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Building profitable **auto insurers** in China

The auto insurance market is booming, but the carriers' profits are not.

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China's transition from bicycles to cars in urban areas has ignited the country's automobile insurance market. Commercial and personal auto insurance premiums are likely to increase at a compound annual growth rate (CAGR) of 24 percent from 2006 to 2010, compared with 18 percent annually during the previous five years.[1] But the industry's profitability is lagging behind growth as managers of Chinese insurance companies chase short-term revenues without developing discipline in underwriting and managing claims—skills needed to bolster the bottom line.

In 2006 we examined China's auto insurance market. Our study, which included a survey of 1,600 consumers and interviews with important industry stakeholders, found that management practices taken for granted in developed insurance markets have made few inroads among local companies. Most carriers have yet to invest in business processes that would let them distinguish between high- and low-risk customers or profitable and unprofitable distribution channels. Also absent are centralized and specialized claims-processing systems that help carriers control costs—standard in developed markets.

[1] We expect a compound annual growth rate of 16 percent in commercial lines and 29 percent in personal lines from 2006 through 2010. The 24 percent CAGR in premiums is the total of these two lines' growth rates, weighted by their respective sales.

Article at a glance

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To raise profits, Chinese insurers must collect and manage market information to mitigate risk and control costs by finding the most cost-effective ways to use distributors, segmenting customers by risk, and managing claims processes more rationally.

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Part of the problem is that information on drivers' claims and on the performance of different distribution channels is difficult to obtain. What's more, many insurers don't understand the impact this information could have on their profitability. Yet the Chinese carriers now ignoring risk-management practices that depend on information gathering do so at their peril. Competition is so fierce that destructive price-cutting has pushed some local entrants to the point of bankruptcy. Meanwhile, regulatory restrictions limit the role of foreign-owned companies (see sidebar, "What multinational companies can do").

To become more profitable, Chinese insurers must mitigate risk and control costs by collecting and managing market information. Forming alliances with insurance distributors—particularly car dealerships and auto repair shops, which account for a large proportion of first-time insurance sales—is an important opening move.[2] Carriers should also focus on retaining their existing customers, both to obtain more information about drivers and to reduce commissions. Finally, most insurers should consider centralizing claims to improve control and cut unnecessarily high processing costs.

A market in transition

The current state of China's auto insurance market shows its immaturity. Today's carriers emerged only recently from the shadows of the former state-owned monopoly: the People's Insurance Company of China, or PICC. (The state divested 25 percent of its stake in 2003.) After 2002, when the industry's regulator, the China Insurance Regulatory Commission (CIRC), deregulated prices and products, the number of insurers doubled. Half of the roughly 34 domestic insurance companies are less than five years old, and about 80 percent of private-car owners have no more than three years of experience buying auto insurance.

[2] The distributors include car dealers (both general ones and OEM-authorized high-end dealers that offer sales, service, and repair services), auto clubs, repair shops, and independent brokers (which have less than a 5 percent market share in China).

What multinational companies can do

American International Underwriters (AIU), Mitsui Sumitomo Insurance, and Tokyo Marine and Fire Insurance are among the roughly dozen foreign companies operating in China's insurance sector. In 2005 the China Insurance Regulatory Commission (CIRC) gave multinational companies operating wholly owned Chinese insurance subsidiaries permission to sell property and casualty insurance, including collision and comprehensive auto policies. But the multinationals may not sell the mandatory third-party liability coverage. The challenge for foreign-owned carriers is that customers often purchase nonmandatory insurance, such as collision damage policies, when they buy third-party liability coverage. Many customers probably won't buy the latter from a domestic carrier and nonmandatory policies from a multinational.

Multinational companies looking to enter the mandatory insurance segment could consider taking a minority stake in local insurers. In this way, multinationals such as AIG (with a 9.9 percent stake in PICC) and HSBC (which owns 20 percent of Ping An Insurance) have entered the market for third-party liability insurance. A multinational might also partner with a local company that sells such coverage, by offering to underwrite commercial policies (for instance, damage waiver insurance) or to supply reinsurance and fee-based operating services, such as claims handling. These partnerships would benefit Chinese carriers, since multinational companies have sophisticated risk selection capabilities, which Chinese ones generally lack.

Many new insurers compete by expanding their branch networks rapidly, offering rock-bottom prices to customers, and paying high commissions to distributors. Prices are so low that many companies are losing money. Some insurers stay afloat by resorting to opaque and inconsistent financial reporting, as well as by generating large amounts of cash that obscure the extent of their difficulties.

In 2006 the CIRC began to address the price wars by lowering the maximum discount on premiums to 30 percent, from 50 percent. The regulator also created straightforward fixed-formula models for basic physical-damage policies. These models base policy premiums on the value and type of vehicles but also give insurers leeway to offer discounts by considering a driver's claims history and gender.

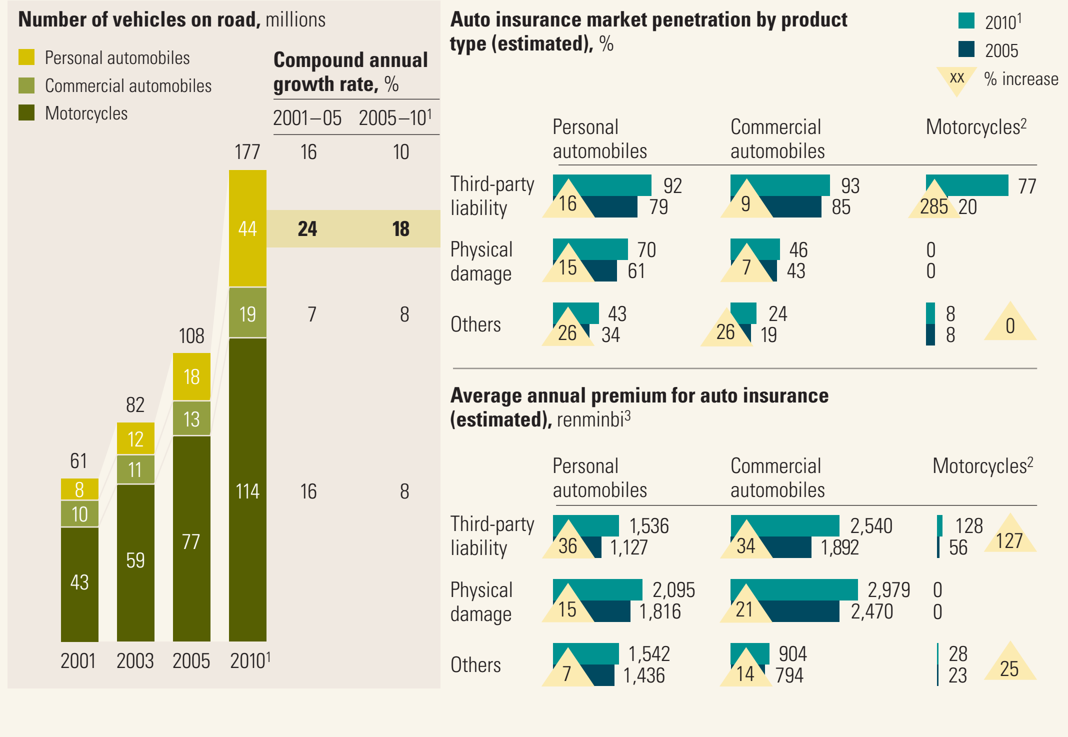
The CIRC recently introduced compulsory third-party liability insurance[3] to guarantee that China's accident victims receive fair compensation. The rollout of this kind of insurance should benefit domestic carriers in two ways, since foreign insurers are prohibited from selling this coverage. First, it should generate more than half of the growth in total premiums over the next five years. Although the government requires insurers to offer such

[3] Third-party liability insurance compensates third parties who are injured or whose property is damaged through the negligence of the insurance holder.

EXHIBIT 1

Premium growth

Assumptions about key drivers of auto insurance premium growth in China



[1]Projected.
[2]Physical-damage insurance for motorcycles is available but unpopular.
[3]Premiums for 2010 assume annual inflation rate of 2%; 1 renminbi (2005) = $0.12.

Source: China Automotive Information Network; CIRC; market interviews; McKinsey analysis

policies at cost—no profits or losses—these sales will give companies an opportunity to cross-sell other insurance products and another way to gather information on new customers (Exhibit 1).

Second, China's government now requires its traffic bureau—a division of the national police department—to share summary reports on drivers' accidents and traffic violations with carriers that sell third-party liability insurance. Insurers will thus have a better position to evaluate the risk posed by individual drivers and to base policy discounts and product offerings on their behavior. The carriers' access to certain kinds of customer information will remain limited, however. Despite persistent lobbying, they still can't tap into data from the national credit bureau, which the central bank, the People's Bank of China, established in 2005 to serve financial institutions.

Moving the focus to profits

To build market share, most Chinese auto insurers focus on sales growth at the expense of profits. This approach plays out commercially in an emphasis on finding new customers. But in insurance, as in most businesses, the economics of keeping customers are far more attractive than those of finding new ones.

At one Chinese insurer, we found branches with customer retention rates below 25 percent. In other words, for every 100 customers these branches served last year, they had to find 75 new ones just to break even—hence the obsessive focus on recruiting agents and paying ever greater commissions to dealers. The top three Chinese carriers boast retention rates of about 80 percent, much better than those of many smaller competitors, though still below the typical retention rates of leading US insurers. Keeping customers not only saves money but also offers insurers an opportunity to gather information on drivers: the longer they stay with a carrier, the greater the chance that it will handle a claim, generating information that could help inform the price of future insurance products.

To profit from the growing auto insurance market, carriers must determine the most cost-effective way to price their policies according to the risks drivers pose, to optimize relationships with distribution channels, and to manage claims more rationally. Carriers that invest the money and resources needed to take these steps are likely to come out ahead in the race for market share, not just to raise profits.

Optimizing pricing and distributor relations

Some auto insurers, assuming that the CIRC's models are appropriate for everyone, use the generic formulas to set all policy prices. In doing so, carriers throw away the ability to adjust premiums for individual customers on the basis of factors such as their claims histories. Even a simple parsing of drivers by gender could help carriers achieve a better balance between premiums received and claims costs. Male drivers in China, as in other markets, have higher claims ratios (claims as a percentage of premiums) than female drivers do, for example. Instead of basing prices on risk, however, Chinese insurers and their distributors often use discounts to win new customers—a practice that does little to discourage high-risk driving. In fact, our study found that in some cities, drivers who had received discounts on premiums had a much higher claims frequency than those without them.

But using driver risk as a basis for pricing premiums would require information that insurers may not have. To obtain more of the kind of data

they need, they should rethink their relationships with the main sellers of policies: auto dealers and repair shops. The former control about 70 percent of the market for first-time personal and commercial auto insurance sales, probably because most people buying cars in China are doing so for the first time. Dealerships and repair shops together also account for 30 to 40 percent of all policy renewals.

While the relationship between insurers and distributors is close, it's often more adversarial than collaborative. Carriers believe that they must pay auto dealerships and repair shops high commissions (as much as 22 percent of the premium) to compete against other insurers. (By contrast, they pay commissions of about 5 percent within their own branch networks.) Given the relative size of these commissions, carriers prefer to switch consumers from the dealer channel into their own network after the initial sale—by purchasing lists of customers from people who work at the dealerships, for example, or by using filed claims to obtain information about customers and then offering them lower prices for renewing within the insurer's network.

Of course, distributors view this poaching as a serious problem. The failure to retain customers not only reduces commissions but also often means a cut in income from repairs and services associated with insurance policies. Chinese drivers are not loyal to particular distributors or repair shops, which earn more from the repair and servicing of autos than from insurance commissions. To discourage poaching, many dealers and repair shops won't give insurers data on customers, such as their names and addresses or information about their vehicles.

One way insurers could obtain such information without relying on distributors would be to use alternative sales channels, such as proprietary call centers and Internet portals. Selling policies through these methods should also make it easier for carriers to centralize information about drivers in a single database. Companies such as China Pacific Insurance Company (CPIC), PICC, and Ping An Insurance have all established Internet portals to facilitate sales. Although the Internet channel may prove more important in the future, only about 2 percent of the Chinese drivers we surveyed used it to make a purchase last year.

A more practical and immediate measure would be to offer distributors incentives to share information about customers. In exchange for better data, for example, an insurer could agree to avoid competing with dealers for the sale of insurance policies. The carrier could also collaborate with distributors by committing itself to halt its poaching efforts against them in

exchange for a guarantee that they would direct a certain percentage of their insurance sales to the carrier (since distributors can offer policies from multiple insurance companies).

In addition, insurers could encourage customers to use certain dealers or repair shops for repair services in exchange for information on drivers. Another approach to obtaining customer information might be to process claims more quickly for distributors who offer repair services. Distributors whom we interviewed said that the efficient and rapid processing of claims is critical to retaining customers.

Insurers can offer these and similar incentives to dealerships and repair shops to encourage them to sell lower-risk or better-priced policies, another critical but overlooked factor affecting the carriers' profitability. In addition, carriers should revise the way they now reward distributors: by sales volumes—fine for increasing revenues but a threat to profitability if a distributor sells policies to high-risk drivers. We found, for example, that insurers often pay their highest commissions to repair shops, the poorest-performing distributors from the standpoint of a carrier's profitability. At one carrier, the claims ratio from repair shops averaged more than 90 percent, far worse than that of any other channel (Exhibit 2).

EXHIBIT 2

Misunderstanding channels

Disguised example of Chinese auto insurance carrier, Mar 2005–Mar 2006

	Average claims ratio[1] of customers acquired through given channel, %	**Average commission rate,** %
Repair shops	93	22
Independent agencies	77	19
Dealers	70	21
Carrier's salaried sales personnel	47	5

[1]Claims as % of premiums.

Source: Sampling of carrier data; McKinsey analysis

To give distributors an incentive to improve their performance, carriers could offer higher commissions to the best ones, as measured either by absolute profitability or by profitability as compared with their peers.

Controlling claims costs

Many insurers have yet to invest in processes and systems that could control costs—for example, by tracking the performance of claims adjusters and centralizing information on repair costs and claims records. Instead, these insurers have devoted their resources to growth. But the lack of standardized claims processes means that costs can vary wildly: for instance, our study found that in 2006 the retail price that insurers paid for the headlights on a Volkswagen Santana varied by as much as 240 percent.

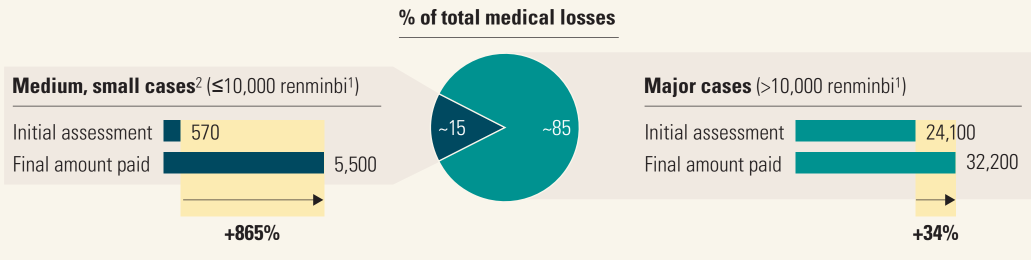
We estimate that carriers could improve their claims ratios by 5 to 10 percentage points if they used better claims processes—for example, databases to track repair costs and claims payments. Some drivers exploit the present system's flaws by submitting the same claim to more than one carrier. If a driver gets involved in an accident with another party, for example, that driver could submit a first-party claim to his or her own carrier and a third-party claim to the other party's insurer. The incidence of this practice could fall greatly if insurers tracked and shared information on claims more systematically.

Hiring teams of specialized adjusters, particularly for medical claims, would also help, since they could develop a more detailed knowledge of the costs of specific injuries. Our study found that medical and death-related claims account for more than 20 percent of the insurers' total losses—a share expected to increase with the rollout of compulsory third-party liability insurance. But carriers don't manage these claims closely enough and often end up paying more than the adjusters' initial estimates (Exhibit 3).

EXHIBIT 3

Medical losses

Average initial assessment and final payment on medical and death-related claims, Mar 2005–Mar 2006, renminbi[1]



[1]Disguised example of Chinese auto insurance carrier; 1 renminbi (2005) = $0.12.
[2]Sample size is too small to conduct meaningful comparisons with major cases.

Source: Carrier interview, claims data; McKinsey analysis

Ping An centralizes claims in its Shanghai headquarters. By concentrating its claims staff of roughly 500, the insurer has created teams that specialize in accidents involving medical claims, simple repairs, and complex accidents, respectively. Since these teams manage all of the company's claims, they can build a database, listing the cost of repairs by claim type and region, that should help Ping An to source repair parts more efficiently and to negotiate with the suppliers. Such measures to improve oversight, standardize processes, and create teams specializing in specific types of claims require a substantial investment and a determination to reach sufficient scale by consolidating operations. While the leading insurers are pursuing these goals, the smaller carriers don't yet see the benefits of such investments and are still focusing on adding branches.

The auto insurance market in China, like many sectors there, is young, immature, and booming, and sales growth is taking priority over profitability. This approach is unsustainable if it means that many players operate at a loss, which seems to be the case today. Investing the resources necessary to mitigate risk and to manage distribution and claims will be essential to the carriers' future performance—and survival. Q

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