2014 Outlook: Sri Lanka Insurance Sector

Regulatory Changes Under Way

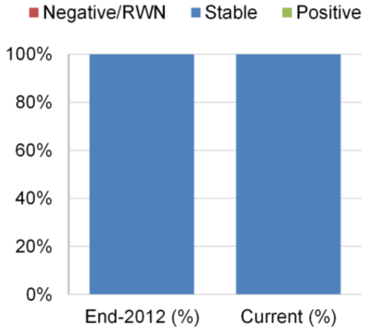
Outlook Report

Rating Outlook

STABLE

(2013: STABLE)

Rating Outlook



Source: Fitch

Sector Outlook

STABLE

(2013: STABLE)

- Underpenetrated market offers growth opportunities despite a slowing economy
- Fierce competition in motor continues
- Major regulatory changes are under way

Related Research

Other Outlooks

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See Figure 6 for list of rated entities

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Steady Fundamentals: Fitch Ratings' stable outlook on the Sri Lankan insurance sector is based on the view that most insurers will maintain stable financial fundamentals in 2014, supported by market growth in a tempered yet growing economy.

Regulatory Reviews Positive: Fitch views the regulatory changes introduced in 2011 and currently being implemented as positive to the industry. These include the risk-based capital (RBC) capital regime, segregation of composites into life and non-life, an increase in minimum regulatory capital and public listing. Fitch also recognises the uncertainty and operational challenges insurers will face at implementation.

Room for Premium Growth: Fitch expects moderate top-line growth to continue, supported by low penetration and a steady flow in vehicle insurance related to rising car ownership. The moderation in gross written premiums (GWP) from their post-war growth spike (2010: 15.12%, 2011: 18.47%) to 11.03% in 2012 and 9.06% in H113 is likely to continue in the short to medium term due to pressure on disposable income in a slowing economy.

Intense Competition in Motor: Intense pricing competition in the motor segment is likely to hold the combined ratios in non-life above 100% and put pressure on the financial performance of the more aggressive companies while challenging the market share of others. Fitch expects poor underwriting discipline to intensify as companies strive to gain critical mass in both life and non-life before the regulator-required split of composites.

Foreign Investor Interest: Fitch views the entrance of foreign investors including a key Asian insurer as a demonstration of confidence in the growth potential of the local insurance industry.

Market Consolidation: Fitch expects the higher minimum capital required, higher RBC and the split of composites to encourage market consolidation. The agency believes that mergers and acquisitions are likely to result only if the new and more stringent regulations are strongly enforced. Consolidation, especially in relation to smaller insurers with low capital bases, would be positive for the industry.

Outlook Sensitivities

Weak Underwriting Discipline: Increased pricing competition in motor leading to weakening technical results that constrain profitability could lead to a negative outlook for the sector.

Weaker Capitalisation or Solvency: A sharp decrease in capitalisation/solvency ratios before or after the composites split, or considerably weaker capitalisation in the post-split entities (life or non-life) could lead to Fitch changing the outlook to negative.

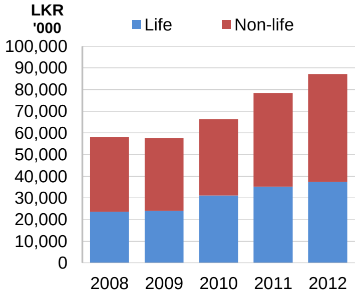
High Risk in Investments: High capital market volatility leading to material investment losses and significant capital erosion could lead to a negative outlook on the sector. High investment risks through a greater exposure to equity (including non-core investments), could put pressure on insurer ratings and the sector outlook.

Stronger Macroeconomic Environment: Significant growth in real GDP and disposable income would be conducive for deeper penetration and lower pricing competition, and so positive for the industry.

Figure 1

Insurance Sector Growth

Gross written premiums



Source: Insurance Board of Sri Lanka, Fitch

- Twenty-two insurers in Sri Lankan market
- Twelve composites, seven non-life and three life
- Five largest insurers (total assets) accounted for 85% of life GWP and 71% of non-life GWP in 2012

Key Issues

Premiums to Grow

Fitch expects premium growth to continue, supported by low penetration in an economy that is still growing, albeit more slowly. The rate of growth is likely to be subdued due to pressure on disposable income affecting life and low growth in vehicle registrations affecting non-life.

The sector has growth steadily for over a decade, except in 2009, when premiums contracted due to a slowing local and global economy. Post-war growth spiked, supported by a sharp increase in vehicle registrations (due to lowered customs duty) and increased trading activity. In 2012 GWP growth slowed to 11.03% (2011: 18.47%), mainly due to a poorly performing stock market affecting unit-linked life products. GWP growth for H113 was 9.06% (life: 10.11%, non-life: 8.35%).

In 2013 the government sought to curtail vehicle imports by requiring a 100% cash margin to open letters of credit for vehicle imports (except for buses, ambulances, lorries and trucks) and also restricted bank funding for this purpose. The government budget 2014 kept customs duty on vehicles largely unchanged. Measures to curtail vehicle imports in this slowing economy are likely to result in low growth in vehicle imports and new vehicle registrations in the short term.

Growth Potential from Low Penetration

Fitch expects greater penetration to depend largely on increased disposal income in this market, where insurance is viewed as a discretionary product by many.

Sri Lanka remains heavily under-penetrated by insurance, with a total premiums/GDP ratio of 1.15% (2011: 1.2%) compared with an average of 6.2% for Asia[1]. Fitch believes a key reason for the comparative under-penetration to be Sri Lanka's low per capita income in relation to some of its Asian counterparts.

The government of Sri Lanka provides free health services and education to all citizens and also has a pension scheme for public sector employees. These schemes eliminate the need for certain insurance products in the segment of the population that relies on government services/schemes. A lack of full appreciation of the concept or benefits of insurance and a lack of confidence in the industry also have a role in this gross comparative under-penetration.

Figure 2

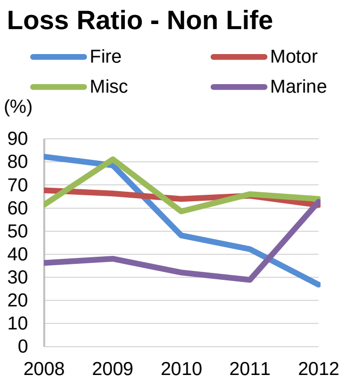
Insurance Penetration

	2012	2011	2010	2009	2008
Total premiums/GDP (%)	1.15	1.20	1.18	1.19	1.32
Insurance density (total industry premium income/population) (LKR)	4,287.28	3,761.11	3,207.91	2,814.33	2,877.33
No of life policies in force as a % of total population	12.1	11.3	10.7	10.1	10.3
No of life policies in force as a % of the labour force	29.1	27.5	27.3	25.6	25.8
GDP growth	6.4	8.2	8.0	3.5	6.0

Source: Insurance Board of Sri Lanka (2012), annual report.

[1] Source: Swiss Re. sigma No2/2011. This figure also includes countries in the Middle East.

Figure 3



Source: Fitch

Motor Underwriting Profitability Under Pressure

As in most countries the motor segment is fiercely competitive, with competition mainly in the form of price. Loss ratios in this segment are high, averaging around 65% in the last four years. Unhealthy price competition has put pressure on underwriting profitability, and in the past insurers have relied on high investment income to compensate for underwriting losses.

Fitch considers there to be an urgent need for better underwriting discipline through alternate forms of competition such as differentiated/flexible products or better service to ensure profitability even in low investment income periods.

Growth in the motor sector dropped to 16.49 % in 2012 (2011: 29.56%) due to a fall in imports with increased customs duty and unfavourable exchange rate movements. Nevertheless, the contribution of the motor segment in non-life remained high at 63.64% and will remain the major GWP contributor in non-life.

Increased Emphasis on Alternative Distribution Channels

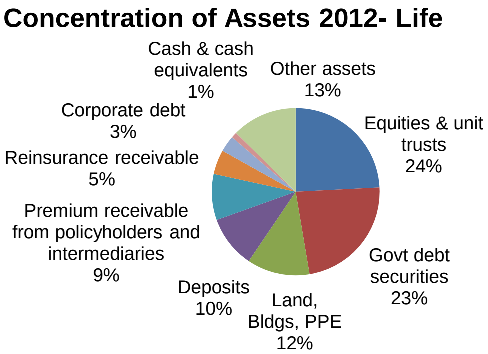
The life segment has traditionally relied on tied agents for distribution, but now there is an increasing emphasis on alternative distribution channels such as bancassurance. This is in line with similar developments in the region.

Most insurers are actively introducing web-based products. The popularity of these is very limited and Fitch does not expect them to gain momentum as a significant distribution channel in the medium term. In this context, tied agents are likely to remain the dominant distribution channel in life for a considerable period.

Foreign Investment Implies Confidence

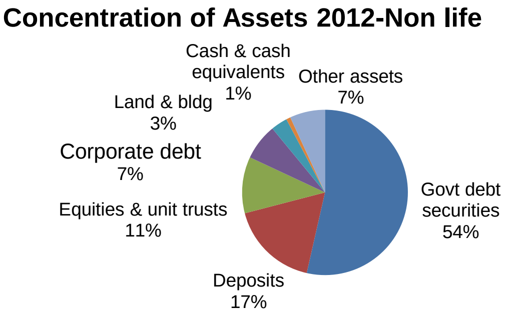
AIA Insurance acquired the number-three composite insurer by assets and two overseas development funds have acquired minority stakes in a smaller (but aggressively growing) company. Fitch views these acquisitions as a demonstration of confidence in the growth potential of the sector, but believes long-term attractiveness will depend on macroeconomic stability and real growth that would allow deeper penetration.

Figure 4



Source: IBSL, Fitch

Figure 5



Source: IBSL, Fitch

Limited Availability of Long-Term Investments

Maturity matching in the life fund is challenging due to the limited availability of longer-term investment assets in this relatively underdeveloped Sri Lankan market. The government is keen to improve the corporate debt market and has actively promoted the listing of corporate debt through tax incentives. Fitch believes insurers will be challenged in asset-liability management until financial markets mature considerably.

At end-H113, 46.24% of the assets of life business and 19.93% of those of non-life business were invested in government securities. In 2012 the life sector investment yield from government securities dropped to 11.9% (2011: 13.6%) and rates have been comparatively low so far in 2013. This is likely to remain unchanged in the short term

The equity investment in life and non-life was 10.47% and 23.15%, respectively, and the investment yield from this segment has been volatile. There has been an increase in investment in non-core subsidiaries by some insurers, which could prove credit negative. Some of these investments have been made in property/infrastructure projects in an effort to increase exposure to long-term investments. Fitch expects the RBC regime to create a culture of risk recognition and management in the investment function by requiring capitalisation to be in line with asset risk.

Adequate Capitalisation

Most insurance companies in Sri Lankan meet local solvency requirements. Nevertheless, the impending business separation will result in many more, smaller life or non-life only entities, some of which are likely to post weaker capital positions than the composites they are a part of at present. This could encourage market consolidation in the medium term, which would be beneficial to the industry, as there is an excessive number of companies given the market size.

Once introduced, RBC will be a more comprehensive indicator of the capital position of the insurers than the current regulation due to the better matching of the regulatory required minimum capital to the risk of the assets and liabilities of each individual business. RBC is likely to strengthen the case for consolidation of smaller/thinly capitalised entities, provided there is strong enforcement of new regulation.

Evolving Regulatory Framework

The Insurance Act was amended by the Regulation of Insurance Industry (Amendment) Act, No.3 of 2011, with significant revisions introduced in relation to capitalisation, and separation of life and non-life businesses. The industry would face operational challenges at implementation due to factors such as a dearth of actuarial expertise locally, increased cost in relation to duplication of some functions after the split and the long-drawn-out nature of legal procedures required in effecting the split.

RBC Reporting to Start

From Q114 companies will be required to provide RBC in their quarterly reporting in tandem with the current solvency reporting, and RBC will be the primary tool for capital regulation from 2016. Insurers have the option of early adoption of RBC from Q214. In 2013 RBC was piloted with 18 companies, and the Insurance Board of Sri Lanka has now provided finalised rules. The valuation of assets and liabilities on the same market-consistent basis is likely to release reserves for some larger insurers.

Split of Life and Non-life

Fitch views the split of life and non-life business from 2015 positively, due to the greater transparency and policyholder protection it will promote. The Insurance Board of Sri Lanka has provided guidelines clarifying the position regarding shared services, common infrastructure, distribution and use of agents after the split, following dialogue with the industry.

Although the groundwork for the split is under way, the level of preparation varies among insurers, with some larger companies better equipped to effect the change due to their existing quasi separation of the two segments, better resource availability including technical expertise, and ability to absorb resulting cost increases.

The proposed government budget for 2014 has declared a tax neutral position for the split, which addresses a major concern for the industry.

Public Listing

The mandatory public listing by 2016 will promote greater transparency and encourage better governance. Tax incentives for listing provided in the 2014 budget may prompt some insurance companies to speed up the process of listing.

Minimum Capital Requirement

The increased minimum capital requirement of LKR500m (previously LKR100m) for each line of insurance business could lead to consolidation within the sector in the short to medium term, provided there is strong enforcement by the regulators.

Convergence to IFRS

In 2012, Sri Lankan companies adopted new accounting standards, starting a process of convergence to International Financial Reporting Standards. This affected insurers' financial statements, especially in the area of financial investments. The process of convergence will continue, with new standards coming in to force in stages.

2013 Review

Total industry premiums grew by 9.06% yoy in H113. The total assets of insurance companies grew to LKR345bn by H113, a yoy increase of 23.95%.

There were no significant credit events during the year. Preparatory work to meet the new and more stringent regulatory requirements began.

Figure 6

Issue Ratings

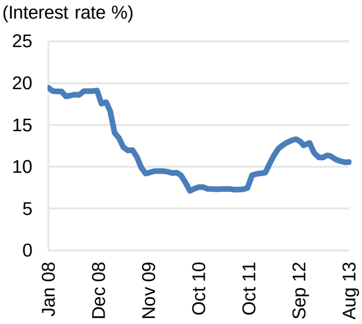
	National IFS Rating	Outlook	IFS Rating	Outlook
Sri Lanka Insurance Corporation Limited	AA(lka)	Stable	BB−	Stable
HNB Assurance PLC	A(lka)	Stable	NR	Stable
Asian Alliance Insurance PLC	BBB+(lka)	Stable	B	Stable

Source: Fitch

Appendix

Figure 7

Interest Rate (2008 – 2013)



Source: Fitch

Figure 8

Colombo Stock Exchange, All Share Price Index

Source: Fitch

Figure 9

Key Financials of Seven Largest Insurers by Total Assets

	Sri Lanka Insurance Corporation Ltd	Ceylinco Insurance PLC	AIA Insurance Lanka PLC	Union Assurance PLC	Janashakthi Insurance PLC	HNB Assurance PLC	Asian Alliance Insurance PLC
IFS	BB−/Stable	n.a.	n.a.	n.a.	n.a.	n.a.	B/Stable
National IFS	AA(lka)/Stable	n.a.	n.a.	n.a.	n.a.	A(lka)/Stable	BBB+(lka)/Stable
Total assets (LKRbn)	120.14	66.95	40.95	25.67	15.84	7.02	5.71
Market share by premium non-life (%)	24.9	21.0	4.3	8.9	11.6	3.3	2.3
Market share by premium life (%)	19.7	28.9	17.3	13.6	5.4	4.0	5.4
Regulatory solvency margin, non-life	3.42	1.13	3.78	2.1	2.24	3.48	2.37
Regulatory solvency margin, life	11.01	10.31	2.53	2.96	4.08	2.28	1.88
Equity/assets (%)	30.6	14.9	9.8	15.8	21.3	26.6	25.0

Data as of end-December 2012
Source: Insurance Board of Sri Lanka, companies and Fitch's calculations