CHAPTER 1

INTRODUCTION
1.1) INTRODUCTION

Insurance is one of the major segments of services sector. Services sector today accounts for more than half of the world’s Gross Domestic Product (GDP). In recent years, the focus of services trade has shifted away from just facilitating trade in goods as the sector has emerged as an independent entity in itself with services trade in the four supply modes opening up new opportunities. In 2009, the share of services, industry, and agriculture in the world’s GDP was 63.4 per cent, 30.6 per cent, and 6 per cent respectively (CIA, 2010). The services sector constitutes a large part of the Indian economy both in terms of employment potential and its contribution to national income. Services sector in India today accounts for more than half of India’s Gross Domestic Product. The services sector grew many folds in the nineties because of liberalisation in the regulatory framework which gave rise to innovation and higher exports from the services sector. Average annual growth in services sector in India which was 6.9 per cent in the decade of the 1980s (1980-90) rose to 7.9 per cent in the next decade (1990-2003). The decadal growth of the Indian service sector in the 1990s is quite high as compared to the world average of 3.2 per cent, East Asia and Pacific average of 6.8 per cent, and South Asia average of 7 per cent (Nair, 2005). During the 1990s, India’s services sector grew at an average annual rate of 9 per cent, well ahead of the growth rate of industry at 5.8 per cent per annum and that of agriculture at 3.1 per cent per annum (GOI, 2008). Even in 2008-09 when GDP growth was relatively lower at 6.7 per cent due to global recession, services growth was at 9.7 per cent with its share in GDP at 57.3 per cent. India is also moving towards a services dominated export growth. In 2008-09 when the merchandise export sector was severely affected by the global recession, services exports grew by a respectable 12.5 percent. The openness of the economy reflected by total trade including services as a percentage of GDP shows a remarkable increase from 27.4 percent in 2000-01 to 52.1 percent in 2008-09 (Prasad and Sathish, 2010). The services sector is currently the fastest growing sector of the economy, and employment growth in the sector has remained more than 5 per cent per annum since the 1990s as compared with the aggregate employment growth at less than 2 per cent (GOI, 2008). The service sector has been the prime mover of India’s gross domestic product in recent years. It accounted for a huge 24.4 per cent of the total Foreign Direct Investment (FDI) inflow in 2008. The 24.4 per cent share of the service sector’s FDI is dominated by the financial sector (12.1). In 2008, the FDI in insurance sector...
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was USD 636.9 mn, which was 6 per cent of the total FDI inflow in services sector (GOI, 2009). Though during 2009-10, the FDI in services sector dropped by 33.5 per cent, it
attracted the maximum foreign inflows out of all the sectors (PTI, 2010). The importance of
the financial sub sector goes beyond the output and employment it directly generates, given
its critical role in enabling broader economic activity, whether in industry, agriculture or
other services. The financial sub sector provides products for mobilising household and
corporate savings, credit for producing and consuming goods and creating long term assets,
transaction banking for facilitating economic activity and insurance for risk mitigation, long
term savings and social security. In the face of growing urbanisation, population mobility,
and formalisation of economic relationships between individual, families and communities,
life insurance has taken on increasing importance as a way for individuals and families to
manage income risks. Life insurance is now considered to be an important part of an
individual’s investment portfolio, not necessarily to accumulate wealth, but to feel financially
secure. Insurance in India has been viewed as a tax saving instrument and risk cover in life
insurance was purely incidental. The mindset continues to be the same, although the unit
linked instruments are becoming popular.

Insurance is basically defined as a financial agreement that redistributes the cost of
unexpected losses. The banking industry provides credit to lubricate the process of socio
economic development, while the insurance industry acts like an umbrella providing cover
and security. The insurance business is unique in the sense that it is rewarded for managing
the risk of other parties. In India insurance sector is not only playing a role within the
financial system but also has a significant socio economic function of providing risk cover to
the poor population. Insurance plays a positive role in meeting the financial services needs of
the poor, and one would need to examine the many challenges involved in offering insurance,
in areas such as property, personal, accident, health and life. Insurance companies not only
provide risk cover to infrastructure projects, they also contribute long term funds. In the last
decade, Indian firms have been transformed by the forces of competition and the economy’s
integration with the world economy. With the opening up of Indian insurance market,
competition has become intense with each player offering better quality products. This has
increased the choices available to customer. In the process, the expectations of consumer
have also gone up, he is expecting value added services in terms of excellence in product price and service, financial security, quality, after sales service, review of terms and conditions as frequently as desired, simplification of claim procedures, etc. Every company is trying to woo customers to have large chunk of the market share, but barring a few companies most of the new insurance companies are struggling to survive in the market. Every insurer must recognise that its “strategic posture” depends partly on the competitive environment and partly on its allocation of marketing resources. This posture should be determined in the light of the insurance firm’s strengths, limitations, and corporate objectives (Meidan, 1982). Advantage in the insurance sector is supported by two pillars, service and risk management. Service is not just customer service; it is service to agents, distributors, policyholders, business partners and employees. Risk management is everything else that insurers do, pricing, actuarial, claims, asset management, reinsurance, everything that has to do with managing risk and money. In addition, many financial services are of a long term nature and a fully informed evaluation may only be possible over an extended period of time. How consumers evaluate service offerings will have important implications for strategies as to how to add value to offerings. An insurance firm’s strategy is a plan for action that determines how an insurer can best achieve its goals and objectives in the light of the existing pressures exerted by competition, on one hand, and its limited resources on the other hand. Availability of business potential, identifying the right market segments and reaching the market are the main items in the business agenda of any of the sectors, more relevant while marketing an intangible service like insurance. This is particularly relevant in a nascent and developing market like India, where the awareness about insurance is very much limited even amongst the higher strata of society; and the stress on developing an acceptable distribution channel will be there on the shoulders of its stake holders. It is critical for life insurance marketers and agents to adopt a winning attitude. In fact, strategies should be driven towards maximisation of gains rather than minimisation of losses.

1.2) INSURANCE
Insurance has been in existence for centuries. As a concept it could not have existed for such a long time without delivering commensurate value, even if it has more than its fair share of disappointed customers (Kumaraswamy and Kumaraswamy, 2005). With a large
population and huge untapped market area, insurance happens to be a very big opportunity in India. In the new millennium, the Indian insurance sector is passing through a phase of structural change under the combined impact of the financial sector reforms, internal competition, changes in the regulations and the global competitive pressures. The insurance market in India has witnessed dynamic changes including entry of a number of global insurers in both life and non life segment. Major international players like AIG, Aviva, MetLife, New York Life, Prudential, Allianz, Sun Life, Standard Life and Lombard have ventured in with minority stakes in joint ventures with Indian companies in both Life and Non life segments. In spite of all this growth the statistics of the penetration of the insurance in the country is very poor. The market penetration of life insurance is low at 4 per cent of GDP in 2008 (IRDA, 2009). Experts generally regard low market penetration as a result of a low level of awareness among consumers about the benefits insurance can provide. There exists huge scope of investment in the insurance sector in India. India has an enormous middle class that can afford to buy life, health and disability and pension plan products. Further, insurance is one of the most important tax saving instrument in the country. During the past five years, the sector has grown in size and penetration. Deregulation has resulted in more diversified insurance product offerings, with a stress on marketing and distribution strategies. Though the concentration in the insurance sector is very high, it has shown a declining trend since the sector was opened to private participation.

1.2(1) Meaning and Definitions
Insurance means to indemnify the loss, to put back the person in his previous position. For example, if fire destroyed a person’s home, the insurance company will reimburse the amount so that the insured can again built the same house. In the context of life insurance, the right word to be used, in lieu of the term “insurance” is the word “assurance” because, the loss of life can not be indemnified (Mathew, 2005). Money can not bring back a person, therefore, the insurance company provides the assurance that after the death of the bread earner his family will be taken care of. Generally the term insurance is used for both life and non life business and henceforth “insurance” will be used in the whole thesis. The person whose risk is covered, is called the “insured” or “assured”. The person who agrees to compensate the loss arising from the risk is called the “insurer” or “assurer” or
“underwriter”. The instrument containing the contract of insurance is called a “policy”. Insurance is, basically, a risk transfer method, whereby the insurer undertakes to reimburse losses arising from specified loss causing events, for a fee called premium. In Hindi (Devnagri script), insurance is called “bima”. The word “bima” has been derived from the Persian word “Bim” meaning “fear” and “Bima” meaning “expense incurred to get rid of fear” (Gulati, 2007). Various authors have defined the term “insurance”. The definitions can be classified into three categories:

**Fig: 1.1**

**Definitions of Insurance**

Source: Based on Literature Review

Insurance may be described as a social and cooperative device to reduce or eliminate loss caused by a particular risk over a number of persons who are exposed to it and who agree to ensure themselves against that risk. The risk cannot be averted but loss occurring due to certain risk can be distributed amongst the agreed persons. They share the loss by payment of premium, which is calculated on the probability of loss. Premium is usually required to be paid in cash and advance payment of the premium is a condition precedent to the creation of a binding contract of insurance.
i. **Social definitions:**
These definitions consider insurance as a tool to protect against risks. As per these definitions, insurance has social significance. In this approach, insurance is seen as a social device to accumulate funds to meet the uncertain losses arising through a certain risk to a person insured against the risk.

According to John Magee, “Insurance is a plan by which large number of people associate themselves and transfer to the shoulders of all, risks that attach to the individuals” (Mathew, 2005).

ii. **Functional definitions:**
These definitions are economic or business oriented and consider insurance as a device providing financial compensation against risk or misfortune. This approach treats insurance as a cooperative device to spread the risk, the system to spread the risk over a number of persons who are insured against the risk, the principle to share the loss of each member of the society on the basis of probability of loss to their risk and the method to provide security against losses to the insured.

According to Roseblanttt, Bennnington and others, “Insurance is a system of protection against financial loss in which risk is shifted to a professional risk bearer (an insurance company), in exchange for a certain sum of money (the insurance premium). The insurer agrees to pay the insured if loss occurs” (Mathew, 2005).

iii. **Contractual definitions:**
These definitions are contract oriented and see insurance as a contract of indemnification. Insurance is defined as a tool in which a sum of money as a premium is paid in consideration of the insurer’s incurring the risk of paying a large sum upon a given contingency.

According to E.W. Patterson, “Insurance is a contract by which one party, for a compensation called the premium, assumes risks of the other party and promises to pay him or his nominee a certain sum of money on a specified contingency” (Mathew, 2005).
1.2(2) History of Insurance in India

Insurance industry in India has completed a full circle. The country has witnessed over 135 years of privatisation followed by more than four decades of nationalisation and finally liberalisation. In fact, India has the unique experience of insurance commencing its journey in the private sector, followed by a period of total government monopoly and eventually a liberalised environment where both public and private sector can co-exist and help in spread of the message of insurance to a wider audience in the country. In this section a detailed history of insurance has been discussed. The insurance history has been divided into two parts, i.e. Ancient Insurance and Modern Insurance.

1.2(2.1) Ancient Insurance:

Insurance has been in existence for centuries. Insurance was developed as a preventive measure against piracy on the sea. It was practised by Chinese and Babylonian traders as long ago as the third and second millennia BC, respectively. Piracy was so prevalent, that as a way of spreading the risk, the Chinese merchants would distribute their cargo over a number of ships so that if one ship was captured, the entire shipment would not be lost. In the ancient land of Babylonia, traders used to bear risk of the caravan trade by giving loans that had to be later repaid with interest when the goods arrived safely. In 2100 BC, the Code of Hammurabi granted legal status to the practice. These provided the underpinning for marine insurance contracts. Such contracts contained three elements: a loan on the vessel, cargo, or freight; an interest rate; and a surcharge to cover the possibility of loss. In effect, ship owners were the insured and lenders were the underwriters.

The earliest traces of insurance are found in the form of marine trade loans or carriers’ contracts, which included an element of insurance. The earliest authenticated insurance contract (i.e. that which displays the characteristics of insurance in the sense of a transfer of risk of loss due to a fortuitous uncertain event in lieu of payment of consideration / premium), is a marine insurance contract on a ship “The Santa Clara” dated 1347 in Genoa. By the middle of fourteenth century, as evidenced by the earliest known insurance contract, marine insurance was practically universal among the maritime nations of the Europe. In London, Lloyd’s coffee House was a place where merchants, ship owners and
underwriters met to transact business. By the end of the eighteenth century, Lloyd’s had progressed into one of the first modern insurance companies (Rajesham and Rajender, 2006). After marine insurance, fire insurance developed. It started from Germany in the beginning of the sixteenth century. The great fire in England in 1666, which resulted in the turning of 85 per cent of the houses to ashes injected life, strength and continuity to the concept of fire insurance. With the colonial development of England, the fire insurance spread all over the world (Jha, 1988).

The origin of life insurance can be traced to ancient Rome. In Rome the burial clubs were formed by the citizens which paid for their members’ funeral expenditure as well as make some payments to rehabilitate survivors of deceased members (Mohan, 2009). The first life insurance policy of which there is any trace was issued in London in 1653 on the life of a person named William Gybbons (Mishra, 2004). Ancient Indian history has preserved the earliest traces of insurance in the form of marine trade loans or carriers’ contracts. These can be found in Kautilya’s Arthashastra, Yajnyavalkya’s Dharmashastra and Manu Smriti. In India, Manusmriti (200 BC) provides Indian version of primitive marine insurance stipulating that “the trader should be made to pay (taxes or duties)” to the state for providing Yogakshema (Risk and safety) taking into consideration the terms of purchase, sale, the length of the journey, expenses and incidentals (Bodla et al, 2003). Kautilya’s Arthasharta is one of the first books to look at the economic impacts of natural calamities.

1.2(2.2) Modern Insurance:
The insurance in its modern form came to India from UK, with the establishment of the Oriental Life Insurance Corporation in 1818 in Calcutta, which failed in 1834. However, the success of Indian life insurance can be traced back roughly to the second decade of the nineteenth century when the Madras Equitable began transacting life insurance business in the Madras Presidency in 1829. The insurance companies were formed to cover the lives of Europeans only, Indians were not provided any insurance. Later when companies started covering lives of Indians, they were charged higher premiums than the Europeans. It was only in the year 1870, Bombay Mutual Life Assurance Society, the first Indian insurance company covered Indian lives at normal rates. After that, it was a rather dull phase with
regard to the growth in life insurance enterprise. Few other companies were also set up in other parts of India. However, this period was dominated by foreign insurance offices, which did good business in India, namely Albert Life Assurance, Royal Insurance, Liverpool and London Globe Insurance. The Indian offices that were set up during this period had to struggle against the prevailing prejudice against life insurance and natural ignorance of the people. The recorded history of Insurance business in India, however, began in 1914 when the Government of India started publishing returns of Insurance Companies in India. The Indian Life Insurance Company Act 1912 was the first statutory body that started to regulate the life insurance business in India. In 1928, the Indian Insurance Companies Act was enacted to enable the government to collect statistical information about both life and non life insurance businesses. This legislation was consolidated and amended to by the Insurance Act in 1938, with the objective of protecting the interests of the public. The Insurance Act 1938 was the first legislation governing not only life insurance but also non life insurance to provide strict state control over insurance business. By 1956 about 154 Indian, 16 foreign and 75 provident firms were established in India. Then the central government took over these companies and as a result the Life Insurance Corporation was formed by an act of parliament i.e. LIC Act 1956. With this, the industry became a government monopoly, devoid of any competition and designed to suit public sector manifestoes and directed to fulfil social obligations.

The history of general Insurance dates back to the Industrial Revolution in the west and the consequent growth of sea faring trade and commerce in the seventeenth century. It came to India as a legacy of British occupation. British and other foreign insurance companies through their agencies in India transacted this business. The general insurance business in India, can trace its roots to the Triton Insurance Company Ltd., the first general insurance company established in the year 1850 in Calcutta by the British. The general insurance in India could not progress much. The slow growth of joint stock enterprise and mechanised production was another reason for the low level of general insurance business. In 1957 General Insurance Council, a wing of the Insurance Association of India, framed a code of conduct for ensuring fair conduct and sound business practices. In 1972 The General Insurance Business (Nationalisation) Act, 1972 nationalised the general insurance business in
India with effect from 1st January 1973. It was after this that 107 insurers were amalgamated and grouped into four companies viz. the National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd. and the United India Insurance Company Ltd.

In 1999, regulatory body for insurance sector was formed and the market was opened for private players. With the entry of private insurers, the General Insurance Corporation subsidiaries were delinked from the holding company in 2000, and a separate body called General Insurers (Public Sector) Association (GIPSA) was created to facilitate interaction among the four. The General Insurance Corporation was re-designated as the National Reinsurer and general insurance companies were mandated to cede 20 per cent of their premiums to the national reinsurer. In 2008 Insurance Regulatory and Development Authority decided to allow insurers to operate in India as only public limited companies under the Company’s Act 1956 to ensure greater transparency and corporate governance.

1.2(3) Insurance Sector Reforms

In 1993, Malhotra Committee headed by former Finance Secretary and RBI Governor was formed to evaluate the Indian insurance industry and give its recommendations. At that time it was observed that though the nationalisation of insurance has contributed to security of savings, India has lagged far behind other developing nations in Asia in the area of insurance coverage and penetration. Life insurance penetration in India was less than 1 per cent till 1990-91. Insurance is related to economic growth. A nation that is aware of, plans for, and, manages risk, paves the way for economic growth. The committee came up with the report in 1994 suggesting the following major provisions:

1. Private companies with a minimum paid up capital of Rs. 1 billion should be allowed to enter the industry. However, a lower capital requirement could be considered for a co-operative sector’s entry in the insurance business

2. No company should deal in both life and general insurance through a single entity.

3. Foreign companies may be allowed to enter the industry in collaboration with the domestic companies.
4. Redesignate the GIC as a national reinsurer to which all of the country’s direct insurers must cede 20 per cent of their business.

5. Only one state level life insurance company should be allowed to operate in each state.

6. The Insurance Act should be changed.

7. An Insurance Regulatory body should be set up.

8. Controller of Insurance should be made independent.

Immediately after the publication of the Malhotra Committee Report, a new committee (called the Mukherjee Committee) was set up to make concrete plans for the requirements of the newly formed insurance companies but the recommendations of the Mukherjee Committee were never made public. On the basis of the recommendations of Malhotra Committee, Insurance Regulatory and Development Authority (IRDA) Act was passed in 1999. This Act repealed the monopoly conferred to the Life Insurance Corporation in 1956 and to the General Insurance Corporation in 1972. The IRDA Act, 1999 created a regulatory body for insurance sector with the name of Insurance Regulatory and Development Authority (IRDA).

In India, the regulatory legislation has made a significant departure from the rest of the world by allocating to the insurance regulator the role of development of the industry. This is done with the intention to ensure that the regulator does not overlook the need of developing and expanding the insurance market and the institutions working within the system so that the benefits of liberalisation and opening up of the sector trickle down to the masses. This would imply that the regulator must emerge as a focal point for all matters concerning insurance with a positive influence on the evaluation of the industry. The IRDA, since its incorporation as a statutory body, has been framing regulations and registering the private sector insurance companies. Being an independent statutory body it has put a framework of globally compatible regulations. Though, the existing rule says that a foreign partner can hold 26 per cent equity in an insurance company, a proposal to increase this limit to 49 per cent is pending with the government. The milestones of insurance regulations in India are briefly discussed in Table: 1.19.
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Table: 1.1

Milestones of Insurance Regulations in the Twentieth Century

<table>
<thead>
<tr>
<th>Year</th>
<th>Significant Regulatory Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1912</td>
<td>The Indian Life Insurance Company Act</td>
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<tr>
<td>1928</td>
<td>Indian Insurance Companies Act</td>
</tr>
<tr>
<td>1938</td>
<td>The Insurance Act: Comprehensive Act to regulate insurance business in India</td>
</tr>
<tr>
<td>1956</td>
<td>Nationalisation of life insurance business in India with a monopoly awarded to the Life Insurance Corporation of India</td>
</tr>
<tr>
<td>1972</td>
<td>Nationalisation of general insurance business in India with the formation of a holding company General Insurance Corporation</td>
</tr>
<tr>
<td>1993</td>
<td>Setting up of Malhotra Committee</td>
</tr>
<tr>
<td>1994</td>
<td>Recommendations of Malhotra Committee published</td>
</tr>
<tr>
<td>1995</td>
<td>Setting up of Mukherjee Committee</td>
</tr>
<tr>
<td>1996</td>
<td>Setting up of (interim) Insurance Regulatory Authority (IRA) Recommendations of the IRA</td>
</tr>
<tr>
<td>1997</td>
<td>Mukherjee Committee Report submitted but not made public</td>
</tr>
<tr>
<td>1997</td>
<td>The Government gives greater autonomy to Life Insurance Corporation, General Insurance Corporation and its subsidiaries with regard to the restructuring of boards and flexibility in investment norms aimed at channeling funds to the infrastructure sector</td>
</tr>
<tr>
<td>1998</td>
<td>The cabinet decides to allow 40% foreign equity in private insurance companies: 26% to foreign companies and 14% to Non resident Indians and Foreign Institutional Investors</td>
</tr>
<tr>
<td>1999</td>
<td>The Standing Committee headed by Murali Deora decides that foreign equity in private insurance should be limited to 26%. The IRA bill is renamed the Insurance Regulatory and Development Authority Bill</td>
</tr>
<tr>
<td>1999</td>
<td>Cabinet clears Insurance Regulatory and Development Authority Bill</td>
</tr>
<tr>
<td>2000</td>
<td>President gives Assent to the Insurance Regulatory and Development Authority Bill</td>
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</tbody>
</table>


At present, the Insurance Regulatory and Development Authority consists of the Chairman, 5 full time members and 4 part time members. The Authority is functioning from its Head Office at Hyderabad, Andhra Pradesh. As per the IRDA Act (1999), the core functions of the Authority include

1) Licensing of insurers and insurance intermediaries;
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2) Financial and regulatory supervision;
3) Control and regulate premium rates; and
4) Protection of the interests of the policyholders.

Major happenings, post liberalisation of insurance sector are briefly outlined in Table: 1.2.

Table: 1.2
Major Events: Post Liberalisation

<table>
<thead>
<tr>
<th>Year</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-2001</td>
<td>Ten life insurance companies were granted registration certificate by IRDA, which were in collaboration with foreign partner.</td>
</tr>
<tr>
<td>2004</td>
<td>Sahara India Life Insurance Company Ltd. became the first Indian insurance company to venture without any foreign collaboration.</td>
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<tr>
<td>2005</td>
<td>Reliance Life Insurance Company Limited, a subsidiary of Reliance Capital Limited under Anil Ambani acquired AMP Sanmar Life Assurance Co. Ltd. The decision to sell the company was taken consequent to AMP’s intention to exit the insurance business in India.</td>
</tr>
<tr>
<td>2008</td>
<td>To ensure better corporate governance and transparency in the insurance sector, Irda decided not to issue licences to companies registered as private limited insurance companies under the Indian Companies Act 1956. Existing private limited insurers were asked to become public limited. Accordingly Aviva Life Insurance Company India Pvt Ltd. and MetLife India Insurance Company Pvt. Ltd. changed their incorporation status to Aviva Life Insurance Company India Ltd. and MetLife India Insurance Company Pvt. Ltd. As per Section 2C of the Insurance Act of 1938, an insurance company should be a public company.</td>
</tr>
<tr>
<td>2008</td>
<td>Government introduced Life Insurance Corporation (Amendment) bill in December in the Lok Sabha.</td>
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<tr>
<td>2008</td>
<td>Government introduced comprehensive Insurance Bill in December in the Rajya Sabha to amend existing insurance laws and another to allow LIC more operational freedom. The key changes proposed in this bill are:</td>
</tr>
<tr>
<td></td>
<td>• FDI in insurance sector to be raised to 49 per cent from 26 per cent.</td>
</tr>
<tr>
<td></td>
<td>• Nationalised general insurers may tap the public for additional equity.</td>
</tr>
<tr>
<td></td>
<td>• To allow London based Lloyds to open a branch in India without registering under the Companies Act.</td>
</tr>
<tr>
<td></td>
<td>• Increase in LIC’s authorised capital to Rs.100 crore from the current Rs.5 crore.</td>
</tr>
</tbody>
</table>

Source: Various
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The IRDA opened the market in August 2000 with the invitation for application for registrations. Companies were required to submit business plans detailing the proposed capital structure, the nature of business they planned to carry out and their plans for selling insurance to the rural and social sectors. The first private life insurance company to enter the market was HDFC Standard Life Insurance Company, which was registered on October 23, 2000. In 2000-01 sixteen private insurance companies ventured into the market, ten in life insurance sector and six in the non life insurance sector. The deregulated market with a potentially large customer base, that is becoming sophisticated and demanding the new products and services, presents attractive opportunities for the local and foreign players.

1.3) COMPETITIVE STRATEGY

A strategy is typically an idea that distinguishes a course of action by its hypothesis that a certain future position offers an advantage for acquiring some designated gain. The word derives from the Greek stratégos, which referred to a “military commander” during the age of Athenian Democracy, reflecting the military roots of strategy. The American Heritage Dictionary defines strategy as “the science and art of military command as applied to the overall planning and conduct large scale combat operations.” Alfred Chandler defines strategy as “the determination of the basic long term goals and objectives of an enterprise, and the adoption of course of action and the allocation of resources necessary for carrying out these goals” (Hill et al, 2001). Strategy originated from the necessity of people to defeat their enemies. Without enemies, the need for strategy is non existent. Keniche Ohmae, acclaimed Japanese business strategist, has also said that the sole purpose of strategy is to enable a company to gain, as efficiently as possible, a sustainable edge over its competitors. When no competition exists, there is no need to strategise. In business, strategy is seen as a way of integrating the activities of the diverse functional departments within a firm, including marketing, production, research and development, procurement, finance etc. This internally consistent set of goals and policies aligns the firm’s strengths and weaknesses with the external (industry) opportunities and threats. Strategy is the act of aligning a company and its environment. Environment and firm’s capabilities are subject to change, therefore, the task of strategy is to maintain a dynamic balance. It also consists of the competitive moves and business approaches that managers employ to attract and please customers, compete
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successfully, grow the business, conduct operations and achieve targeted objectives. To achieve a position of competitive advantage, Porter (1980) gave few strategies which are better known as competitive or generic strategies. Two central questions underlie the choice of competitive strategy. The first is the attractiveness of industries for long term profitability and the factors that determine it. The second central question in competitive strategy is the determination of relative competitive position within an industry. Even though an industry may have below average profitability, a firm that is optimally positioned can generate superior returns. The generic strategies imply different organisational arrangements, control procedures, and inventive systems. Sustained commitment to one of the strategies as the primary target is usually necessary to achieve success.

1.3(1) Genesis of Competitive Strategy

Many of the concepts that form the basis of today’s understanding of business strategy development were developed during the first half of the twentieth century. After that the competitive space has been dramatically altered. In Fig: 1.2, Herrmann (2005) explains the development of strategic management from an evolutionary perspective which sees technology as the product of evolving cycles of variation, selection and retention. In an industry, breakthrough innovations, or technological discontinuities, initiate eras of ferment that end when a dominant design, or standard of the industry, starts an era of incremental change. The emphasis on product that helps in developing an industry standard is replaced by an emphasis on process. A new era of ferment in strategic management was generated by the notion of competitive advantages based on core competencies and resources. Over time, the increasing attention given to intangible and invisible assets has emphasised the role of new sources of competitive advantages. The cycles of this evolutionary perspective provide an explanation of the ever evolving nature of the field. The theories and concepts of strategic management in fact follow evolutionary cycles that explain alternating emphasis on process or content research as well as shifts of attention, first to the environment, then to the firm, now to the human potential of individuals. Firms now compete in a complex and dynamic environment transformed by the flow of, and need for, instant information, where knowledge is increasingly becoming the most valuable resource.
Evolution of strategic management: The Need for New Dominant Designs

The impact of technology and globalisation increasingly determines that high capability of firms, to acquire information, create knowledge and innovate, is essential to competing successfully. Through the 1960s and 1970s, the study of strategy was assumed that firms with better leaders would make better choices and would ultimately do better than their competitors. Porter turned this paradigm on its head. Michael Porter provided the first ‘dominant design’ in strategic management with his classic book Competitive Strategy, considered the most influential contribution to the field. In the 1980s, the focus shifted from strategic planning towards strategic management. In transforming the study of imperfect competition into the analysis of competitive advantage, Porter shifted the focus of strategy research outward, towards the analysis of the firm’s microeconomic environment. Strategic management saw the strategy of firms as one of adaptation to rather vague environmental forces until Porter (1985) developed his Five Forces framework (Fig: 1.3).

**Fig: 1.3**

**Five Forces Model**

This concept assumes five competitive forces which determine the attractiveness of a given industry: threat of entry, intensity of rivalry among existing competitors, pressure from substitute products, bargaining power of buyers, and bargaining power of suppliers. Profit

potential relates directly to the combined strength of these forces. Thus, intense forces generally result in low returns, whereas moderate forces generally result in high returns. The industry structure framework can be applied at the level of the industry, the strategic group or even the individual firm. An effective competitive strategy takes offensive or defensive position against the five competitive forces. As the speed of change and the level of uncertainty in the competitive environments further increased it was realised that it is not possible to determine a strategic direction for an organisation on a systematic basis but that organisations must constantly adapt to fast changing circumstances and, hence, move towards dynamic strategy development. Porter presented generic strategies for improving competitive position of an organisation. He imported ideas of industrial organisational economics to build a framework of generic strategies and industry analysis.

Although the best strategy is one tailored to the individual capabilities of a firm, there are three generic strategies to earn superior returns: overall cost leadership, differentiation and focus. Competitive strategy is the search for a favorable competitive position in an industry, the fundamental arena in which competition occurs. It aims to establish a profitable and sustainable position against the forces that determine industry competition (Porter, 1985). During this period, a broad range of concepts and techniques evolved which were aimed at building and sustaining competitive advantage by anticipating and exploiting business opportunities. The formalisation of these concepts was instrumental in pushing strategy development from the realm of “the intuitive genius of the founder or a top manager” to that of logical process. The aim of competitive strategy is to gain competitive advantage in the industry. When a firm sustains profits that exceed the average for its industry, the firm is said to possess a competitive advantage over its rivals.

1.3(2) Competitive Advantage

Adam Smith’s “Theory of absolute advantage (1776)” with its utopian assumption of two country two product matrix, and its improved version the “Theory of comparative advantage” by David Ricardo (1817) using the same assumptions (but taking into account the comparative efficiency of production of different products by a country with respect to the competing country), ruled the international trade theory until the nineteenth century.
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Heckscher and Ohlin (1933) introduced relative availability of basic factors of production in twentieth century (Ghai, 2006). Michael Porter (1980) defined competitiveness as having an edge over the competitors on account of higher productivity and/or efficiency. This explained the competitiveness of some industries and commodities in certain countries.

Competitive advantage of an organisation involves gaining an advantage over other competing firms with regards to the design and delivery of the product or service. It allows the firm to generate greater sales or margins, retain more customers than its competition and an ability to generate greater value for the firm and its shareholders. It means that a company is better placed in its power alley than all other competitors. The business has something that makes it better. This could be a better product, or better service, or a lower cost, or the best people in the industry, or the best brand or reputation, but better always means different. For the difference to be lasting, it must not be easily imitated. If there is to be real competitive advantage, imitation must be costly, or take ages, or both. By the time competitors have caught up, the leader should have moved on to something better again (Koch, 1999). Gaining competitive advantage entails a set of specialised skills, assets, and capabilities for the organisation. To win competitive advantage in any market, a firm needs to be able to deliver a given set of customer benefits at lower costs than competitors, or provide customers with a bundle of benefits its rivals cannot match (Porter, 1980). The more sustainable the competitive advantage, the more difficult it is for competitors to neutralise the advantage.

Sustainable Competitive Advantage refers to the company’s attempt at building up and maintaining advantage over competition for a long period. The term “competitive advantage” has been described in terms of the attributes and resources of an organisation that allow it to outperform others in the same industry or product market. The term “sustainable” considers the protection such attributes and resources have to offer over some usually undefined period of time into the future for the organisation to maintain its competitiveness. Sustainability of the competitive advantage is considered along the dimensions of durability, mobility and replicability. Durability determines how long the competitive advantage can be sustained and is considered in terms of the ability of competitors to imitate through gaining access to the resources on which the competitive advantage is built. This is because the speed at which the
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uniqueness of the resources of an organisation becomes accessible dictates the speed at which the competitive advantage of an organisation diminishes. With a durable competitive advantage, a company has good prospects for winning in the marketplace and realising above average profitability. Without competitive advantage, a company risks being beaten by stronger rivals and/or locked into mediocre financial performance (Thompson et al., 2006). Examples of company characteristics that could constitute a sustainable competitive advantage include customer focus, customer lifetime value, superior product quality, extensive distribution contracts, firm’s experience with particular market segments, accumulated brand equity and positive company reputation, low cost production techniques, patents and copyrights, government protected monopoly, superior employees and committed management team. To qualify as a winner, a strategy has to be well matched to industry and competitive conditions, a company’s best market opportunities, and other aspects of the enterprise’s external environment. At the same time, it has to be tailored to the company’s resource strengths and weaknesses, competencies, and competitive capabilities. There can be many types of competitive advantages including the firm’s cost structure, product offerings, distribution network and customer support etc. The various approaches of gaining competitive advantage are briefly discussed below:

![Fig: 1.4 Gaining Competitive Advantage](image-url)
1.3(2.1) Generic Strategies

In his book *Competitive Strategy* (1980), Michael Porter gave three “generic” business strategies that could be adopted in order to gain competitive advantage. Porter described two broad ways in which firms can deliver this value: lower cost and differentiation. A lower cost emphasis is one where the firm can provide a good or service more efficiently than the other competing firms; a differentiation emphasis is one where firms create superior value in the form of product or service quality. Porter juxtaposes another dimension, that of competitive scope, against the two broad categories of competitive advantage. Again, scope is divided into two categories: a broad target and a narrow target. The firm’s target includes not only the breadth of its service and/or product offerings (i.e. specialised versus a range of offerings) but the identified customer market as well. The narrowest focus would be one where a firm provides a singular service or good to a particular client or type of client in a geographically specific area. Combining these two dimensions of Porter’s framework, that of competitive advantage and scope, results in the generic strategies. These strategies are *cost leadership*, *differentiation* and *focus*; and relate to the extent to which the scope of a business’ activities are narrow versus broad and the extent to which a business seeks to differentiate its products. Focus strategy, again has two dimensions, it could be either cost focus or differentiation focus. The generic strategies are summarised in the following figure:

**Fig: 1.5**

**Competitive Strategies**

<table>
<thead>
<tr>
<th>Strategic Advantage</th>
<th>Uniqueness perceived by the customer</th>
<th>Low cost position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrywide</td>
<td>Differentiation</td>
<td>Overall cost Leadership</td>
</tr>
<tr>
<td>Strategic Target</td>
<td>Focus</td>
<td></td>
</tr>
<tr>
<td>Particular Segment only</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

These generic strategies model form the basis of the present study. The differentiation and cost leadership strategies seek competitive advantage in a broad range of market or industry segments. By contrast, the differentiation focus and cost focus strategies are adopted in a narrow market or industry. Focus strategy adverts to products which fulfill the needs of particular buyers who are fewer in number in an industry. While the cost leadership and differentiation strategies attempt to address a whole industry, the focus strategy addresses specific and smaller clusters of buyers within an industry. It has two variants. In cost focus a firm seeks a cost advantage in its target segment, while in differentiation focus a firm seeks differentiation in its target segment. Competitors may be under performing in meeting the needs of a particular segment, which opens the possibility for differentiation focus. Broadly targeted competitors may also be over performing in meeting the needs of a segment, which means that they are bearing higher than necessary cost in serving it. An opportunity for cost focus may be present in just meeting the needs of such a segment and no more. The focuser can thus achieve competitive advantage by dedicating itself to the segments exclusively. An effective competitive strategy takes offensive or defensive position against the five competitive forces.

1.3(2.1a) Differentiation

In a differentiation strategy, a firm seeks to be unique in its industry along some dimensions that are widely valued by buyers and that which buyers perceive to be better than or different from the products of the competition. It selects one or more attributes that many buyers in an industry perceive as important, and uniquely positions itself to meet those needs. Differentiation could be in terms of price, image, support, multiple features, quality or design. Firms that successfully differentiate themselves are rewarded for the uniqueness with a premium price. The firm is not affected by competitive rivalry because of brand loyalty by customer and resulting lower sensitivity to price. As the product has unique attributes, if suppliers increase their prices the firm may be able to pass along the costs to its customers who cannot find substitute products easily. Differentiation strategy is attractive when buyer’s needs and preferences are too diverse to be fully satisfied by a standardised product or by sellers with identical capabilities.
Introduction

Example of Differentiation Strategy: Mercedes cars, Harley Davidson Motorbikes.

1.3(2.1b) Cost Leadership

With this strategy, the objective is to become the lowest cost producer in the industry for a given level of quality. This strategy is usually associated with large scale businesses offering “standard” products with relatively little differentiation that are perfectly acceptable to the majority of customers. The firm sells its products either at average industry prices to earn a profit higher than that of rivals, or below the average industry prices to gain market share. In the event of a price war, the firm can maintain some profitability while the competition suffers losses. Even without a price war, as the industry matures and prices decline, the firms that can produce more cheaply will remain profitable for a longer period of time. The cost leadership strategy usually targets a broad market. The firm has a broad scope and serves many industry segments, and may even operate in related industries.

Example of Cost Leadership Strategy: Dell Computers, Walmart and Southwest airlines.

1.3(2.1c) Differentiation Focus

In the differentiation focus strategy, a business aims to differentiate within just one or a small number of target market segments. This strategy strives to tailor products to the specialised needs of a market segment. The important issue for any business adopting this strategy is to ensure that customers really do have different needs and wants, in other words, there is a valid basis for differentiation and that, existing competitor products are not meeting those needs and wants. The target market niche should be big enough to be profitable and should offer good growth potential.

Example of Differentiation Focus Strategy: e-bay online auctions, Chanel and Gucci.

1.3(2.1d) Cost Focus

Here a business seeks a lower cost advantage in just one or a small number of market segments. For example, a firm may seek to be the low cost producer in only one product line or in a limited geographic market. Since the cost of value activities as
well as the most efficient value chain may differ for different segment, a firm that dedicates its efforts to a well chosen segment of an industry can often lower its costs significantly. The product is basic, perhaps a similar product to the higher priced and featured market leader, but acceptable to sufficient consumers. Cost focus exploits differences in cost behaviour in some segments.

Example of Cost Focus Strategy: Federal Express

According to Porter, the generic strategies are mutually exclusive or at least non complementary and he identifies what is really a fifth outcome; being “stuck in the middle”; where firms attempt to pursue multiple strategies. He argues that such an approach is “a recipe for strategic mediocrity and below average performance, because pursuing all the strategies simultaneously means that a firm is not able to achieve any of them because of their inherent contradictions” (Porter 1990).

1.3(2.1e) Stuck in the middle

A stuck in the middle firm lacks market share, capital investment and resolve to play the low cost game, the industrywide differentiation necessary to obviate the need for a low cost position, or the focus to create differentiation or a low cost position in a more limited sphere. The firm in the middle must make a fundamental strategic decision. Either it must take the steps necessary to achieve cost leadership or at least cost parity, which usually involve aggressive investments to modernise and perhaps the necessity to buy market share, or it must orient itself to a particular target (focus) or achieve some uniqueness (differentiation). The latter two options may well involve shrinking in market share and even in absolute sales. Porter emphasised that the three strategic orientations represent three fundamentally different alternatives to a firm seeking to establish a competitive advantage. Firms that are “stuck in the middle” compete at a disadvantage because the cost leaders, differentiators and focusers are all able to concentrate their capabilities more effectively. Being “stuck in the middle” means that any advantage a firm might have at one point of time is unlikely to be sustained. These firms have no clear business strategy, which adds to their running costs causing a fall in sales and market share. ‘Stuck in the middle’ companies are
usually subject to a takeover or merger. Porter argued that firms that are able to succeed at multiple strategies often do so by creating separate business units for each strategy. By separating the strategies into different units having different policies and even different cultures, a corporation is less likely to become stuck in the middle.

The generic strategies appealed to strategists for two reasons. First, they captured a common tension between cost and differentiation. Second, the generic strategies are appealing because the capabilities, organisational structure, reward system, corporate culture and leadership style needed to make a low cost strategy succeed are, contrary to those required for differentiation. For the sake of internal consistency and to ensure that it maintains a single minded purpose, a firm might have to choose to compete either one way or the other.

The generic strategies can be summarised as:

### Table: 1.3
**Generic Strategies**

<table>
<thead>
<tr>
<th>GENERIC STRATEGY</th>
<th>COMMONLY REQUIRED SKILLS AND RESOURCES</th>
<th>COMMON ORGANISATIONAL REQUIREMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Cost Leadership</td>
<td>Sustainable capital investment and access to capital Process engineering skills Intense supervision of labor Products designed for ease in manufacture Low cost distribution system</td>
<td>Tight cost control Frequent, detailed control reports Structured organisation and responsibilities Incentive based on meeting strict quantitative targets</td>
</tr>
<tr>
<td>Differentiation</td>
<td>Strong marketing abilities Product engineering Creative flair Strong capability in basic research Corporate reputation for quality or technological leadership Long tradition in the industry or unique combination of skills drawn from other businesses Strong cooperation from channels</td>
<td>Strong coordination among functions in R&amp;D, product development, and marketing Subjective measurement and incentives instead of quantitative measures Amenities to attract highly skilled labor, scientists, or creative people</td>
</tr>
<tr>
<td>Focus</td>
<td>Combination of the above policies directed at the particular strategic target</td>
<td>Combination of the above policies directed at the particular strategic target</td>
</tr>
</tbody>
</table>

Achieving lower costs or delivering greater benefits than competitors can lead to competitive advantage, but the question is, whether such advantages can be persisted over time or not. The goal of much of business strategy is to achieve a sustainable competitive advantage.

1.3(2.2) Value Chain Analysis

Competitive advantage grows fundamentally out of value a firm is able to create for its buyers that exceeds the firm’s cost of creating it. Value is what buyers are willing to pay, and superior value stems from offering lower prices than competitors for equivalent benefits or providing unique benefits that more than offset a higher price. The value chain is a business system concept, which was originally developed by McKinsey and Company and was further developed and clarified by Porter. This concept captures the idea that a firm is a series of functions (e.g. R&D, manufacturing, marketing, distribution etc.) and that each of these can be analysed to determine ones own and the competitors’ strengths and weaknesses. Porter suggested an analysis of ones own and the competitors’ value chain. This is a view of the internal functioning of a firm.

Fig: 1.6

The Generic Value Chain

Firms create value for their customers by establishing a value chain within the organisation. When customers recognise these values as being superior to the firm’s competitors, the firm has established competitive advantage within its marketplace. The combined costs of all the various activities in a company’s value chain define the company’s internal cost structure. Further, the cost of each activity contributes to whether the company’s overall cost position relative to rivals is favourable or unfavourable. The task of value chain analysis is to develop the data for comparing a company’s costs activity by activity against the costs of key rivals and to learn which internal activities are sources of cost advantage or disadvantage.

The value chain is made up of five categories of primary activities, which are sub divisible into activities, dependent on the industry and the firm’s strategy. These primary activities are assisted by four support activities. The primary activities are:

i. **Inbound Logistics**: activities associated with receiving, storing and disseminating inputs to the product (materials handling, warehousing, inventory control, vehicle scheduling, and returns to suppliers).

ii. **Operations**: activities associated with transferring inputs into the final product form (machining, packaging, assembly, equipment maintenance, testing, printing, and facility operations).

iii. **Outbound Logistics**: activities associated with collecting, storing and delivering the finished product to the customer/buyer (finished goods warehousing, material handling, delivery vehicle operation, order processing, scheduling).

iv. **Marketing and Sales**: activities associated with providing a means by which buyers can purchase the product and inducing them to do so (advertising, promotion, sales force, quoting, channel selection, channel relations, pricing).

v. **Service**: activities associated with providing service to enhance and maintain the value of the product (installation, repair, training, parts supply, and product adjustment).

Each of these areas varies depending on the industry but all the areas will be present to some degree and may be vital to competitive advantage. Dramatic shifts in relative cost position often arise from a firm adopting a value chain that is significantly different from its competitors. A low cost producer must find and exploit all sources of cost advantage and
they typically sell a standard or ‘no frills’ product placing great emphasis on getting cost advantage from all sources. A cost leader’s low cost position at equivalent or lower prices than the competitors, translates into higher returns. If a firm can achieve and sustain overall cost leadership, it will be an above average performer in its industry provided that it can get prices at or near the industry average. The generic support activity categories of the value chain are:

i. **Procurement**: activities performed in the purchasing of inputs used in the value chain.

ii. **Technology development**: activities that can broadly be grouped into efforts to improve product and process.

iii. **Human resource management**: activities of recruiting, hiring, training, developing, and compensating personnel.

iv. **Firm infrastructure**: activities of general management, planning, finance, accounting, legal, government affairs, and quality management.

Value chain analysis is a method for decomposing the firm into strategically important activities and understanding their impact on cost and value. The value chain activity focus can be used for identification of strategic improvement needs or opportunities, but is not necessarily useful for specifying a reengineering of business processes. The cost behavior of value activities is determined by structural factors that are defined as cost drivers. The relative importance and absolute magnitude of cost drivers varies from industry to industry and from firm to firm. Exploiting and shaping these structural factors is a main source of competitive advantage. The drivers are partly related to internal relationships, partly related to external factors, and partly related to the relationship between internal and external factors. **Porter (1985)** identifies ten generic drivers: scale, capacity utilisation, linkages, interrelationships, vertical integration, location, timing, learning, policy decisions, and government regulations. The relative importance and role of cost and value drivers might differ across firms. For the generic value chain, the major driver of cost is scale and capacity utilisation.

According to **Porter (1985, 1990)**, the overall value creating logic of the value chain with its generic categories of activities is valid in all industries, but the activities vital to a given
firm’s competitive advantage is seen as industry dependent. In some industries, however, it is not only difficult to assign and analyse activities in terms of the five generic primary value chain categories, but the resulting chain often obscures the essence of value creation. For example, in insurance company, it is very difficult to say what is received, what is produced, and what is shipped. Uninsured people cannot be seen as the raw material from which insured people are produced; nor can the insurance company be regarded as a paper transforming company, producing policies from blank paper, capturing the value creation logic. Although significant savings can be realised by reengineering the paper and data handling process. However, such a description hardly captures the essence of value creation in an insurance company from a strategic point of view. It can be said that an insurance company creates value by facilitating exchange among their customers (Stabell and Fjeldstad, 1998)\(^2\).

1.3.2 Core Competence

Competitive advantage results from matching core competencies to the opportunities. The term core competence was coined by Prahalad and Hamel (1990)\(^2\) in their article “The core competency of corporations”. Core competence as a managerial concept is at the centre of the development of business strategy. As such, it is the fundamental basis of the competitive position of an organisation in the market. Business strategy development is concerned with matching customers’ requirements (needs, wants, desires, preferences, buying patterns) with the capabilities of the company; based on the skills and resources available to the business. This leads to the concept of core competence, defined as ‘something that the company does well and preferably better than, any other company in the market’.

The concept of core competence should not be confused with competence and distinctive competence. A competence is something an organisation is good at doing. It is nearly always the product of experience, representing an accumulation of learning and the buildup of proficiency in performing an internal activity. A core competence is a proficiently performed internal activity that is central to the company’s strategy and competitiveness. A company may have more than one core competence in its resource portfolio, but it is very rare. A distinctive competence is a competitively valuable activity that a company performs better
than its rivals. A distinctive competence thus represents competitively superior resource strength. A competence which is central to business’s operations but which is not exceptional in some way does not translate into a distinctive competence unless the company enjoys competitive superiority in performing that activity. Consequently, a core competence becomes a basis for competitive advantage only when it rises to the level of a distinctive competence. Core competencies are competitively more important than simple competencies because they add power to the company’s strategy and have a bigger positive impact on its market position and profitability. The importance of a distinctive competence to strategy making rests with (1) the competitively valuable capability it gives to a company, (2) its potential for being the cornerstone of strategy, and (3) the competitive edge it can produce in the marketplace (Thompson et al, 2006). Core competency is something that a firm does exceptionally well and that meets the following three conditions:

i. a core competence provides potential access to a wide variety of markets.

ii. a core competence should make a significant contribution to the perceived benefits of the end product.

iii. a core competence should be difficult for competitors to imitate.

In the long run, the competitiveness derives from an ability to build, at lower cost and more speedily than competitors, the core competencies that spawn unanticipated products. The real sources of advantage are to be found in management’s ability to consolidate corporate wide technologies and production skills into competencies that empower individual businesses to adapt quickly to changing opportunities. Core competencies are the collective learning in the organisation, especially how to coordinate diverse production skills and integrate multiple streams of technologies. Core competencies are complex sets of resources and capabilities that link different businesses in a diversified firm through managerial and technical know how, experience, and wisdom but the resources which are standardised or easily available will not enable a business to achieve a competitive advantage over rivals (Prahalad and Hamel, 1990). Businesses success can be based on a number of factors, including raw materials, patents, product differentiation and customer loyalty. Success may not be based on a physical product. It can be dealing with large numbers of small consumer transactions, marketing, or simplifying a complicated service. A core competency can take various forms,
including technical/subject matter know how, a reliable process, and/or close relationships with customers and suppliers. It may also include product development or culture, such as employee dedication. A most common form of core competence is knowledge based, residing in people and in a company’s intellectual capital and not in its assets on the balance sheet. Firms combine their resources and skills into core competencies, loosely defined as that which a firm does distinctively well in relation to competitors. Core competencies are the most significant value creating skills within a company and key areas of expertise which are distinctive to a particular company and critical to the company’s long term growth. A company’s core competencies are the things that can be done better than the competitors in the critical, central areas and where the most value is added to the products.

1.3(2.4) Resource based View (RBV) of Competitive Advantage

The idea of resource based view of the firm was first of all given by Penrose (1959), which was later developed by Wernerfelt (1984). The resource based view originated from an interest in the relationship between firm specific resources and growth and also the effect of firm differences on the ability to generate rents and create sustainable competitive advantage (Wernerfelt, 1984). The resource based view emphasises that a firm can create competitive advantage if it succeeds in creating superior value for customer in comparison to its competitors, by making use of its internal resources and capabilities rather than external forces and industry variables, as claimed by the traditional view. The sources of competitive advantage are valuable resources or competencies that firms possess, which are often intangible assets such as skills, reputation etc. These are considered as the basis of sustainable competitive advantages if they are costly, rare and non replicable. The resource based view has the greatest significance in environments where change is incremental, and the number of strategic variables and combinations is limited, so that a few scarce resources can govern outcomes. Resources become valuable because of social complexity, implying that resources that resist imitations, such as culture and reputation, are the result of complex interactions (Barney, 1991). Sustainability of competitive advantage is considered in terms of the organisation positively embracing change, constantly adapting to altered ways and new demands through introducing new resource configurations, while at the same time preserving the best of its past. Viewed in this way, sustainable competitive advantage assumes two
primary pillars: **Resource management** and **Resource development**. The central focus of the former is on the present using the resources developed in the past, whereas the primary concern of the latter is the future and the resources that will have to be developed for future competitiveness. The RBV of the firm can be presented as following in **Fig: 1.7**.

**Fig: 1.7**

**Sustainable Competitive Advantage**

**Resource Based View**

\[
\begin{align*}
\text{Resources} & \rightarrow \text{Build} \\
\text{Distinctive Competencies} & \rightarrow \text{Shape} \\
\text{Capabilities} & \rightarrow \text{Build} \\
\text{Strategies} & \rightarrow \text{Competitive Advantage} \\
\text{Competitive Advantage} & \rightarrow \text{Superior Profitability}
\end{align*}
\]


**Barney (1991)** states that not all firm resources hold the potential of sustainable competitive advantage; instead, they must possess four attributes.

i. **Valuable**: It must enable a firm to employ a value creating strategy, by either outperforming its competitors or reduce its own weaknesses.

ii. **Rare**: To be of value, a resource must not be commonly available.

iii. **Inimitable**: If a valuable resource is controlled by only one firm it could be a source of a competitive advantage. This advantage could be sustainable if competitors are not able to duplicate this strategic asset perfectly.
iv. **Non substitutable**: The resource should be non substitutable because if competitors are able to counter the firm’s value creating strategy with a substitute, prices would fall resulting in zero economic profits.

Resource based view holds that firms can be defined as collections of tangible and intangible skills and resources *(Peteraf, 1993)*. To the extent that these skills and resources are valuable, inimitable, non substitutable and non tradable in external markets, they are expected to generate rents and provide the foundation for sustainable competitive advantage. Existing skills and resources are seen as important determinants of both the direction and success of entry into new products or industries *(Penrose, 1959)*. Barney *(1991)* grouped all firm resources into three categories: physical capital resources, human capital resources and organisational capital resources. Resources are the firm specific assets useful for creating a cost or differentiation advantage and that few competitors can acquire easily. Some of the examples of resources are patents and trademarks, know how, value, beliefs, reputation, brand name etc. Capabilities refer to the firm’s ability to utilise its resources efficiently. These resources and capabilities constitute the competencies. Not all the resources and capabilities can create competitive advantage, only those resources should be leveraged which have the potential to create competitive advantage. This is where the concept of core competence comes. In addition, knowledge, values, and beliefs create an advantage for a firm through their influence on information processing and behavior. As cognitive structures unique to a firm, they enable its strategists to make superior evaluations of the rent earning potential of the firm’s resources relative to outsiders *(Rindova and Fombrun, 1999)*. They also guide the actions of all members of a firm and enable it to enact a systematic strategic direction. The resources are made up of factor networks which have specific inter factor and inter resource relationships that result in the characteristic traits being evidenced. These strategic resource factor relationships include network type, available substitutes and cogenesis relationships (compensatory, enhancing and suppressing) *(Black and Boal, 1994)*.

The proponents of this theory posit that strategies should be based on what the organisation is best at rather than focusing on the external environment. Resources and capabilities can
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originate from different areas, these include resources which (Feurer and Chaharbaghi, 1997):

i. improve the organisation’s competitiveness through cost advantage (e.g. manufacturing capacity, process technology, access to raw materials, etc.)

ii. can be used for differentiation purposes (e.g. marketing experience, distribution channels, brand names, etc.)

iii. make it more difficult for others to enter the market (e.g. patents, market share, etc.)

iv. have an influence on the bargaining power in the industry (e.g. firm size, financial capabilities, etc.).

Extensions of the resource based view suggest that the inward looking perspective has produced an overly narrow understanding of how firms may generate rents and secure long term growth. Specifically, firms may use access to external sources of information and knowledge and draw upon resources which are not independently ‘owned’ or controlled by the individual firm (Zander and Zander, 2005). The resource view focuses on factor market imperfections and highlights firms’ varying degrees of specialisation, complementing the industry analysis framework which considers the characteristics of the industry as sources of profitability, holding that type, magnitude and the nature of resources and capabilities are important determinants of profitability (Amit and Schoemaker, 1993). The Resource based theory attributes advantage in an industry to a firm’s control over bundles of unique material, human, organisational, and locational resources and skills that enable unique value creating strategies.

1.4) CUSTOMER SATISFACTION

Customer satisfaction is a measure of how products and services supplied by a company meet or surpass customer expectation. In a competitive marketplace where businesses compete for customers, customer satisfaction is seen as a key differentiator and increasingly has become a key element of business strategy. In response to an increasingly competitive marketplace, a growing number of organisations are actively using customer satisfaction measures in developing, monitoring, and evaluating product and service offerings. The concept of consumer satisfaction occupies a central position in marketing thought and practice. It is one
of the most studied areas in marketing. Over the past twenty years, more than 15,000 academic and trade articles have been published on the topic (Peterson and Wilson, 1992). Satisfaction is a major outcome of marketing activity and serves to link processes culminating in purchase and consumption with post purchase phenomena such as attitude change, repeat purchase, and brand loyalty. It can broadly be characterised as a post purchase evaluation of product quality given pre purchase expectations (Kotler, 2003). Satisfaction is believed to mediate consumer learning from prior experience and to explain key post purchase activities, such as complaining, word of mouth, and product usage (Westbrook and Oliver, 1991). When a company retains just 5 per cent more of its customers, profits increase by 25 per cent to 125 per cent (Bowen and Chen, 2001). Consumer satisfaction provides the basis for the marketing concept and has been shown to be a good predictor of future purchase behaviour (McQuitty et al, 2000). The centrality of the concept is reflected by its inclusion in the marketing concept that profits are generated through the satisfaction of consumer needs and wants. The need to translate the philosophical statement of the marketing concept into pragmatic operational guide lines has directed attention to the development and measurement of consumer satisfaction. In the early 1970s, consumer satisfaction began to emerge as a legitimate field of inquiry. Improving customer satisfaction has become a key strategy of many firms. The underlying premise is that fully satisfied customers lead to long term competitive advantage and thus profit.

1.4(1) Meaning and Definition of Customer Satisfaction

A review of the existing literature indicates a wide variance in the definitions of satisfaction. The lack of a consensus definition limits the contribution of consumer satisfaction research. Most definitions have favored the notion of consumer satisfaction as a response to an evaluation process. Researchers have defined consumer satisfaction in various ways. Some of the definitions provided in the consumer satisfaction literature are fundamentally inconsistent with one another. In other cases, the definitions have overlapping components but are partially inconsistent. Giese and Cote (2000) resolve existing inconsistencies in these definitions and conclude that, when examined as a whole, three general components can be identified in most definitions:
Introduction

i. consumer satisfaction is a response (emotional or cognitive);

ii. the response pertains to a particular focus (expectations, product, consumption experience, etc.); and

iii. the response occurs at a particular time (after consumption, after choice, based on accumulated experience, etc).

The literature views satisfaction as:

i. some type of affective, and/or cognitive response.

ii. based on an evaluation of product related standards, product consumption experiences, and or purchase related attributes (e.g., salesperson).

iii. expressed before choice, after choice, after consumption, after extended experience, or just about any other time a researcher may query consumers about the product or related attributes.

Customer satisfaction is a psychological concept that involves the feeling of well being and pleasure that results from obtaining what one hopes for and expects from an appealing product and/or service (WTO, 1985). Customer satisfaction is one of the objectives of marketing activity, linking the processes of purchasing and consumption with post purchase phenomena (Churchill and Surprenant, 1982). In economics, customer satisfaction is defined as the function of product and service attributes (Yu, 2007). Beginning with Oliver (1977, 1980), research concerned with the antecedents of satisfaction focuses primarily on the expectancy disconfirmation paradigm.

1.4(2) Determinants of Customer satisfaction

While there are a variety of approaches to the explanation of customer satisfaction/dissatisfaction, the most widely used is the one proposed by Oliver (1980) who has developed the expectancy disconfirmation theory. The disconfirmation of expectations model (DE) model assumes that individuals evaluate offering performances by comparing the perceived performance with their expectations. When perceived performance exceeds expectations, it causes positive disconfirmation or satisfaction, and when perceived performance is below expectations, it causes negative disconfirmation or dissatisfaction (Cadotte et al, 1987). To encourage actions, which will lead to an optimal level of satisfaction, it is necessary to understand the link between the antecedents of satisfaction and
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satisfaction’s behavioral and economic consequences. As per Anderson and Sullivan (1993), an individual’s expectations are:

1. Confirmed when a product performs as expected.
2. Negatively disconfirmed when the product performs more poorly than expected.
3. Positively disconfirmed when the product performs better than expected.

Fig. 1.8
Antecedents of Customer Satisfaction


The vast majority of studies hold that satisfaction is related to the size and direction of the disconfirmation experience, where disconfirmation is related to the person’s initial expectations. Dissatisfaction results when a subject’s expectations are negatively disconfirmed. The full disconfirmation paradigm encompasses four constructs: expectations, performance, disconfirmation, and satisfaction. First, buyers form expectations of the specific product or service prior to purchase. Second, consumption reveals a perceived quality level, which is influenced by expectations if the difference between actual quality and expectations
is perceived as being small. Hence, perceived quality may increase or decrease directly with expectations as indicated by the arrow drawn from expectations to perceived quality in Figure 1.8. Third, perceived quality may either confirm or disconfirm pre-purchase expectations. The determination of the extent to which perceived quality expectations are disconfirmed is depicted by arrows drawn from expectations and perceived quality to disconfirmation. Fourth, as shown by the arrows in, satisfaction is positively affected by expectations and the perceived level of disconfirmation. Expectations provide a baseline or anchor for level of satisfaction. If disconfirmation is perceived to have occurred, then customer satisfaction increases or decreases from this baseline level. Expectations are expected to have a direct positive effect on perceived quality. However, expectations affect satisfaction only via perceived quality and disconfirmation.

Expectancy disconfirmation is two processes consisting of the formation of expectations and the disconfirmation of those expectations through performance comparisons. Although linked conceptually, the two components of this paradigm, expectation and disconfirmation, have been shown to have separate effects. The expectation level appears to provide a baseline around which disconfirmation judgments are made; the higher (lower) one’s expectations, the higher (lower) the subsequent satisfaction judgment, ceteris paribus. The disconfirmation effects are thought to originate from their associated emotional experiences. The delight of a positive disconfirmation enhances a satisfaction judgment, while the disappointment of a negative disconfirmation decreases it. Confirmation simply maintains the adaptation level (Oliver and DeSarbo, 1988). Some consequences of customer satisfaction are: improvement of the firm’s reputation and image; reduction of customer turnover; increased attention to customer needs in Total Quality Management (TQM) planning; reduction of marketing costs and, vice versa, lower transaction costs; reduction of costs related to product/service failures; and, lastly, increased satisfaction among personnel and greater stability of the workforce (Muffatto and Panizzolo, 1995).

1.4(3) Customer Satisfaction in Insurance

Insurance is not a commodity. It is a promise to perform in future in return for a present monetary consideration. Such a promise is made in an environment when the customer is
absolutely not sure whether the promise will be fulfilled if and when the need arises, but then, if and when the need comes, it is already late for him to evaluate the customer service standards of the insurer. Yet another unique feature of the industry is the peculiar rules of the game such as uberrimae fidei (utmost good faith), indemnity etc, of which underwriters are more aware of than the customers. Insurance being an intangible product, the “technical quality of the service” depends upon its reliability.

Over the last few years, developments in the insurance sector have resulted in a paradigm shift in the way the business is conducted. In a free market scenario, the customer has a choice from whom to buy. He exercises this choice based on perceptions formed through his experiences. Customer servicing today has become the focal point of insurance companies. It is an area where the new companies are clearly ramping up by bringing in their best practices and operational efficiencies by appropriate use of technology. There is a greater sensitivity in dealing with the customers. However, a lot needs to be done. Insurers need to fast gear up to the situation and the real response and turn around time in delivery of services needs to be reduced in specific areas like delivery of first policy receipt, policy documents, premium notice, maturity payments, death claims etc. As customers are becoming more and more demanding, retention of their loyalty has become a big challenge for financial services providers, including insurance companies; and that is where the relative importance of ‘soft skills’ has increased.

The factors affecting perceptions of customers are different before, during and after purchase. Before purchase, they are affected by the image created by the brand, previous experience, what the friends say, published results and endorsements and the price as advertised. During purchase, the relevant factors are the performance specifications, the salesman, the warranties, service and repair arrangements, support programs and the price which is quoted. After purchase, the relevant factors shift to ease of installation and operation, handling of claims and repairs, spare parts availability, reliability and service effectiveness. If he does not receive such attention and expressions of concern, he could start doubting the bonafides of the salesman. This is the first step to having doubts about the wisdom of the purchase. This is
what is referred to as ‘Dissonance’. Dissonance is likely to be more frequent in the case of insurance purchases than in other purchases, because of the following:

a) In insurance, the payment of premium is immediate, while the benefit is distant and uncertain. In most other purchases, there is predisposition to buy, while in insurance, it is as if the purchase has been forced. The need is not felt strongly.

b) Policyholders feel a sense of loss or waste if the claim does not occur before the end of the term.

c) There are conditions and warranties which the policyholders could ignore, being unaware of their implication, affecting validity of the insurance policy.

Apart from the help in processing the claim when it occurs, post sales servicing would include regular reminders as to the customer’s obligations like payment of renewal, furnishing of data as may be required, compliance with warranties and so forth. There could also be changes in the customer’s situation, which the agent should become aware of to decide whether the policy conditions need amendment. There is absolutely no exaggeration in mentioning that the amount of customer grievances in the insurance domain has gone up steeply. Grievances arise where there is a certain level of expectation by a customer and the reality does not match up to it. This could be in terms of response time or quantum or the lack of response itself. It is time that insurers take stock of the situation and wherever there is need for plugging the loopholes, attend to that without any further loss of time. Instead of looking for reasons to explain the emergence of customer related problems, it would be more desirable to ensure that there is a fall in their number. The redressal of customers’ grievances is just a reactive way of insurers providing the minimum expected customer service. The need of the hour is a more proactive approach aimed at seeking what additional elements would delight the customer more and more.

The shots for market changes are called by the consumers and no longer by the insurers. Competition has enabled more choices of services and products to consumers; and excellence in perceived service by insurers is seen as a differentiator, instead of price; as the real value of the product. Customers want the best of all the worlds; price reductions, wider product coverage and excellent claims settlement. Once that is available, customers would ask, what next? That is the trend seen in all other sectors. Price reduction is a one time exercise. After...
collecting a large number of customers, how does one retain them? The obvious question to ask is: how many customers are happy? How would insurers deal with the changing loyalties of consumers, who only think of their interests to the exclusion of those of the insurers, annually seeking more value to be delivered at lower costs? Sentiment to crush competition at any cost should not be the sole marketing guide; but excellence in execution of assurances given to consumers and internal cost cutting should be the goals to pursue for insurers to become more competitive. Insurers should know that in a competitive scenario, there would be only one winner to emerge out of the market scene and that is the “customer”, the powerful change agent of the market that would call the shots to shape the future of the insurance market.

1.5) SUMMARY

Today’s companies are experiencing significant pressures from increased levels of competition, rapidly changing market requirements, higher rates of technical obsolescence, shorter product life cycles and the heightened importance of meeting the needs of increasingly sophisticated customers. The ways in which companies meet these challenges depend largely on the nature of the business they are in, the dynamic forces of the market in which they operate, and the resources and skills that can be applied to ensure their business objectives are met. For a business in a competitive environment, success and survival depend primarily upon creating a defendable competitive position. India is among the important emerging insurance markets in the world. Life insurance, in India, will grow over the next few decades. The major drivers include sound economic fundamentals, a rising middle income class, an improving regulatory framework and rising risk awareness. The insurance sector has come into sharp focus in India in the recent time due to the phenomenal changes taking place in terms of number of companies offering insurance products, the variety of products in the market and the proliferation of intermediaries selling them. Opening up the insurance industry to the private sector was to create competition in the market so that a consumer has the freedom to choose his insurer for his rightful claim of efficient and prompt service. No doubt, the existing insurance set up in the country has gone a long way in developing and marketing insurance product, but a great deal remains to be done.
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