April 2008

Indian General Insurance Industry Outlook
Major Changes Expected as Deregulation Continues

Summary Opinion
The outlook for the general insurance industry in India is stable based on Moody’s expectations for steady fundamental credit conditions in the sector over the next 12-18 months.

With the Indian economy forecast to grow at 7.5% in 2008 and given rising income levels and higher risk awareness among insureds, the country’s insurers are optimistic about demand for their products. However, intense competition from new entrants, deregulation and a moderation in returns from the equities market will pressure pricing and ultimately short-term profitability.

At the same time, despite rising inflation and a severe correction in the stock market (the key Sensex index fell 26% in 1Q2008), the prevailing view in Asia is that while China and India are not insulated from the credit crisis afflicting the US and EU, domestic demand is strong enough to support GDP growth. Being less export dependent, India is also less vulnerable than some of its neighbors.

Rising income levels, low penetration for most consumer products, availability of financing and changes in lifestyles/ aspirations are likely to sustain consumer demand over the next few years. In the short term, the focus on infrastructure development will keep the economy going, even if the tightening in credit leads to a slowdown in consumer spending.

1 See the central scenario of differentiation outlined in a Moody’s report, Mapping the Near Future – Macro Stress Scenarios for 2008-2009.
Furthermore, over the medium and long term, India’s insurance market will continue to experience major changes as its operating environment increasingly deregulates.

On the one hand, a mix of new products, new delivery systems and a greater awareness of risk will generate growth. On the other hand, competition will remain intense as private sector insurers and those about to enter India seek to win market share from the more established public sector entities.

**Strengths/Opportunities**

- The intense competition brought about by deregulation has encouraged the industry to innovate in all areas; from underwriting, marketing, policy holder servicing to record-keeping.
- Aggressive marketing strategies by private sector insurers will buoy consumer awareness of risk and expand the markets for products.
- Competition in a deregulated environment will allow market forces to set premiums that are appropriate for exposures and push insurers to differentiate their products and services.
- Innovations in distribution and improvements in market penetration will follow as public and private insurers compete to market their products.
- Allowing insurers to issue their own policy wordings and set their own rates will enable underwriters to tailor products to meet client needs.
- The existence of stringent licensing requirements ensure that only adequately capitalized and professionally managed companies are eligible to carry out insurance and reinsurance.
- The Insurance Regulatory Development Authority of India’s (IRDA) emphasis on quarterly reporting/monitoring of insurer solvency will enhance capital adequacy and transparency.
- Licensed brokers are very much part of the intermediary structure and only those with adequate capital, professional experience and expertise will be licensed by IRDA.

**Weaknesses/Challenges**

- Premiums rates will remain under pressure due to intense competition on the more profitable lines.
- Falling premium income -- without a corresponding reduction in claims -- is likely to drive down profits.
- Reinsurance is likely to cost more as treaty reinsurers reduce ceding commissions to compensate for the lower rates following deregulation.
- Public and private sector insurers’ greater reliance on their investment portfolios to generate sufficient income and gains for net profits would subject them to the volatility of the financial markets.
- Private insurers need to raise more capital, otherwise growth could be constrained since reliance on reinsurance for capital relief is not always viable or available.
- Traditional distribution channels, especially tied agents, need to be improved to match the new product offerings.
- There is general lack of transparency as financial and operational data for insurers are not readily available as none of India’s insurers are directly listed on stock exchanges.
- Like all developing economies on a fast track, the shortage of trained insurance professionals and technicians at all levels cannot be remedied in the short term.
- Natural catastrophes will always be present; the Indian sub-continent is vulnerable to cyclones, floods, hurricanes and earthquakes, and until there is a national capacity (similar to the terrorism pool) to manage losses, dependence on overseas reinsurers will continue.
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Moody's-ICRA Global Insurance - Indian General Insurance Industry Outlook

Market Overview

India is the 5th largest market in Asia by premium, following Japan, Korea, China and Taiwan.

The country is geographically large and has the world's 2nd largest population -- 1.13 billion in 2007 -- but it also has one of the lowest penetration rates for property and casualty insurance in Asia in terms of premium as a percentage of GDP. This situation reflects the fact that India’s insurance market is still in its infancy, meaning good growth potential.

Even though the economy is expected to slow, it has sufficient momentum to maintain an impressive rate of growth when compared to the more advanced economies. Against the backdrop of rising income levels, insurers operating in a now deregulated environment will be able to expand product lines to cater to the demand for more customized and sophisticated risk solutions.

And as India continues to revamp its infrastructure, the flow-on effects will ensure ongoing growth of commercial insurance.

In 2006-2007, India’s general insurance market witnessed a variety of changes as deregulation continued at a hectic pace. On the whole, the sector achieved double-digit growth and this trend is expected to persist over the medium term on the back of greater penetration, due partly in turn to the intense marketing efforts of private insurers.

With the removal of pricing controls on fire and engineering lines in 2007, insurers have since discounted their rates by 50% or more in their quest to retain or win market share. These practices will translate into weaker underwriting performances in the short term.
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Private players will continue to capture market share at the expense of public enterprises on a mix of aggressive distribution and service. Having penetrated the corporate segment in the past, most private insurers now seek to grow their retail books.

Furthermore, the number of private insurers is expected to grow as various foreign companies have announced intentions to establish joint ventures. Given the low level of penetration in some segments, this trend towards foreign participation is likely to continue.

Rate reductions in the recently de-tariffed corporate portfolio (fire & engineering) will impact premium growth, but this outcome will be offset by greater sales of existing and new products.

The formation of a third party motor pool, where all general insurers are required to participate based on the size of their overall market shares, will reduce the underwriting burden on public entities. The claims ratio for the segment is likely to improve in the medium term as premium rates for the third party motor pool have also climbed.

Although public entities have sustained consistent underwriting losses on some product lines, in particular for third party motor business, their investment income and gains have more than offset their underwriting losses and helped them achieve solvency margins.

With the regulatory environment in India, it generally ensures that insurers adopt sound underwriting, valuation and investment practices, while protecting the interests of policyholders. At the same time, the environment will undergo reform and modernization.

Market Place – Moving Quickly

The Indian insurance sector is rapidly moving towards international standards of free (risk-based) market pricing and new/innovative product offerings. Big changes have occurred over the last seven years, during which the sector was opened to private participation, but with foreign direct investment (FDI) capped at 26%.

In line with forecasts for a continuation of solid growth and strong domestic demand, the number of insurers in the private sector will keep growing. Major foreign players see opportunities to increase both volumes and types of products. With the regulator possibly lifting the ceiling on foreign ownership to 49%, the capacities of domestic partners would no longer constrain capital levels for joint ventures.

Until 2000, the general insurance sector had only four public sector players, formed after the nationalization of 107 general insurers. The public enterprises – Oriental Insurance Company of India (OIC), National Insurance Company of India (NIC), New India Assurance Company of India (NIA) and United Insurance Company of India (UII) -- were located in Delhi, Kolkata, Mumbai and Chennai respectively. They primarily focused on their immediate regions and there was little competition, leading to a near monopolistic environment.
In the private sector, there were nine players with Future Generali the latest entrant as of September 2007. A number of potential new entrants await the necessary approvals. Most private players have tie-ups with international companies to compensate for their lack of experience in insurance.

Within the private sector, ICICI Lombard (IL) leads with 12.4% market share for the period April-December 2007.

Recently, Reliance General Insurance (RGI) has emerged as the fastest growing player, recording a 150% rise year-on-year in gross direct premium in the first nine months of 2007-08. Chart 3 presents the gross direct premium income of various insurers for April-December 2007 along with growth over the same period in 2006.

**Business Profiles**

**Private Sector’s Growing Influence**

The private sector has been steadily growing market share despite the fact that public sector companies have been around for a lot longer. The private insurers enjoy considerable operational flexibility, whereas the public sector companies have been constrained by their traditions and inability to innovate.

**Market Share – Redistribution**

Due to the effectiveness of private marketing strategies, the market share of public insurers has consistently declined. Chart 4 depicts the trend over the last five years.

Given a faster growth rate, the market share of the private sector is catching that of the public sector and the two will likely converge over the medium term. In the past, private insurers had aggressively targeted the more profitable (and tariffed) corporate fire and engineering businesses by combining them with discounted offers on de-tariffed products, for example, personal accident & health, marine cargo and hulls.

The inherent operational flexibility of the private players – such as through aggressive pricing – has allowed them to capture a greater share of large corporate accounts. But such strong penetration of large corporate clients makes future growth in this segment more difficult.
Charts 5 and 6 compare the premium income of the private and public sectors. Before the removal of tariffs, fire, engineering and motor own damage (OD) contributed a much greater proportion of business for private players than was the case for public firms.

The private sector share of third party motor business was much lower in the past than that for public firms as the former did not pursue this market because of its negative underwriting margins. However, with the formation of the common third party motor pool, the situation has changed. The losses related to this segment now get shared among all the players, leaving little incentive to avoid this segment. This is also evident from the 9-month, 2007-08 data.

Fire and engineering now broadly contribute a similar proportion of overall business for the private and public sectors.

In terms of overall business, the focus has shifted towards the retail segments of motor and health, where good growth is expected.

**Regional Focus**

Public insurers have traditionally focused at the regional level with one each in north, east, west and south India. On account of their public charters and the absence of competitive pressures, these entities did not have to actively market their products and just wrote whatever business came their way.
Operational Flexibility
Moreover, the public entities lack the operational flexibility enjoyed by the private players. Their limited capacity to innovate has impacted their ability to tailor and aggressively price products for large corporations. The private players by contrast have focused on account-level profitability for large corporations and have expanded their shares by cross-subsidizing tariffed products.

Client Servicing
The public insurers have also been hampered in claims servicing by their process-oriented approach and limited operational flexibility. They have been unable to expedite claim settlements through out-of-court negotiations since a large proportion of their claims pertain to the third party motor segment, which is subject to adjudication by the Motor Accident Claim Tribunal. The result is a time-consuming and involved process.

Strong Infrastructure and Systems
Private players are not hindered by their charters or legacy systems and have constructed technologically advanced infrastructure.

They started with large investments in technology, which helped them to build robust data management systems. This characteristic enables in turn quick and effective decision-making for pricing and claims settlements, attributes vital to building franchises.

On the other hand, public entities have only recently upgraded their systems and have to grapple with transition issues, such as moving from paper to paper-less systems. They are encumbered by legacy systems and fragmented databases, and have not fully used their past claim experiences, something which could give them a strong pricing edge in a de-tariffed environment.

Focused Underwriting Strategy
The private players, especially during their initial years, have selectively targeted the more profitable lines of the public sector companies for growth. They benefit from the experiences of the public sector as well as their international joint-venture partners. They have drawn talent from public sector companies.

Superior Claim Paying/Processing Capability
The combination of superior technology and selective underwriting has allowed the private sector to set high standards for policyholder services, thereby differentiating themselves from public sector insurers. The claim settlement performance of the private sector has also been superior because of the limited amount of third party motor business that they have underwritten. Such claims normally take a longer time to settle.

Distribution – Rise of Bancassurance
The Indian general insurance industry has historically been dominated by the agency channel, through which 75% of total premium income is sourced. But in recent periods other channels – for example, bancassurance, brokers, corporate agents, direct marketing and direct sales channels -- are gaining importance.

Most insurers now have tie-ups with the banks, which act as corporate agents and are remunerated on a commission basis. For example, ICICI Lombard sources a major portion of its business from a tie-up with ICICI Bank. Similarly, Bajaj Allianz General Insurance Company Limited (BAIL, second largest private player) has tie-ups with large number of banks, which contribute a big share of its total premium income.

As of December 31 2007, 267 brokers were registered with IRDA, including 228 direct brokers, 33 composite brokers and 6 reinsurance brokers. In a deregulated environment, the broking community will have plenty of opportunity to become an integral part of the insurance and risk financing process.

At this time, low cost channels like tele-sales and the internet are still not developed in India, mainly due to relatively poor knowledge about insurance products and low internet penetration.
Regulatory Environment

Impact of Regulation – Emphasis on Policyholder Protection

IRDA was set up with introduction of the IRDA Act in 1999. Its initial purpose was to bring about general discipline to the industry. It is responsible for protecting the interest of policyholders and promoting efficiency in the insurance business.

To ensure their stability, transparency and financial strength, new entrants are subject to rigorous scrutiny and the conduct of their business is closely monitored, particularly in relation to capital adequacy and prudent investment policies. The regulatory environment to date has attracted many insurers whose domestic partners are leaders in their chosen fields and their foreign counterparts are all well-established with considerable experience in developed and emerging markets.

The regulator has laid down investment guidelines that limit exposure in certain class of assets and also sets threshold limits for some assets. At the moment, insurers have to invest a minimum 30% in government securities, in contrast to some of the more mature markets like the US and Australia, which do not have such restrictions. Compliance with these relatively restrictive guidelines could limit insurers’ ability to diversify and build optimal portfolios.

The guidelines also stipulate a minimum 10% investment in the social and infrastructure sector. The investment in un-approved securities has been limited to 25% of total investment books.

General insurers must maintain a solvency ratio (available solvency margin/required solvency margin) of 1.5 times, calculated based on net premium earned and net claims incurred in various segments. Public sector entities have maintained comfortable solvency margins, supported by their strong investment portfolios and capitalizations. The private players, being in a growth phase, may require capital infusions from time to time to maintain their solvency requirements.

The Indian insurance regulator has set the minimum capital required at a level to ensure that all insurers -- especially the start-ups -- have enough funds to meet their claim obligations and to limit their overall writings to the amounts supported by their capital bases. The need to manage capital to comply with IRDA’s solvency margin will induce insurers to be more risk conscious when taking on new business.

To ensure an orderly transition towards a deregulated insurance market and risk-based pricing, IRDA has enacted enabling legislation and issued guidelines to de-tariff various segments. De-tariffing -- introduced in January 2007 -- has been well accepted and corrections to prices in profitable lines have been dramatic and have noticeably impacted premium growth rates. In fact, the discounting has been so extreme that the regulator intervened in September 2007 and capped maximum discounts at 52.5%.

Three Phases of De-Tariffing

India’s general insurance industry has undergone de-tariffing in three phases:

- 1994 -- marine cargo, personal accident, health, banker liability and aviation
- 2005-06 -- marine hull segment
- 2007 -- fire, engineering and motor own damage (OD). However, the de-tariffing did not immediately allow for free pricing. Instead, insurers were required to follow the “file and use” method, whereby they were expected to file a charter of proposed rates, which was then approved by IRDA.

The restrictions on price discounts during the initial periods were intended to ensure orderly price adjustments. They were removed in January 2008.

The only segment that remains under a tariff regime is the third party motor business, although there has been a large upward revision in this area’s premium rates by regulators in recent times. Moreover, commercial third party motor business, which has traditionally contributed to adverse claims ratios, has been moved to a common pool, resulting in loss sharing.
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Charts 7 & 8 show that until December 2006 a very large proportion of premium income (64.4% in 1H2006-07) came from tariffed segments. Post-January 2007, this portion declined sharply, and was 14.5% in 1H 2007-08. The discounting of fire rates also reduced its premium contribution.

IRDA has indicated that by April 2008 remaining product restrictions will be removed and insurers will be able to roll out policies with different wording. The regulator has till now not allowed free wording, mainly to avoid any confusion among policyholders.

Financial Profile Trends

Insurer Investment Policy and Practices

According to our analysis of the investments portfolio of India’s top six insurers, there are sizeable deployments in government (central and state) securities, which are usually held to maturity.

The public insurers have fairly strong equity portfolios, which provides them with considerable liquidity and adds to their financial strength. Due to the equities boom, all public sector insurers booked robust profits during the last three years. Their investment portfolios however have large “fair value change” accounts (un-booked gains), which are vulnerable to equity market downturns.

Table 1: Investment Portfolios – Public versus Private Players

<table>
<thead>
<tr>
<th></th>
<th>Public Enterprises</th>
<th>Private Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government of India Securities</td>
<td>34.3%  35.3%  34.2%</td>
<td>29.6%  37.4%  41.9%</td>
</tr>
<tr>
<td>Other Bonds</td>
<td>16.0%  15.1%  14.7%</td>
<td>44.8%  38.8%  36.6%</td>
</tr>
<tr>
<td>Equity/Preference Shares/ MFs</td>
<td>11.9%  11.5%  12.5%</td>
<td>7.1%  9.0%  6.5%</td>
</tr>
<tr>
<td>Cash &amp; Bank Deposits</td>
<td>19.0%  19.0%  18.7%</td>
<td>15.9%  11.3%  10.6%</td>
</tr>
<tr>
<td>Other Approved Securities</td>
<td>1.3%  1.9%  1.1%</td>
<td>0.0%  0.0%  0.0%</td>
</tr>
<tr>
<td>Other than approved securities</td>
<td>11.5%  9.8%  9.7%</td>
<td>2.6%  3.5%  4.4%</td>
</tr>
<tr>
<td>Loans</td>
<td>6.0%  7.4%  9.1%</td>
<td>0.0%  0.0%  0.0%</td>
</tr>
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</table>

As the table shows, according to book values, insurers have major investments in Indian government securities, in excess of the minimum statutory requirement of 30%. The comfortable capitalization levels of public sector entities are supported by large amounts under fair value change accounts. This situation, however, also makes them vulnerable to equity downturns.
Underwriting - Investment Income and Gains Offset Unprofitable Businesses

Not surprisingly, compared to public sector companies, private sector insurers have accumulated fewer losses and generated less investment income.

As late-comers, private insurers have not been exposed to the under-priced third party motor business, evident until the creation of the liability pool in April 2007. And having been in business much longer, the public sector companies have considerable investment portfolios and have benefited greatly from the strong performance of the Indian economy.

Table 2: Profitability Indicators

<table>
<thead>
<tr>
<th></th>
<th>Public Enterprises</th>
<th></th>
<th>Private Entities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31-Mar-07</td>
<td>31-Mar-06</td>
<td>31-Mar-05</td>
<td>31-Mar-07</td>
</tr>
<tr>
<td>Underwriting surplus/ NPE</td>
<td>-19.8%</td>
<td>-33.6%</td>
<td>-23.4%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Net investment income/ NPE</td>
<td>24.1%</td>
<td>21.9%</td>
<td>23.8%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Realised gain/ NPE</td>
<td>25.2%</td>
<td>27.2%</td>
<td>16.6%</td>
<td>0.6%</td>
</tr>
</tbody>
</table>

NPE: Net premium earned

The substantial investment portfolios of the public firms have compensated for their relatively weaker underwriting performances.

These sections summarize the underwriting performances (based on the 12-month April-March periods) of the fire, marine, motor and health categories. This segment performance analysis is based on the top six players in the general insurance sector for last three years. Together, they account for over 80% of total business in the sector.

The data from public insurers included NIA, NIC, OIC and UII; while private includes IL and BAIL. The 2006-07 data does not include NIC.

- Fire (16% of gross premium 1H 2007-08)

De-tariffication in January 2007 resulted in a major correction in fire rates; reflected in an 11.7% decline in gross fire premium for 1H 2007-08. Historically, the fire portfolio has enjoyed a favorable claims ratio due to its tariffed pricing structure. The loss ratio is expected to deteriorate following de-tariffing. The 2006-07 loss ratio does not fully incorporate the impact of the price declines as only three months of free pricing have been included.
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- Marine insurance (6.5% of gross premium 1H 2007-08)

Marine comprises the marine cargo and hull segments, and accounts for a relatively smaller proportion of gross premium. In 1H 2007-08, marine grew 1.9% year on year. A marine hull is typically reinsured to a large extent since the sum assured under each policy is of a great magnitude. Over the years, marine has been a profitable portfolio, but there have been some instances of unfavorable claim ratios.

- Motor (42.1% of gross premium 1H 2007-08)

Motor accounts for the largest proportion of gross premium for all players. Penetration in this business is high. Third party motor, which is about 34% of business, is mandatory.

Growth in this segment largely depends on the automobile industry and regulatory changes regarding tariffs. The private players in the past have been reluctant to pick up commercial third party motor policies due to adverse claims histories. Accordingly, public sector companies show a disproportionate share of such loss-making policies.

To ensure availability and reduce the burden on the public sector, the regulator created a Third Party Motor Vehicle Pool, wherein an insurer’s participation in premiums and losses is based on its market shares in all businesses.

The pool is managed by GIC, which charges a nominal (1-2%) management fee. The insurers retain 10% of the premium as service charges. The third party motor premium has increased on a large scale to reduce losses. Overall, these developments benefit the public sector.

However, the private sector insurers have voiced concerns that the premium increase is still not adequate (capped at 70%, well short of the 150% needed) and their compulsory participation will hurt their bottom lines.
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- Health Insurance (16% of gross premium 1H 2007-08)

Health has low penetration levels and most business is from group policies taken by corporates for employees. Historically, the group business on its own would not have been profitable. It had until January 1 2007 been cross-subsidized by the tariffed and highly profitable fire and engineering business. To dilute exposure to the corporate sector, insurers are expanding into the retail segment, potentially very large and not well penetrated.

 sticking to medical providers which are not part of the Third Party Administrator network.

To better managed the high costs of health care and the reputation of the franchise, insurers are starting to handle more claims in-house and moving away from the Third Party Administrator model.

Expense Ratios – Public Sector Struggles to Reduce Expenses

Unlike private insurers, public companies have been plagued by higher expense factors. Even though there is an expectation that insurers conform to the statutory management ratio of 19.5%, the public companies have been operating well above that level at 24%.

The management ratio is a prescribed cap for containing wages, dividends and commissions, but intense competition following deregulation has instead driven up acquisition costs and reduced prices. With wages, the influence of unions means public insurers have very little scope for reductions.

Capital Adequacy – Insurers Well Capitalized, but Regulator Increasing Scrutiny

In line with IRDA (Assets, Liabilities and Solvency Margin of Insurers) regulations, all insurers should maintain a mandatory solvency ratio of 1.5x throughout the year and file solvency margin statements every March 31.

In the post de-tariffed environment, the regulator is concerned that intense competition will drive down insurance rates, a development which could ultimately impact solvency margins. IRDA signaled its intention to monitor solvency margins on a regular basis when it announced in November 2007 that all insurers must file solvency margin statements quarterly and in addition to their annual March 31 filings.

<table>
<thead>
<tr>
<th>Solvency report as on</th>
<th>To be submitted on or before</th>
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<tbody>
<tr>
<td>30 June</td>
<td>15 August</td>
</tr>
<tr>
<td>30 September</td>
<td>15 November</td>
</tr>
<tr>
<td>31 December</td>
<td>15 February</td>
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The new regulation -- with its increased emphasis on capital management -- will ensure that capital adequacy is given top priority when insurers develop or update their business plans.

The capitalization levels of public entities in general remain comfortable, supported by their investment books, which have benefited from large gains in their equity portfolios. By contrast, private insurers with much smaller investment portfolios and better underwriting results are less dependent on investment return to maintain solvency margins.
Private Sector Growth Dependent on Reinsurance

Direct insurance companies are required to cede a minimum of 15% (down from 20% since April 2007) of their business to the national reinsurer, GIC. In general, the public firms' stronger capital bases have enabled them to retain more of their portfolios.

Private insurers, with relatively lower capitalization (and hence lower capacity to retain risks) have resorted to higher utilization of reinsurance. Besides domestic reinsurer, GIC, all major international reinsurers are present and participate in the re-insurance program.

However, as rates declined sharply over the last year, the reinsurers are paying less ceding commissions and imposing ceilings on liabilities. This situation will ultimately add costs to expense ratios and reduce underwriting capacity, especially for private sector entities which are more dependent on their reinsurers for capital relief.

Furthermore, although no timeframe has been set, the government wants to raise its foreign participation cap to 49% from 26%. It hopes to encourage foreign joint venture partners to increase their stakes and the statutory capital of insurers. The larger capital bases will reduce private sector reliance on reinsurance and permit them to write and retain more business.

Website

For additional information, please see the company’s websites: [www.moodys.com](http://www.moodys.com), [www.icraratings.com](http://www.icraratings.com)

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Moody’s Related Research

Rating Methodology:

- Moody’s Global Rating Methodology for Property & Casualty Insurers, September 2006 (98046)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
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