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The long wait for reform

Is greater foreign investment in India's insurance sector still a pipe dream?

Neeraj Tuli and Celia Jenkins investigate

The Indian insurance industry has come a long way since the Oriental Life Insurance Company opened its doors in Calcutta in 1818, becoming the first insurer in India. The Triton Insurance Company established itself as India's first general insurer in 1850, and in 1907 the first homegrown insurer arrived in the form of the Indian Mercantile Company of Bombay.

In those early days regulation was so light that the sector could have been described as unregulated, and this continued until the passing of the Indian Life Assurance Companies Act, 1912. Although focused on the regulation of life business in India, it was the first step on the regulatory path for the Indian insurance industry and it was followed by the more wide ranging Insurance Act, 1938.

The road to nationalization

Following independence, and in line with the overtly socialist bent of the ruling classes, the 245 life insurance companies and provident societies were nationalized in January 1956. In their place, the Life Insurance Corporation Act, 1956, ushered in the Life Insurance Corporation, which was given a monopoly over the transaction of the life insurance business in India.

The general insurance industry was nationalized in January 1973 by the General Insurance Business (Nationalisation) Act, 1972, under which 107 general insurance companies gave way to the state-owned General Insurance Corporation (GIC). In addition to being India's reinsurer, the GIC was also parent to four subsidiaries: The United India Insurance Company; The National Insurance Company; The Oriental Insurance Company, and The New India Assurance Company.

So, within 150 years, the Indian insurance industry had grown to some 350 insurers in an unregulated market and then gone to a state-owned and operated market of one life insurer, four general insurers and one reinsurer. No private competition or foreign investment (whether direct or indirect) was permitted in the Indian insurance market or in relation to Indian risks except for reinsurance and retrocessions.

Cautious reform

And that is how the market remained until the New Economic Policy (NEP) of 1991. Among the sea of changes heralded in or signposted by the NEP was the opening up of the insurance sector, a particularly useful sector for (among other things) the regular collection of sums that can be used for medium to long-term projects.

To ensure that liberalization of the insurance sector was planned and regulated rather than rushed, in 1993 the Indian government tasked the RN Malhotra Committee to suggest reforms. The committee's report of 1994 recommended both private competition and foreign participation; the latter preferably through joint ventures with Indian partners.

Based on these recommendations, the Insurance Regulatory and Development Authority (IRDA) Act, 1999, was passed "to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry …". However, the real liberalization of the insurance sector began when the Foreign Direct Investment Policy of 1999 allowed foreign investment limited to 26% in the insurance sector under the automatic route, subject to licensing by the IRDA, which was ready to accept applications by August 2000. Shortly after this, the doors were opened to a new industry, insurance broking, again with foreign investment limited to 26%.

Steady growth

In spite of growing complaints about the relatively low 26% cap on foreign direct investment (FDI), the insurance sector has grown by 15-20% a year since liberalization. India now has 47 life and general insurers, although still only one reinsurer. There are 29 third-party administrators and 310 brokers, and innumerable corporate agents and insurance agents. One wonders how many more entities may have been formed and how much more the sector would have grown if the FDI cap had been lifted.

In addition to vetting and licensing the entities that have sprung up, and monitoring what they sell and how they sell it, the IRDA has been busy establishing and enforcing the regulatory framework in areas as diverse as the distribution of insurance products, insurance advertisements, rural and social obligations, the valuation of assets, solvency margins, the outsourcing of insurance-related activities to third parties, distance marketing and agents' qualifications and training.

Regulatory rage

It has not been smooth sailing. The recent turf war between the IRDA and the Securities and Exchange Board of India (SEBI) is an example. In January 2010, SEBI issued notices to several life insurers questioning the basis on which they were selling unit linked insurance products (ULIPs). In SEBI's view, a ULIP without life cover was nothing more than a mutual fund and therefore subject to regulation by SEBI. The IRDA rejected SEBI's intervention and was adamant that there was no regulatory overlap – ULIPs were solely within the purview of the IRDA.

Public interest litigations were filed, and SEBI filed a petition with the Supreme Court seeking to prevent the proliferation of litigation. The public spat between the IRDA and SEBI was only settled when the Securities and Insurance Laws (Amendment and Validation) Act, 2010, was passed, which put ULIPs firmly within the IRDA's regulatory ambit.

A further turf war is feared between the Pension Fund Regulatory and Development Authority (PFRDA) and the IRDA in relation to pension products, which the IRDA permits Indian life insurers to sell. Although both regulators deny any conflict, some market players are not convinced.

The PFRDA chairman recently stated that the PFRDA wants annuity products to be sold by pension fund managers rather than insurance companies. The IRDA chairman followed up with a statement that the PFRDA and IRDA may eventually merge as the law does not allow the PFRDA to regulate pension schemes regulated by the IRDA.

Recent press reports indicate that the matter has been referred to the Financial Stability and Development Council (FSDC) – an institutional mechanism established after the SEBI-IRDA turf war to settle

Keep your distance: Motor insurance is a loss-making business in India.

disputes between regulators. The decision of the FSDC could dramatically affect the growing annuity market in India and may result in the dilution of either the IRDA or PFRDA's powers.

The 26% cap

Perhaps the biggest challenge to the growth of the insurance sector remains the 26% cap on foreign investment. Some players have investments sitting in the wings waiting for the cap to be lifted, and some foreign entrants struggle to persuade their local partners to maintain the investments needed to expand an insurance entity. An increase in the stake of foreign players could help insurers raise additional capital, increase resources and bring in new management skills and knowledge.

Insurance is a capital intensive business, not meant for short-term players. It is perhaps more so in India as a result of a combination of regulatory caution, regulatory changes and other developments, which means it is often harder to generate and retain business in India than it is elsewhere.

A recent spate of regulatory moves, such as the monitoring of insurers' management expenses, guidelines on outsourcing of insurance-related activities, and distance marketing guidelines, have required insurers to change business plans, budgets and even business models to remain compliant with the regulatory framework.

Insurers now face wider compliance and reporting requirements, particularly with the IRDA asking insurers to report all payments made to intermediaries and related parties of intermediaries, file all outsourcing arrangements and make periodic public disclosures on a number of aspects of their business. The regulatory changes have resulted in a tremendous capital strain, particularly for life insurers.

An unwelcome increase in contributions to the motor pool was partly offset by moves to permit increases in third-party liability premiums, which should go some way to addressing the cause of the potential deficit in the pool. However, the two largest areas of business for general insurers – health and motor – are loss-making and, while business has been growing, underwriting has tended to be unprofitable.

All of this calls for lifting the 26% cap, but despite repeated assurances that the cap will be raised, it remains in place.

There are, however, signs of change, not only in relation to the cap, but also other areas of operation and structuring. For example, in January 2010, the IRDA instructed all insurers to publish their accounts twice a year. In addition, insurers making or planning IPOs must publish on their websites all financial disclosures for the five years prior to the IPO and must also disclose solvency margins, capital structures and details of investment performance for that period.

Level playing field

In February, the IRDA published the exposure draft on mergers and acquisitions in the non-life insurance business, which has now been finalized. The IRDA (Scheme of Amalgamation and Transfer of General Insurance Business) Regulations, 2011, equalize the playing field for life and general insurers.

The regulations require parties to the process to submit an application along with notice of intention, and set out a three-stage process for obtaining approval before an arrangement can be implemented. The stages are: (1) in-principle approval by the IRDA; (2) approvals from various regulatory bodies/authorities; and (3) final approvals from the IRDA. Transactions are anticipated following the notification of these regulations on 20 May.

It should be noted that the process to obtain the approvals and the documentation required for those approvals is highly detailed. The intention of the IRDA is clear, namely that approval for a merger or acquisition will only be granted if it helps to create a stronger insurer and is beneficial to policyholders.

Wings of change

The Insurance (Amendment) Bill of 2008 is yet to be passed by parliament, but it too seeks to implement several changes to the existing scenario. Some of the key changes include raising the cap for foreign equity in Indian insurance companies from 26% to 49% and maintaining the FDI cap at 26% for insurance cooperative societies.

The bill would also allow reinsurers to conduct business in India through branch offices rather than having to form an Indian joint venture company, and would recognize Lloyd's as a branch of a foreign reinsurer. The only reinsurer in India now is the state-owned GIC.

In addition, the bill would permit companies to enter the health insurance market with less capital than is required for a full-service insurer. Standalone health insurance companies with ₹500 million (US$11 million) of capital could enter the market, compared with a minimum paid-up capital of ₹1 billion for a full-service insurer.

The bill would delete section 40B of the Insurance Act, 1938, which places a ceiling on management expenses, as increases in operational costs have made it difficult for private insurers to meet the ceiling requirements.

If the insurance bill is passed, it will change the insurance landscape in India significantly, but there are doubts about whether the bill will be passed in its current form. Several Indian and foreign players have made representations before the Finance Committee, seeking changes.

The next stage

By any measure, the liberalization of the Indian insurance industry has been a success, both economically and from a regulatory perspective. The industry is by no means been perfect, and practices such as mis-selling, routine repudiation of claims and excessive pay-outs by insurers need to be stamped out. What we have seen over the past decade, however, gives rise to justified confidence for the future.

Those who believe that the market is saturated with insurers should bear in mind that India's population of 1.2 billion is serviced by around 50 insurers, while the UK's population of about 63 million is serviced by around 400 insurers. The Indian insurance market has more than enough room to grow.

Despite the trouble in developed markets over the past two years, the Indian insurance industry witnessed a 19% rise in insurance premiums in the financial year ended 31 March 2010, up from a 10% rise in the previous year, with insurance premiums totalling ₹3,000 billion, according to the IRDA. Lifting the FDI cap is likely to accelerate growth – particularly in the field of reinsurance – and to open the door to the next stage of the development of the Indian insurance industry. ■

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