.
Note: 1 USD = INR 45.

previously while discussing the impact of regulatory changes). In fact, this has already happened in the first six months post the regulatory changes.

Pension will be large, as low penetration and inadequate pension cover will drive growth in "true pension" (including annuities). However, lack of depth in the bond / derivative markets could limit growth. In the case of non–life insurance, auto insurance, which is large today, will continue to be a dominant product, potentially accounting for more than a third of the GWP by FY 2020 (as shown in Exhibit 4.4).

Health insurance will emerge as a second dominant product given its low penetration today and the rising cost of health care in the future. It could potentially account for approximately 40 percent of the total GWP by FY 2020. Householders or personal lines will also witness significant growth.

Product / service offering — "From basic products to comprehensive solutions"

The next 10 years will see a major shift in the offerings, which will be larger and starker than what has been seen in the past 10 years. Health insurance is a case in point. This market will see a shift from offering simple, "reimbursement of hospitalization" products to "solutions" that cover disease management and wellness.

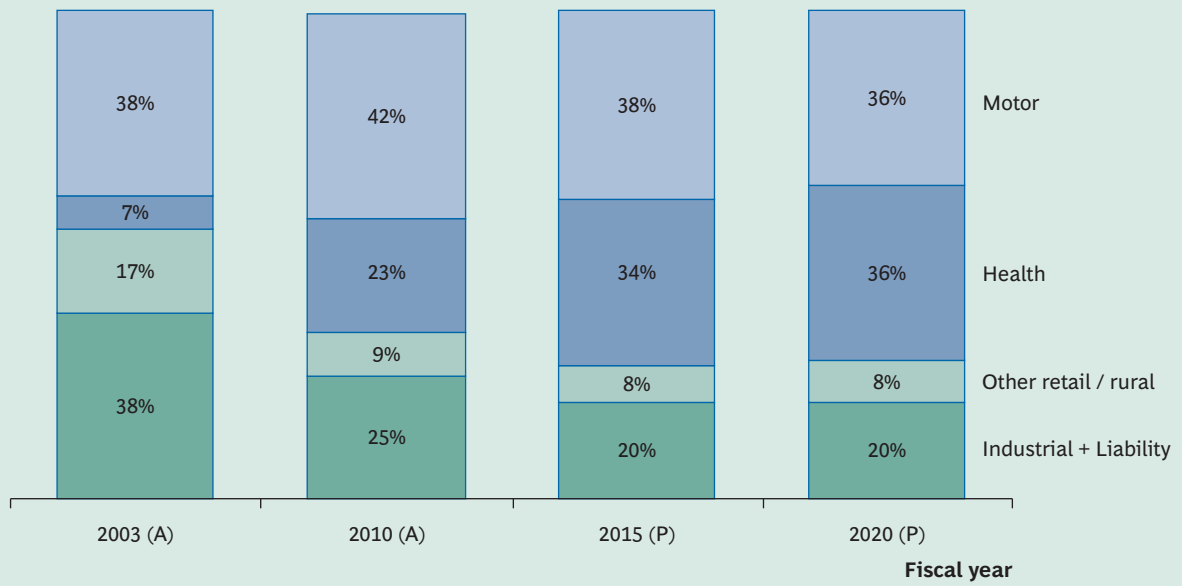
Personal insurance will evolve significantly with the addition of new products beyond auto. Exotic insurance products such as vintage car insurance and art insurance will come into the market. Further, bundling of products is likely to grow as an effective way to sell low–ticket size, mass–market products. For example, personal accident and health insurance could be bundled with mortgage or credit cards.

Similarly, the life insurance market could see the emergence of variable annuities. This could, however, take time because it will need the Indian debt / bond / derivative market to gather more depth.

Customer mix — "SMEs and micro / rural, the next frontier"

The SME sector has the potential to be an important revenue pool for insurers. While the number of large

Exhibit 4.4: Non–life product mix (2003–2020)



Source: IRDA; BCG analysis.
Note: (A) = Actual; (P) = Projected.

corporates is growing (as mentioned previously), competition among insurers to serve the SME segment is also high (which has resulted in pricing pressure).

Large corporates account for almost 60 percent of the corporate insurance business with mid–size corporates accounting for almost 25 percent of the business. Also, penetration in the case of large corporates is 80 to 90 percent, while the number for mid–size corporates is 60 percent. The SMEs, in contrast, account for only around 15 percent of the corporate insurance business and have a low, 10 to 20 percent penetration (as shown in Exhibit 4.5). Therefore, there is significant white space to expand the SME insurance segment.

Further, the possibility of large claims in the SME sector is low compared with the large and mid–size corporates. Also, the underwritten risks can be mainly retained by the insurer as the sum assured is typically in the range of ₹1 crore to ₹5 crores.

While the cost of customer acquisition and service for the SMEs was prohibitive earlier, it is likely to become less of a challenge for two reasons. First, the profitability of the SME segment is becoming attractive compared with the large corporate segment for reasons mentioned earlier. Second, as banks start increasing their funding to the SME sector, they insist on the collateral being insured, and this provides an opportunity to leverage the bank's distribution channel to compress the insurance administration cost to SMEs. In fact, several first–movers in this space are witnessing high double–digit growth rates in income from the SME segment.

The large and mid–size corporates are undergoing significant globalization and their business models are getting increasingly complex as described earlier. Also, there is already very high competition in this segment. In such an environment, insurance companies with global reach, reinsurance tie–ups, and sophisticated products to support globalization will succeed.

Rural insurance will grow and become important for insurers. Financial Inclusion (FI) is one of the top ranking national priorities. Already several path–breaking changes have been undertaken to drive FI. Aadhaar by UIDAI has been launched, for–profit Business Correspondent (BC) guidelines have been published by

Exhibit 4.5: Commercial business segments



Source: Customer interviews; BCG analysis.

the Reserve Bank of India, and new mobile technology changes are eliminating the compromise between quality of service and cost of service, thus making it viable for companies to take financial services to rural areas. Also, banks are likely to become more aggressive on FI.

Already, Indian scheduled commercial banks have submitted their plans to the RBI and the Ministry of Finance to use the BC model to cover almost 72,000 villages without a bank branch, but with a population of more than 2,000, by FY 2012. As a result, new channel infrastructure will get built out and insurance can ride this wave. Initial pilots are showing a strong pull for personal insurance among the financially excluded populace. For example, three FI pilots conducted by Kshetriya Gramin Financial Services (KGFS) offered Personal Accident Insurance (PAI) from HDFC Ergo at an extremely attractive price (₹10 for every ₹25,000 sum assured). By 31st March 2010, 62 percent of all KGFS FI customers had opted for the product.

The health insurance Rashtriya Swasthya Bima Yojna (RSBY), sponsored by the Government of India, will also likely continue to grow and provide opportunities for FI companies to enter the market. In fact, RSBY already accounts for 10 percent of the health insurance market.

Pricing — "From copying competition to risk–based"

The biggest challenge in a deregulated and de–tariffed environment will be getting the pricing right. Globally, insurance pricing is significantly more sophisticated than seen in India. For example, in auto insurance, which forms the bulk of the non–life insurance market in India, a rather rudimentary approach is adopted for pricing – the price of auto insurance is primarily governed by the type of vehicle (commercial / personal) and the written down value of the vehicle.

Contrast this approach with those in developed markets, where multiple parameters are considered for pricing the policy. These include age, gender, education, marital status, and occupation of the driver(s), the number of drivers, the track record of driver(s), the location of their office and home, the size and color of vehicle (indicates mindset), and usage. Based on empirical data for these multiple variables, insurers are able to estimate risk and price accordingly.

Going forward, Indian insurers will also start deploying sophisticated risk–based pricing approaches. In fact, companies are already experimenting with advanced pricing methodologies.

Continuing with the example of auto insurance, companies are seen to be moving away from the traditional IRDA–recommended uniform tariff based on the age of the vehicle, cubic capacity, geographic zone, and IDV to dynamic pricing, which includes variables such as fuel type, cities, model of car, etc. Most companies are experimenting with risk–based pricing and there are attempts to offer pay–per–use pricing as well.

Geography — "Look beyond traditional regions"

Traditional regions have served the insurance sector well in the past decade. Tier 1 cities (particularly in the south and west) have provided opportunities for insurance companies to build out a channel for serving these markets. The argument against entering the next tranche of cities is the inability to recover channel costs. However, this does not take away from the fact that tier 2 cities and beyond offer sizable white space for companies to enter in the future.

The key challenge will be for the insurance companies to aggressively focus on making their channel costs variable. There is a strong case for the insurers to partner with natural allies such as banks and retailers with customer and channel complementarity. Additionally, usage of alternative channels, and mobile and internet technologies will help drive down operating break–even points.

Channel mix — "Bancassurance and direct, the two emerging giants"

Channel mix is also going to undergo significant change in the future. This will happen along three dimensions:

- New channels will emerge; for example, tele and on-line channels will become important
- Some existing channels will gain in importance; for example, broking and bancassurance will grow rapidly
- Channel management approach will also become more professional

In life insurance, banks will become an even more important channel with almost 40 to 45 percent share in the channel mix (as shown in Exhibit 4.6). This development is along the lines of what has been happening in Asia in the past five years.

The other key trend in life insurance will be the proliferation of alternative channels, especially channels that leverage existing distribution capabilities through tie–ups with retailers, FMCG companies, airlines, hospital chains, etc. In the case of non–life, the five large channels are depicted in Exhibit 4.6. The big shift is likely to be the emergence of the "direct – internet + phone" channel. This is estimated to grow from almost nothing today to approximately 10 to 15 percent by 2020.

Action Agenda for Life Insurers — The Journey to Sustained Profitability

BCG has defined a six–point agenda for life insurance companies, based on an understanding of the life insurance market landscape, the challenges, and the likely market evolution.

1. Fix the agency operating model

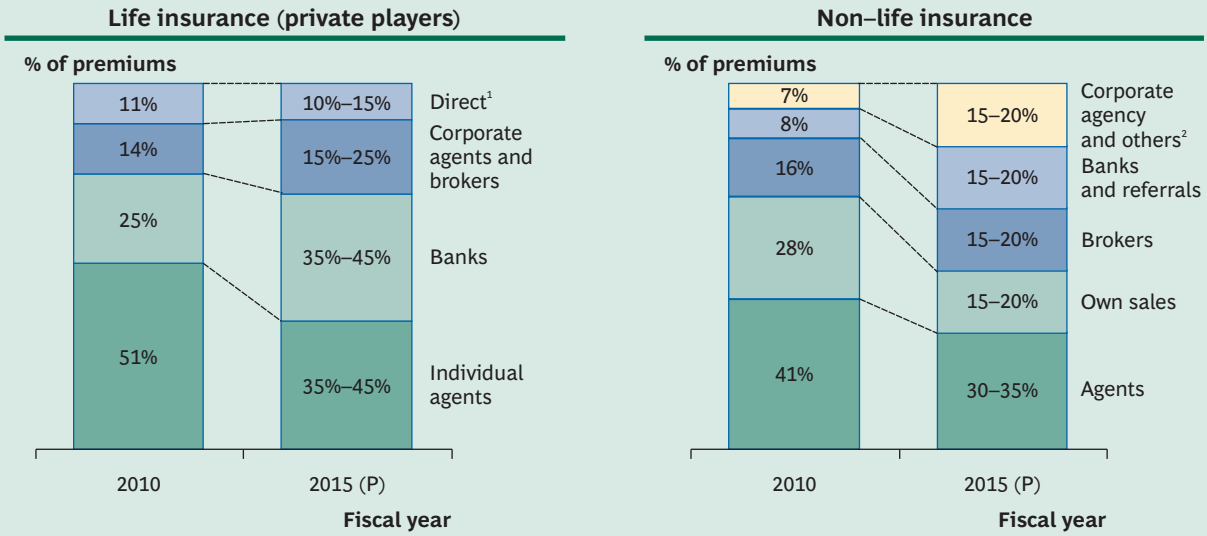
Ensuring profitability of the channel will require redesign of the model along three dimensions — structural changes, "back to the basics" agency productivity enhancement, and cost optimization.

a. Structurally, life insurance companies need to address a set of issues

Segment the sales force and align actions with different segments. To successfully achieve this, insurers need to answer the following three questions:

- What is the appropriate level of segmentation – branch level, agency manager, or agent only? The key challenge is to identify the appropriate level to segment at and how to link between the different levels.
- What are the dimensions of segmentation – performance, vintage, profile, etc.? The trick is to keep it simple and yet actionable, otherwise this has the possibility of becoming complicated and wasteful.
- What are the different actions for different segments? It is critical to have actionable points and real differences for the segments.

Exhibit 4.6: Channel mix



Source: IRDA reports; Company annual reports; Industry estimates; BCG analysis.
Note: (P) = Projected.
[1]Including own sales force, tele and online.
[2]Including tele and online.

Examine the role of the branch manager: Does (s)he have only sales responsibility or should (s)he be an "entrepreneur" with comprehensive P&L responsibility, accountable not only for sales targets but also all controllable costs at the branch level? What are the implications for key capabilities required for such a role? Irrespective of the choice companies make, they need to have branch–level profitability assessment as a critical part of their reporting.

b. **Back to the basics:** Life insurers need to build a leaner but more productive sales force by executing against a comprehensive and rigorous program, which focuses on the key elements of enhancing sales effectiveness. Companies need to implement a set of practices to: increase the time devoted to sales and development, improve commercial activity planning, and increase effectiveness of selling activities. This will require strengthening recruitment; designing and aligning training and coaching programs with distinct segments, ensuring focus on not just induction but also post–induction development; rigorously using a set of simple dashboards that track key activity metrics besides sales output; redesigning the performance management and incentive program with end–productivity goals in mind and with stronger linkage to key productivity metrics (for example, agent activation); and aligning the organizational roles and support functions to distinct segments.

c. **Cost optimization of the channel will require a set of strategic initiatives besides tactical steps.** These include, for example:
   - Revisiting branch strategy in line with the economic potential of the city and branch economics: Insurers need to look at a mix of full–service branches and lean or spoke formats based on the city potential and their likely share of business. In addition, companies need to look at leveraging alternative channel or partner assets to expand geographically into smaller cities.
   - Increased variabilization of costs by more explicitly linking compensation to productivity (and activity metrics such as number of calls) and a more comprehensive use of outsourcing.

2. Build strategic, long–term non–agency partnerships

Insurers need to build a partnership model with banks and other large third–party distributors based on the following five levers to maximize premiums and develop a sustainable long–term relationship.

- Dedicated organization support with clear accountability and account management structure.
- Appropriate coverage model of partner branches / sales locations.
- Best–in–class sales management structure, including HR policies enabling productivity focus, disciplined sales–management practices, and front–end support to partner (for example, joint calls, access to product kits, and illustrations at branches). This will need to be complemented by a set of sales–management initiatives by the channel partners — for example, incentives to improve lead generation.
- Tailored products, where appropriate.
- Robust back–end processes to ensure best–in–class service, for example, fast and flexible underwriting, quick turnaround times for high net worth customers of channel partners, dedicated service desk, local language reminder calls to enhance persistency, analytics support, etc.

Importantly, the model needs to be tailored for each partner's specific context and operating model.

Success of these relationships is incumbent on channel partners as well; long–term success will be driven by realigning expectations and their own business model. The objectives have to be profit for the "partnership" and a focus on business quality, not just quantity. Large channel partners also need to realign their business models to enhance viability. This includes strengthening their own sales–force management practices to enhance productivity and leveraging tie–ups / cross–sell to reduce lead generation costs.

3. "Incubate, experiment, and develop" alternative channels

The internet offers multiple options for life insurers as a small but emerging sales channel in itself, playing a role in a multichannel network as a source of information and / or for customer servicing, and a social media opportunity to engage with customers and agents. While the channel is nascent and will require experimentation,

it is transforming the way certain customer segments engage with companies (including life insurers in developed markets). Insurers in developed markets are experimenting with multiple models, and companies in India need to make an explicit choice about whether, when, and how to use the channel and its growing influence.

Alternative channels such as business–to–consumer companies with access to customers can have significant potential, for example, telecom companies with more than 50 million subscribers. The key issues are prioritizing partners based on their attractiveness (access to large customer base, quality of customer relationship) and defining the optimal operating model to convert each alliance into a profitable opportunity.

4. Develop a customer–centric operating model

Maximizing lifetime value from customers requires building an integrated "customer–centric" program. This includes:

- More active life–cycle–based sales approach
- Proactive customer engagement at each key touch point, including:
  - Pre–sales activity to ensure hassle–free policy issuance, minimize mis–selling
  - Post–sales efficient and effort–free execution against basic service requests, for example, address change, issue duplicate policies, fund switches
  - Proactive communication, for example, information on fund performances, new product launches, and renewal reminders
- Building channel alignment and support processes to focus on retention, upselling / cross–selling. This includes performance assessment of channel partners based on quality of business; enabling processes such as training focused on persistency management and cross–selling / upselling; effective lead hand–offs; and customer analytics to make more targeted sales
- Creating an enabling organization setup and infrastructure, which covers the following:
- Management systems aligned to monitor and manage customer value maximization
- Performance assessment / incentives based on lapse and cross–sell / upsell, not only for sales channels but also for employees, for example, agency manager promotions explicitly linked to lapsation performance
- Appropriate MIS reports and IT systems to facilitate customer–centric view (customer profile, policy information, contacts with customer, etc.)

5. Target customer / product white spaces

This includes a mix of product, customer or region based opportunities. Health insurance offers one such opportunity. The market is likely to see strong growth, driven by the current low penetration of insurance, rapid growth in disposable income, and changing demographic profile. While it is feasible to build a profitable play, it will require a focus on TPA and hospital management, customer segmentation, product innovation, and risk–based pricing.

Similarly, the market for retirement products is significantly under–penetrated, for example, only about 15 percent of working population is covered under retirement plans. While current regulations have slowed down sales of pension products, in the long term, life insurers could look at multiple plays in this market. Cover for the High Net–worth Individuals (HNIs) segment could be the most attractive, but it is also the segment that has the most competition. Cover for the mass affluent segment will have lower profitability and will need wide distribution reach, but it is the largest segment and is also growing rapidly. Selling annuity to retirees could be a small but attractive segment, which will need good–quality data. End–to–end fund management solutions for corporates could be another opportunity.

A concerted push toward FI also holds potential for insurers. While this is an immediate priority for banks, recent regulatory changes (for example, introduction of for–profit BCs significantly expanding the pool of interested organizations) and technology innovations (for example, mobile–phone–based POS terminals) could unlock the market for life and non–life insurers as well. Targeting this segment will require innovation in product design and sales models, including partnerships and operations.

6. Go lean — "lean is in"

Lean operating model and proactive expense management is critical to ensure a healthy bottom line and to protect against the downside. Insurers also need to examine options to variabilize their cost structure. This will include, for example:

- Building a lean distribution infrastructure (lean branches, shared infrastructure)
- Thoughtful prioritization of locations for opening own branches based on potential. This needs to be complemented with other options such as leveraging of partner assets to penetrate smaller centers / locations
- Building leaner organization structures (especially at the head office and zonal office levels)
- Optimization of key processes — including optimal use of outsourcing to lower costs
- Stronger linkage of employee compensation to productivity

But what is most important is a profitability–focused mindset with expense management (and associated operating ratios), a more integral part of CEO dashboards.

Action Agenda for Non–Life Insurers — The Journey to Sustained Operating Profits

Similar to the action agenda for life — based on BCG's understanding of the market landscape today, the challenges, and the likely evolution — a six–point action agenda for non–life insurers' journey ahead has been defined.

1. Create optimal product portfolio

As the market matures, with increasingly demanding customers, better infrastructure, and more data, insurers will have to continually evolve better products. For example, in the case of health, moving from hospitalization reimbursement alone, to adding dental and OPD, to wellness and disease management offerings is a journey that is underway. The only question is the optimal timing — when will these services take off in India? This is the typical chicken and egg question. As insurers look at this opportunity, it will be critical for them to partner with hospitals, pathology labs, and pharmaceutical companies, as well as service providers like Medco, Healthways, Medybiz, etc.

Similarly, on the auto insurance side, insurers need to take the lead to offer today's products such as pay–as–you–use and zoning tariffs.

2. Innovate to target product / customer white spaces

There are several product / customer segments in India that are very small but have a high potential to grow. A few such segments include householders' policies, rural / next–billion customers, SME / shopkeeper policies, and HNIs. Let's take a couple of examples:

Householder's policy: Householder's insurance constitutes about 13 percent of the total property and casualty (P&C) premiums in the United States, whereas this figure is negligible in India. There are several reasons for this, including lack of awareness of insurance products, lack of appreciation of their value, product complexity, inability of current channel structures to handle low–ticket sizes, and complex and cumbersome claims–handling processes.

There is a need to address all challenges holistically. This can be done by designing simple, competitively priced products that meet customer requirements; by radically redesigning underwriting and claims processes to control operational expenses; by leveraging technology to automate processes and make the operations simple and efficient; and by using alliances.

Rural / Next–Billion customers: India has a very large number of people who do not have access to formal financial channels. Financial Inclusion (FI) is critical for the long–term sustainable growth of India and is being actively pursued by both the government and by RBI. Several enabling steps have been taken to improve FI, which include allowing for–profit BCs to offer banking services, rolling out unique identifiers that will help in easy and cost–effective authentication of customers, and using of mobile technology.

Banks have made detailed plans to reach out to all villages with a population of more than 2,000

(approximately 72,000 in number). Life and non–life insurance companies can ride this channel to increase their sales to rural customers. They will have to develop customized products suited for rural customers and also design customized claims processes, taking into account low–ticket sizes and geographic dispersion.

3. Move toward risk–based pricing

BCG's experience of working with insurance companies worldwide is that pricing is a very effective, yet often neglected, value driver. Until a few years ago, prices of most non–life products were determined by the regulator. All companies had to offer the same price to the customer. However, the situation changed post de–tariffing, and now companies are free to decide their own price.

Many companies still continue to quote prices with reference to the tariffed price. The tariffed price was based on a few basic variables. Going forward, companies will have to invest in building sophisticated pricing processes. Pricing should based on three Cs — cost, customer, and competitors. Cost is the risk–based price of a customer and is based on the probability of claim. Customer view is about the willingness of customers to pay for different services. Competitor view is about tracking and benchmarking key competitor moves.

Companies need to start collecting a lot more data than they currently do. The data collection should be done both at the selling and claims–settlement stages. This has implications on both the processes and IT systems. The next step is to build strong analytical capabilities to be able to analyze historical claims costs and correlate that to different variables. This is a long journey and takes three to five years before meaningful trends from data can emerge and become useful in pricing decisions.

4. Develop next–generation claims management processes

Claims management is one of the most important functions in non–life insurance. It is not only the largest contributor to costs, but also has a large impact on customer satisfaction. Thus, optimal design of a claims process is a delicate balance between claims payout costs, claims processing costs, and customer service. The three objectives are not always aligned. For example, by tightening the checks and balances to control payout claims, processing costs go up and customer satisfaction can decrease.

Global experience shows that claims optimization programs can lead to a 3 to 7 point reduction in the combined ratio, and significant improvement in customer retention and cross–sell ratio. The key is to perform conscious and economic trade–offs between payout, process, and customer satisfaction, with some bias for reducing payout. Key levers in claims–process optimization are segmentation, garage management, hospital management, and data analytics.

a. **Segmentation:** Many insurance companies treat claims of different sizes and complexity in the same manner. The result is overinvestment in process costs for small claims and under–investment for large claims. For small value claims, claims processing cost as a percentage of payout can be quite significant. Standardization, elimination of redundant steps, and automation of simple claims–handling tasks can yield huge process savings. On the other hand, specialization can be a large lever to effectively control payout in large and complex claims.

b. **Garage management:** So far, most insurance companies in India have not actively tried to manage garage networks. As a result, insurance companies see a large variation in payout for similar kinds of claims within one city. For example, in a small survey of claims payout for one insurance company, it was found that the labor costs of the same task on the same car model in the same city varied from x to 1.8x. This demonstrates the large value in pro–actively managing repair costs. There is a large potential for insurance companies to create a preferred garage network, with negotiated rates, and start diverting traffic pro–actively to these garages. Insurance companies in developed markets not only build garage networks but also actively manage sourcing of parts. This is also an opportunity for third–party garage networks to partner with insurers and help manage claims, for example, Carnation.

c. **Hospital management:** As in the case of auto insurance, there is a large variation in average payout per claim by health insurance companies for the same disease in the same city across hospitals. The variation can be from x to 2–2.5x. There is a growing trend

among insurers to use in–house TPA to settle health claims. This gives them direct access to hospital networks and access to detailed claims–wise data. The next logical step for them is to create a preferred hospital list with negotiated rates.

d. **Data analytics:** Going forward, one of the key success factors in optimizing claims costs for insurance companies will be their ability to collect and analyze large quantities of data. Companies with superior analytics will be able to better segment claims, use automated process where optimal, identify fraud pro–actively, be able to negotiate better with suppliers, and be able to price new contracts better. For example, if a person reports a vehicle loss or accident from a business district on a holiday, the system can raise an alert to probe the claim further.

5. Go direct — build alternative channels for retail products

Over the last four to five years, there has been a significant growth in people buying goods and services through the internet / phone. The share of online / tele channels in airline tickets has grown from almost nothing to more than 60 percent in just three to five years. This shows that given the right experience and value proposition, Indian consumers are ready to buy through online / tele channels. Global experience shows that the online / tele channel can become a significant channel for non–life retail products, especially for auto and health insurance. Four countries with very large and successful online / tele channels for auto insurance are United States, United Kingdom, Australia, and South Korea.

There are several reasons for non–life insurance companies to seriously think about investing in this channel. Global experience shows that early movers in direct channel typically retain a disproportionate share. Direct play is also usually more profitable than offline models. Direct channel also allows for insurance companies to better connect with customers, is more amenable to risk–based pricing, and offers better opportunities for cross–selling / upselling. Apart from auto, other personal insurance lines like travel, PA, and health also can be sold through this channel.

There are also several challenges in successfully building this channel. The first is providing the right experience and value proposition to make customers move away from the convenience of using the agency channel. The second is the need to invest in brand–building and creating a pull. The third challenge is to build a robust pricing engine to offer differentiated pricing to online customers.

Apart from online / tele channel, insurance companies should also explore building other non–traditional channels, such as retail stores / malls, post offices, social media sites, telecom companies, direct–to–home / cable companies, etc. Some companies are trying out these channels as a new source of referrals that can be converted using agency / own sales force.

6. Define and enhance agency sales–force operating model

Although a number of new channels like brokers, corporate agents, and banks have emerged in the last decade, agency still continues to be the dominant channel accounting for nearly 40 percent of sales. The advantages of agency channel over other channels are many — agents are tied to one company and are an extension of the companies' sales force; the company has complete control over this channel.

However, there are several challenges in building a viable agency channel and these have been detailed in the previous chapter. As the non–life industry grows at 18 to 20 percent CAGR per annum, many companies will start having enough scale over next three to five years to build a viable and cost–effective agency channel. The key to do this would be to ensure best–in–class sales–force productivity.

The key elements of enhancing sales–force productivity are improving volume, focus, and quality. Volume is the amount of time an agent spends on selling activity. This can be increased by providing him / her with optimal technology and operations support. Focus is prioritization of efforts toward clients, products, and segments with higher profitability of selling. Quality is the capability of agents to close deals. This can be improved by reviewing the sales preparation process, supporting the agent in client visits, and by measuring and monitoring sales conversion rates. The key enablers of agency productivity are recruiting agents from the right talent pool, providing tailor–made training to different groups of agents, proving sales support through lead generation, and having the right tools for target setting and activity planning.

Action Agenda for Regulator / Government

In addition to the insurers, the regulator / government also has a huge role to play in enabling the journey of the insurance industry through the troublesome teens to sustained profitability. In fact, it would be ideal for the regulator to prepare a 3–5 year road map for the industry and share it with the insurers to help the insurers be prepared for the changes. In brief, the 10–point agenda for the regulator / government will need to cover the following:

1. **Relax ownership norms:** Specifically, increase FDI cap from 26 percent to 49 percent.

2. **Define IPO norms:** Allow insurers to tap the public, reduce the load on promoting companies, and instill market discipline.

3. **Enhance bancassurance distribution:** This can be done by permitting bank multi–tie–ups, which will increase competition and hence, improve offerings / services.

4. **Enable "direct" channel:** This can be done by defining progressive policies on "wet signature".

5. **Refine outsourcing guidelines:** This will permit insurers to optimally outsource some tasks to deliver superior customer experience at efficient costs.

6. **Create environment to enable electronic statements of insurance:** This will deliver greater customer convenience at lower unit costs.

7. **Refine investment norms:** This will provide controlled access for insurers to alternative asset classes — for example, derivatives, commodities, and real estate.

8. **Define flexible norms:** This will permit Indian insurers to go international.

9. **Build depth in debt / bond / derivative market:** This helps broaden product offerings for customers — for example, variable annuities.

10. **Ensure appropriate taxation policies:** This will ensure appropriate support for the insurance sector — for example, maintain relative attractiveness of long–term insurance in DTC; ensure appropriate service tax policy for micro policies / FI.

Note to the Reader

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