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A‘ Culture of underwriting’—The survival and Growth Mantra A ‘ CULTURE OF UNDERWRITING’ — THE SURVIVAL AND GROWTH MANTRA FOR INDIAN GENERAL INSURANCE INDUSTRY IN POST DETARIFF SCENARIO V. S. Ananda Kuttan Faculty Member, National Insurance Academy, Pune Abstract Decades of tariff regulated market and rule-based underwriting has deprived Indian General Insurance Industry of an opportunity to develop sound Underwriting Practices and Professional Risk Management Policies. Detariffing, which is a reality, coupled with high competition, makes it inevitable for the Industry, especially the public sector segment of it, to undergo a fast course of firmly embracing risk-based Underwriting, founded on a robust Risk Management Policy. Perhaps the magnitude of 9/11 terrorism losses and the underlying monstrous dimensions of such risks and the huge liability losses and natural calamity—caused catastrophic losses which shook even the Loyyds recently, could not be even remotely predicted by the best of Risk Experts and Underwriters across the World. Nevertheless, there is still a huge segment of total risk environment that is largely amenable to the discipline of Risk Management and sound, profitable underwriting. Indian General Insurance Industry has to hold the hands of the hesitant culture of professional underwriting and scientific Risk Management practices and formally usher them in to the arena of the Insurance Game. Background The momentous opening up of Indian Insurance Industry in the beginning of this Century had thrown up a major challenge of intense competition to the existing Public Sector players. Before the shock could be absorbed by them and get stabilized, Detariffing is hanging above their heads like a double-edged sword. In the absence of the much needed culture of ‘ Risk Management’ in its true sense, the detariff regime is emerging as a threat, especially to Public Sector players. Equally, it provides a great opportunity to exhibit their real strength & efficiency in the open market with the long awaited autonomy and product innovations. The need to eliminate cross-subsidies, the compulsions to practice risk-based Underwriting, regulatory compliance requirements, the need for survival and sustained growth has put all Bimaquest - Vol. VII Issue I, January 2007 q 21 A‘ Culture of underwriting’—The survival and Growth Mantra the Indian General Insurers in a real fix. The gradual but sure emergence of India as a Global Insurance Market (with many more players targeting India) is adding gravity to the situation. About 70% of the Rs. 2, 40, 000 million market was governed by ‘ Tariff’ until Dec. 2006. Lack of product differentiation and innovation had already pushed Indian Insurers to the only alternative of price competition even in Tariff Regime, unethical and often bordering illegal breach of tariff. General Insurance Penetration in India is below 4% as compared to 8% worldwide. IRDA has laid down sufficient checks & controls on critical aspects like Underwriting, Rating Support, Policy terms & conditions, Corporate Governance and role of Tariff Advisory Committee. In the above background the options before the Industry for survival and growth are to be explored. Options Options are limited. Miracles cannot be performed. The key requirements for success in the highly competitive, open market are prudent Underwriting Policy, adequate Risk Management Policy and appropriate processes and true Corporate Governance. The Motor TP Liability Insurance Claims Ratio is as high as 250%. The Industry is neither able to avoid losses nor the TP insurance. In Fire segment the claims ratio is around 40%. Tariff regulations neither allowed reduction of rate nor relaxation of conditions to deepen the penetration, which is well below 4%. ‘ Tariff and Controls’ on the one side and ‘ Liberlisation & Professionalism in Underwriting’ on the other side are antitheses. These stumbling blocks in business sustainability and growth can be overcome only with the basic building blocks of a ‘ Risk Management Culture’. It must be back in place for Indian General Insurers in the Detariff Regime, if the clear guidelines / deadlines to meet the requirements of Detariffing on the following key elements are religiously met. a) b) c) d) e) f) Risk based Underwriting. Rating Support of Data Bank. Policy Terms & Conditions. Underwriting Structure & Audit. Role of Tariff Advisory Committee and Corporate Governance. Road Blocks Substantial investments were made by Public Sector Insurers on Information Technology in the last few years. But they could not build proper data bank. The historical data, for its insufficiency, and whatever data captured recently using Information Technology may not be sufficiently mirroring the risk profile, which is emerging in the Detariff Regime. The 22 q Bimaquest - Vol. VII Issue I, January 2007 A‘ Culture of underwriting’—The survival and Growth Mantra applicability of such data will be much limited in precisely factoring the highly dynamic risk profile. A common and relevant National Data Bank is missing. It would be painstaking to bring back the basics of Risk Management Philosophy to our Business Culture, which has been scantly present in the Tariff Regime. ‘ Culture’ is a matter of attitude and behaviour of people, whether of Organizations or Nations. One of the most major hurdles in culture-transformation will be People and the steadfast practices they followed for long. ‘ People Development’ acquires sharp focus and top attention. Significant initiatives and planned expenditure in terms of HRD, both qualitative and quantitative are imperative. Risk Management Risk Management is fundamental to the underwriting policy of any Insurer. Cardinal requirement of underwriting in Detariff Regime are a) b) c) d) e) f) Formulation of Underwriting Policy, Implementation & Control. Risk Management Policy. Reinsurance Policy. Preparation of Internal Guide Rate. Compliance with Regulatory Norms. Rating the Risk Right. All these are directly related to Risk Management Process, comprising of Risk Identification Risk Analysis Risk Evaluation Risk Selection Risk Retention Transfer of Excess Risk to the Reinsurer Profitability and solvency depends on Risk Management Policy and Processes of the Organisation. It is part of History that most of the Insolvencies and Bankruptcies of Insurance Companies resulted from Bad Underwriting, which is a direct consequence of Bad Risk Management Policy. Risk Management Philosophy, which is basic to Insurance Underwriting, has hardly been followed in our Underwriting activity except for limited cases of Fire and in Engineering Portfolios, which account for only about 15% of the total business. In the result, Fire Insurance has been generating 50 to 60% profit while Group Mediclaim producing a claims ratio of over 120%. This is an extreme cross — subsidization, which cannot continue Bimaquest - Vol. VII Issue I, January 2007 q 23 A‘ Culture of underwriting’—The survival and Growth Mantra in Detariff situation where rating will be based on Risk Process and Risk Cost (Experience / Merit Rating or Risk Factor Rating System — RFRS) and not on Subsidy. Culture of Underwriting — Key Elements a) Risk Classification, Detailed Analysis, Capacity-Based Estimation of Risk Appetite and appropriate Risk Management Structure, Judgment based on experience and not on assumptions. Strict separation of Underwriting and Marketing Functions Setting limits of acceptance Skilled, Qualified, Experienced Risk Managers — the right people in major functional areas like Operations, Finance, Legal & Audit Dissemination of Risk expertise throughout the Organisation. People and attitude are most important in bringing in a culture of Underwriting. Control — Underwriting Audit, Regular Review of Risk Management Policy Sensitivity to regulatory norms relating to Financial Markets b) c) d) e) f) g) THE PROCESS Risk Identification Defining and Identifying all the actual, perceived or anticipated risk, in respect of Operations, Financial, Legal, Market, Technology & Environment. Accepted methods are a) b) c) d) e) f) g) Events Analysis. HAZOP Analysis. Risk Inspection. Process / Flow Charts Analysis . Study of Accounting Records. Analysis of Organisational Charts. Analysis of Historical Data — Past Records. Experts in the fields of Technology, Engineering, Financial, Legal and Information Technology are required for this purpose. Risk Quantification This means determination of financial impacts that Risks can have on the Organization. Typically, this is done employing quantitative tools and statistical analysis like measurement of central tendency, probability etc. For Property Insurance methods like COPE (Construction 24 q Bimaquest - Vol. VII Issue I, January 2007 A‘ Culture of underwriting’—The survival and Growth Mantra Occupation Protection & External Exposure) analysis are employed. When it comes to Financial Risk (Credit Risk for example) tools of financial mathematics based on analytics are used. Risk Management Policy Decisions This signifies decision on acceptance / rejection; if accepted the price, terms & conditions. Guide prepared by the Organisation will be helpful in this process. Methodologies of Actuarial Applications are of relevance in the determination of MPL / PML. Capacity based retention limits, Reinsurance methods, selection of Reinsurers, selection of Alternative Risk Transfer Methods (if regular Reinsurance costs are prohibitive), Monitoring of Risk Management Feedback are the exercises to be regularly performed for arriving at realistic and effective decisions. Techniques of Risk Management Depending up on the degree of exposure, the insurer has to develop various Risk Management Techniques like Loss Control. Loss Financing. Loss Avoidance. A simple approach to Risk Management Techniques, as depicted below, largely holds good in this respect. Loss Frequency Low High Low High Loss Severity Low Low High High Technique / Combination of Techniques Suggested Retention Prevention & Retention with Safeguards Loss Financing Avoidance / Rejection. Bimaquest - Vol. VII Issue I, January 2007 q 25 A‘ Culture of underwriting’—The survival and Growth Mantra Any one or a combination of Techniques at optimum proportions is to be prudently selected by the insurer. Avoidance, though un-businesslike, is also to be ruthlessly resorted to at times. There is certainly a dividing line between ‘ acceptable’ and ‘ unacceptable’ risks, in business. But it should not lead to an extreme risk aversion. Assuming risks relating to high frequency — high severity processes and technology may not be commercially viable propositions either from insurers’or from insureds’ point of view. System may have to seek methods transcending normal definitions of insurance, for such exposures. In selecting the appropriate technique, prudence must employ a combination of quantitative and qualitative methods. Quantitative methods are mathematical models & techniques to identify, quantify and manage exposures, as detailed above. Qualitative methods primarily focus on experience, judgment and common sense, which are very crucial. Financial Risks Deregulations across the world from the 70s have resulted in cross-border movement of capital, doing away with natural, international trade barriers across markets and asset classes. As a result there is a high increase in the volatility of market and corresponding huge rise in Financial Risks. By streamlining the Risk Management philosophy and utilizing appropriate tools, this area of Risk and Losses are to be addressed. Market Related Aspects Pricing Pricing, setting terms & conditions and product development are the crucial areas of freedom, which the insurers will enjoy as a result of detariffing. Pricing which is most vital in the success of a business and of a particular product is a great challenge due to the ever-dynamic multitude of variables, which go behind it. The historical data with the Public Sector Units and the data collected recently by them engaging IT will be only partially usable in the emerging risk scenario. They do not properly mirror all ‘ factors’, which will have to support pricing in the ensuing market. Data may be huge but devoid of vital fields. In short, fully relevant and reliable data is to be built, which will take at least half-a-decade to accumulate to any useful size. Full freedom of pricing is the sure catalyst for the market to achieve a new equilibrium once the launch of Detariff triggers of a violent agitation of the existing (unviable) equilibrium. A ‘ fuzzy logic’ built in to the pricing programme, certainly with required transparency will be ideal. 26 q Bimaquest - Vol. VII Issue I, January 2007 A‘ Culture of underwriting’—The survival and Growth Mantra Customer The long deprived Indian Customer must be now the sharp focus. Industry owes him a much wider opportunity to choose what he wants at the right price, not being subjected to extortion to fund an unethical system of Cross-Subsidies. Simultaneously, the risk based underwriting culture must ensure equity by compelling those customers who were hither to being subsidized, to pay the right price for covering their risks. In the process those who have to pay hefty prices will be compelled to upgrade their risks which in turn is bound to reduce national losses / losses for society as a whole. Good underwriting is an effective tool in reducing avoidable losses to the society to a considerable extent. Competition will ensure upgradation of service and customer delight. Customer is the King and has to drive the market. Product Development and Product Differentiation In a country like India differential pricing even on scientific basis may generate political overtones, not to speak of differentiation on ‘ unfair’ grounds, which is inherently unacceptable. Autonomy in packaging may prove beneficial to insurers in reducing administrative costs, leaving fewer hassles for consumers too. But it is fraught with the danger of bundling products leading to continuation of Cross-Subsidisation in a stealthy manner. The Detariffing experience of Japanese Economy in 1996 however, gives an interesting picture of product innovation. Development of New Products 100 80 60 40 20 0 1996 1997 1998 1999 Years \* Source: General Insurance Association of Japan \* 1996 to 2002 represents the anchor years of detariffing of Japanese market. The period represents the tumultuous years immediately following detariffing Values 2000 2001 2002 Bimaquest - Vol. VII Issue I, January 2007 q 27 A‘ Culture of underwriting’—The survival and Growth Mantra A steep spurt was experienced in all classes in the first two years of Detariffing, which by the sixth year (new equilibrium) has considerably reduced. Lack of transparency, value and comfort in the plethora of new products (presumably ‘ new for the sake of new’, concealing the ulterior motive of a possible stealthy Cross-Subsidisation) and legitimate interference of the Regulator might have been the reasons. Intermediaries Brokers and the other Intermediaries have a crucial role in ‘ ushering in a culture of underwriting’. Risk Management Culture and Risk based Underwriting are the true reflections of their professionalism and effectiveness in ‘ developing’ insurance market. Adequacy of regulations and code of conduct must ensure healthy competition and an acceptable level of professionalism among Intermediaries. Self-regulation among them, setting high standards of professionalism will be vital for the health of the market and justification of the system. Market Penetration Deplorably low market penetration of General Insurance in India, which is well below 4%, erodes the applicability of ‘ the Law of Large Numbers’, the fundamental viability principle of insurance business. The essential requirement of commercial viability and capacity generation is an intense penetration both in width & depth. It can legitimately be hoped that the ensuing market will afford the most needed freedom to Insurers to achieve this through ‘ risk-based underwriting’ in its true sense. The coexistence of the world-class Indian Financial Market with the specter of General Insurance Industry with less than 4% penetration is indeed irrational. Industry Cooperation Qualitative aspects of Risk Management will point to another very vital aspect of the market. The players have to show a reasonable level of maturity in order to eliminate suicidal tendencies. Avoidance of Casualties during the crucial years of detariffing warrants Cooperation, Commonsense, Discipline and Proper judgment among them. In spite of quality Regulatory Oversight and ‘ Early Warning Systems’, many Casualties were recorded in the Comparative experience of other Countries and Unions. Any tendency to form Cartels and manipulation of the market are fundamentally wrong, unethical and against the spirit of opening up and liberalization. Nevertheless mad and senseless competition will be equally disastrous for both the Operators and Consumers. Discipline, Maturity, Commonsense and healthy Cooperation among them will ensure success of detariffing and survival and growth of Players. 28 q Bimaquest - Vol. VII Issue I, January 2007 A‘ Culture of underwriting’—The survival and Growth Mantra Corporate Social Responsibility A high- technology country like Japan has a substantially higher expense ratio than India in insurance operations. The following graph may be read. L o s s R a tio & E x p e n s e R a tio 5 2 . 8 3 9 . 5 5 2 . 8 39 5 3 . 8 3 9 . 2 5 7 . 4 3 9 . 4 5 9 . 3 3 8 . 6 5 9 . 5 3 7 . 6 5 9 . 2 5 4 . 7 V a lu e s 70 60 50 40 30 20 10 0 3 7 3 4 . 5 1995 1996 1997 1998 1999 2000 2001 2002 Y e a rs S o u r c e : G e n e r a l In s u r a n c e A s s o c ia t i o n O f J a p a n L o s s e s R a t io E x p e n s e R a tio \* 1996 to 2002 represents the anchor years of detariffing of Japanese market. The period represents the tumultuous years immediately following detariffing The expenses ratio hoverd around 30% for the Indian general insurance industry during the corresponding period. Obviously, with a comfortable loss ratio, they can afford to discharge their responsibility to the society. One of the major reasons for a high expense ratio according to the G. I. A of Japan is the substantial expenditure they incur on Promoting, such as a) Consumer Services Consumer relation, understanding of General Insurance among People and presence of General Insurance Industry. Social Responsibility Automobile theft prevention, Crime prevention, Fraud prevention. (Response to Fraud), Natural disaster prevention, Compliance with laws and regulations, Environment protection, Donations, Contributions and Corporate Social Responsibility Report. Lobbying for just and equitable legislations Contribution to Global Community Global Cooperation among insurers, setting up International Supervisory Standards and Promoting Deregulation, everywhere. b) c) d) Bimaquest - Vol. VII Issue I, January 2007 q 29 A‘ Culture of underwriting’—The survival and Growth Mantra e) Development of Business Environment Research and Study on Risks, Developing Business Infrastructure for supporting business of Members. These expenditures and actions are obvious contributions to risk reduction and a comfortable loss ratio, which overcompensates the outgo. Pure business sense and logic indeed (which has a lofty social aspect also), Indian Insurance Industry has a good example to emulate, certainly in the spirit of good UnderWriting and Risk Management. Conclusion Deprived of an opportunity to develop professional Risk Management and UnderWriting practices, during decades of rule-based UnderWriting, Indian Geneal Insurance Industry ought to have hiccups and much pain initially, trying to usher in a culture of UnderWriting. Detariffing which will afford the much-needed freedom of Risk-based UnderWriting and Product Development is not only an Opportunity but also a compulsion to professionalise their operations, upgrading them to International Standards. Professionalism will be achieved by embracing the philosophy of Risk Management and Risk-based UnderWriting, in their true spirit and scientific contents. Insurance Penetration both horizontal and vertical has to grow by leaps and bounds, ensuring the viability and success of the industry, ending the paradox of an emaciated and limping insurance industry coexisting with a robust, world class Indian Financial Market. Total consumer focus and highest standards of customer service both in terms of right price and quality must be the prime concerns. By discharging their Corporate Consumer Responsibility and Social Responsibility the Indian General Insurance Industry can achieve further risk reduction and loss reduction and augment their visibility, credibility and industry image. Indeed market realities and compulsions and positive attitude of the insurers are enough for the culture of underwriting to ensue. “ In a sustainable economy, it is each activity gaining out of the total activity and not one at the cost of another" - Artha Shastra, Kautilya The profound insight of ‘ Chanakya’ into the unsustainability and illegitimacy of crosssubsidisation is amazing. So precisely did the Ancient Scholar understand the essence of intelligent economic activity that ‘ everyone has to pay his right price and everyone has to earn his due profit,’ which only will sustain. No cross subsidies. No extortions. No perennial losses for insurance companies. qqq 30 q Bimaquest - Vol. VII Issue I, January 2007