2016 Outlook: Sri Lanka Insurance

Regulatory Changes Promote Transparency, May Spur M&As

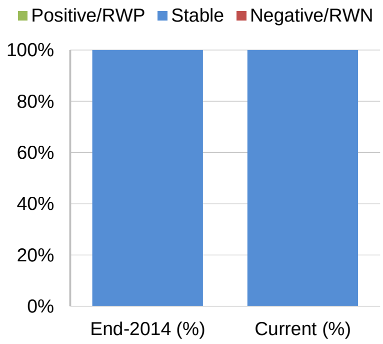
Outlook Report

Rating Outlook

STABLE

(2015: STABLE)

Rating Outlooks



Source: Fitch

Life Sector Outlook

STABLE

(2015: STABLE)

- Growing Industry supported by low penetration
- Greater focus and transparency with the split of composites
- M&As expected as insurers keen to augment more-profitable life business

Non-life Sector Outlook

STABLE

(2015: STABLE)

- Intense market competition to lead to weak technical results
- Premiums growth to slow with motor segment slowing down

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Other Research

Global Economic Outlook (December 2015)

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Analysts

Kanishka de Silva
+94 11 254 1900
kanishka.desilva@fitchratings.com

Jeffrey Liew
+852 2263 9939
jeffrey.liew@fitchratings.com

Fundamentals to Remain Steady: Fitch Ratings sees the outlook on Sri Lanka's insurance sector as stable even though the split of composite insurers into life and non-life companies, as mandated by the regulator effective February 2015, may create industry uncertainty. This is based on the view that most insurers will maintain stable financial fundamentals in 2016, supported by moderate sector growth.

Regulatory Reforms Positive: Fitch views the many regulatory changes as positive for the industry as they will promote efficient capital allocation, corporate governance, and better risk management. Minimum regulatory capital has been increased to LKR500m from LKR100m, risk-based capital (RBC) will replace the current rules-based solvency regime by 2016, and insurance companies – with few exceptions – are required to list by 2016.

Challenging Non-life Profitability Outlook: Intense pricing competition in the motor segment is likely to hold the combined ratios (sum of loss ratio and expense ratio) in non-life above 100%, put pressure on the financial performance of the more aggressive companies, while challenging the market share of others. With most insurers' profitability weakening, we expect revised pricing to somewhat prevent their combined ratio from worsening, while that of non-life firms improved to 107.6% in 1H15, from a sharp increase to 109.7% in 2014 (2013: 102.1%).

Moderate GWP Growth: Fitch expects economic growth and under-penetration in the market to support the growth of total gross written premiums (GWP). Fitch does not expect significant improvement in life penetration in the short term, due to the low disposable income of the population, and life premiums growth is expected to be moderate. Fitch expects non-life growth to slow as higher vehicle taxes may reduce new car registrations in 2016.

Most Composites Have Split: Eight of the twelve composites have so far split by end-June 2015. Fitch views the split of composites positively due to greater transparency and policyholder protection it will promote, but recognises that some insurers may face operational uncertainties. Post-split ownership structures and capital will have a bearing on the credit profiles of the individual life and non-life companies.

M&A Expected: Fitch expects market consolidation in the medium and long term, encouraged by the more stringent regulations. Fitch views this as positive, given the high number of insurers in Sri Lanka. Many are keen to concentrate on the more profitable life business and are looking to augment their portfolios through inorganic growth. Some composites are willing to divest the fiercely competitive non-life business.

Outlook Sensitivities

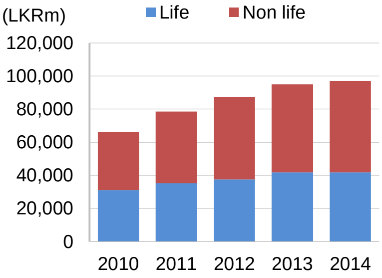
Weaker Capitalisation: We may revise the sector outlook to negative if the split of the composites caused a major drop in capitalisation and solvency ratios. Weaker risk capital due to profit volatility or higher equity exposure in investments will be negative for issuer ratings.

Sustained Losses: Severe price competition in motor, leading to weak technical results and/or significant reduction in investment income due to falling interest rates that result in sustained losses would be negative for the non-life industry.

Stronger Macroeconomic Environment: Significant growth in real gross domestic product and disposable income that is conducive to deeper penetration will be positive for the industry.

Figure 1

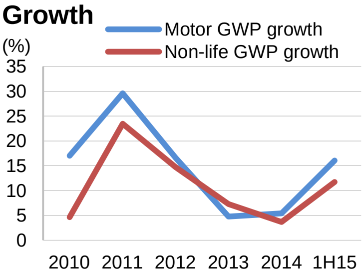
Insurance Sector Growth Gross Written Premium



Source: IBSL, Fitch

Figure 2

Motor Driving Non-life Growth

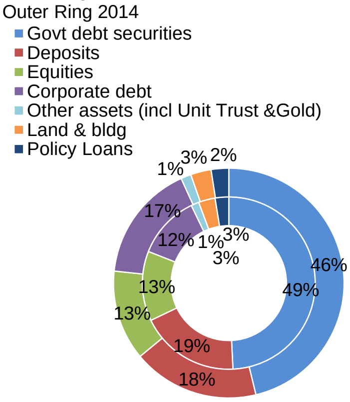


Source: IBSL, Fitch

Figure 3

Life Average Investments

Inner Ring: 2013
Outer Ring 2014

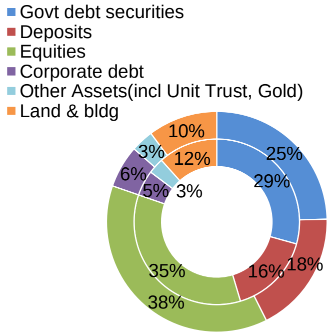


Source: IBSL, Fitch

Figure 4

Non- Life Average

Inner Ring: 2013
Outer Ring 2014



Source : IBSL, Fitch

Key Issues

Non-Life Underwriting Losses to Continue

Fitch expects the underwriting losses of many non-life entities to continue in the short- and medium-term, driven by intense competition, especially in the motor sector. The combined ratio of non-life players had improved to 107.6% in 1H15, after it had worsened to 109.7% in 2014 (2013: 102.1%) due to higher claims ratio, notably in motor. Motor insurance is the largest line in the non-life insurance market, representing 63.2% of total net premiums written in 2014 (2010: 59.7%).

The smaller companies will strive to achieve critical mass, with each segment of business operating separately subsequent to the split in 2015. Many of the smaller companies have been successful in gaining market share from the well-established companies through aggressive pricing. Some larger players have kept away from this unhealthy competition and focused on bottom-line profitability.

Net claims ratio in the motor segment worsened to 64.7% in 2014 (2013: 62.1%) due to higher repair costs of vehicles and claims frequency resulting from the record number of new vehicle registrations in the last 12-18 months.

GDP Growth to Support Premiums

Fitch expects moderate premium growth, in both life and non-life, supported by a growing economy and the low penetration levels in the market. The government's budget expects GDP growth to accelerate to 7-8% in 2016, from expected growth of 6% in 2015, while Fitch forecasts growth of 6.4% in 2016.

The insurance sector has expanded steadily for over a decade, except in 2009, when premiums contracted due to a slowdown in the global and local economies. Non-life GWP is sensitive to vehicle import tax rates and the resulting movement in new registrations. Non-life GWP grew 11.7% in 1H15 (2014: 3.7%), with motor business recording a 16% growth (2014: 5.4%), driven by the government's favourable tax policy towards small cars. Small-car taxes were reduced in February 2015 to 155% of cost, insurance and freight value (CIF), from 173%. A wage increase for civil servants and lower fuel prices in 2015 also spurred demand for cars.

Fitch expects a slowdown in the growth rate for motor insurance in 2016 as new vehicle registrations are likely to fall after the government proposed to increase taxes on vehicles in its budget, including small cars which will increase to around 173% of CIF. Similarly, in 2012, motor premium growth fell to 16.6%, from 29.6%, in 2011, after small-car registrations more than halved when the government increased taxes on small cars to 200%, from 120% of CIF.

Sri Lanka remains heavily under-penetrated by insurance with the total premium/GDP ratio falling further to just 1.02% in 2014 (2010: 1.18%) with 0.46% penetration for life and 0.56% for non-life. This compares with a 5.4% penetration rate for Asia, 3.8% penetration for life and 1.6% penetration for non-life (as reported by Swiss Re No3/2014).

Fitch does not expect any drastic increase in life penetration in the short and medium term as disposable income levels remain low; a lack of awareness and appreciation of the concept and benefits of insurance, and a lack of confidence in the industry have also contributed to the status quo, while pushy sales tactics have led to high lapse ratios.

Free health services and education that are available to all citizens and a pension programme for public sector employees eliminate the need for certain insurance products for the segment of the population who choose to rely on these state services.

Figure 5

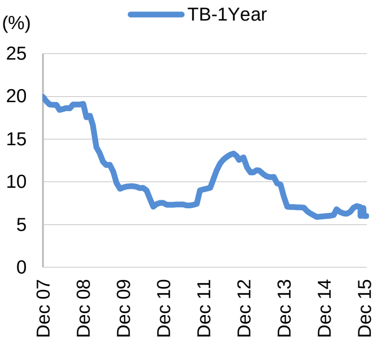
Insurance Penetration

	2014	2013	2012	2011	2010
Total premiums/GDP (%)	1.02	1.10	1.15	1.20	1.18
Insurance density(total industry premium income/population) (LKR)	4,831	4,637	4,288	3,761	3,208
No of life policies in force as a % of total population	12.6	12.1	12.0	11.3	10.7
No of life policies in force as a % of the labour force	29.6	28.1	28.8	27.5	27.3
GDP growth	7.4[a]	7.2	6.3	8.2	8.0

[a] Old method
Source: IBSL, Fitch

Figure 6

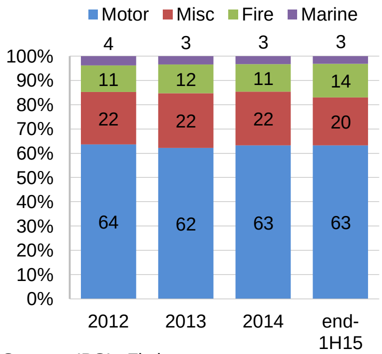
Interest Rate (2012 - 2015)



Source: Central Bank of Sri Lanka, Fitch

Figure 7

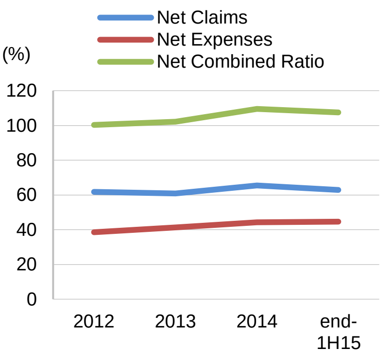
Non-Life GWP by Class



Source : IBSL, Fitch

Figure 8

Combined Ratio - Non-Life



Source : IBSL, Fitch

Split Pending for Four Composites

Insurance Board of Sri Lanka (IBSL) regulation required composites to split their life and non-life businesses by February 2015. However, four insurers including Sri Lanka Insurance Corporation Limited (SLIC, AA(lka)/Stable) have yet to split. SLIC is in discussions with the regulator on separating its businesses, while minimum capital requirements impede the split of smaller companies. Minimum regulatory capital has been increased to LKR500m, from LKR100m; and most insurers have met the minimum requirement, though not a number of smaller companies.

Fitch expects post-split operational issues to be minimal for established companies, as they had previously operated with a quasi-separation between the two segments. IBSL has allowed shared services in some functions including actuarial, legal, finance and IT to ease the process of splitting and minimise immediate cost escalations from the split. The regulator requires the shared services to be phased out by 2020.

Fitch expects the split to provide greater focus and promote efficient use of capital, in the medium and long term. In the short term, the credit profiles of a few smaller insurers could be affected, depending on factors such as ownership structures and the split of existing capital and growth.

Most composites have adopted a post-split structure where the life business is placed in the holding company, with a subsidiary incorporated for non-life. Few have a holding company with two subsidiaries for life and non-life, as well as a non-life holding company with a life subsidiary.

RBC to Replace Existing Solvency Regime in 2016

RBC will be the primary tool for capital regulation from 2016, replacing the current rules-based solvency regime. The regulator required all insurers to report RBC parallel to the existing solvency from 2014. The parallel run has been successful, and a smooth transition is expected, according to the regulator.

The move to RBC has already encouraged better discipline in terms of investment. RBC will result in greater precision in measurement of capital on a risk-adjusted basis and promote better risk management. Fitch expects the higher compliance and administrative costs of adopting RBC to burden the smaller companies.

Listing to Promote Transparency and Governance

Fitch expects the mandatory public listing by 2016 to provide greater transparency and promote better governance, thereby improving policyholder protection. Certain exemptions to the requirement to list on the Colombo Stock Exchange may be granted. This covers fully foreign owned insurers, whose holding companies are incorporated abroad and are listed on a stock exchange acceptable to the regulator.

Low Interest Rates Constrain Investment Yield

Fitch expects low interest rates to affect the investment income of insurers that are accustomed to higher returns, which had masked poor underwriting performance in non-life operations in the past. Interest rates have been in the mid-single-digit range in 2014 and 2015 from the double-digits experienced before. Fitch expects some insurers to increase their exposure to equities because of moderate interest rates, but that could be offset due the high capital charges under RBC. Industry equity exposure is high at 38% of average investment in non-life and 13% in life as of end-June 2015.

Regulatory Changes to Spur M&A Activity

Many established insurers are striving to expand their profitable life businesses through mergers and acquisitions. Some insurers are also considering divesting their non-life businesses where there have been large underwriting losses because of intense price competition.

Historically, high investment yields from high interest rates enabled some non-life businesses to record profits despite poor technical results. Non-life losses, when combined with life profits, produced bottom-line profits for many composites. Fitch believes the split will create greater visibility on the profitability of each line of business, which will promote greater focus and encourage consolidation across companies.

Fitch expects all regulatory changes underway (split, RBC and listing) to promote consolidation due to the higher compliance and administrative costs.

In October 2015, AIA Insurance Lanka PLC sold its non-life business (4.8% non-life market share by GWP) to Janashakthi Insurance PLC (11.6% non-life market share), citing focus on its core business of life insurance that is in line with the aim of the AIA Group. John Keels Holdings PLC, parent company of Union Assurance PLC (fourth largest insurer by assets) divested 78% of its non-life business to Fairfax Asia Limited, an international company in 2014. AIG Insurance, which held less than 1% of non-life market share, also announced in 2014 that it is exiting the market, citing a lack of fit between the local operations with the group’s strategic growth plans.

Appendix

Figure 9
Issuer Ratings

Issuer	National IFS Rating/ Outlook/RW (Current)	IFS Rating/ Outlook/RW (Current)	National IFS Rating/ Outlook/RW (End-2014)	IFS Rating/ Outlook/RW (End-2014)
Sri Lanka Insurance Corporation Limited	AA(lka)/Stable	BB-/Stable	AA(lka)/Stable	BB-/Stable
HNB Assurance PLC	A(lka)/Stable	n.a.	A(lka)/Stable	n.a.
HNB General Insurance Limited	A(lka)/Stable	n.a.	n.a.	n.a.
Continental Insurance Lanka Limited	A-(lka)/Stable	n.a.	A-(lka)/Stable	n.a.

Source: Fitch

Figure 10
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	Asian Alliance Insurance PLC	HNB Assurance PLC
IFS	BB-/Stable	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
National IFS	AA(lka)/Stable						A(lka)/Stable
Total assets (LKRbn)	161.97	92.08	47.67	35.44	20.15	10.21	9.91
Market share by premium non-life (%)	21.92	19.49	4.81	8.96	11.75	2.99	4.00
Market share by premium life (%)	18.2	26.91	16.29	13.33	4.87	6.83	5.25
Regulatory solvency margin, non-life	3.52	1.47	3.13	3.17	1.71	1.71	3.07
Regulatory solvency margin, life	13.90	14.29	4.32	4.74	2.54	3.14	2.29
Equity/assets (%)	38.86	19.26	10.14	17.53	25.83	25.05	24.29

Data as of end-December 2014
Source: IBSL and Fitch