29 January 2016

New life insurance regulations in India

After the passage of the Insurance Laws (Amendment) Act 2015 (Act), the Insurance Regulatory and Development Authority of India (IRDAI) has released a number of new regulations and draft (proposed) regulations. These regulations exercise the IRDAI's newly acquired powers under the Act, and may change the course of the industry in areas where the regulator feels action must be taken.

In this e-Alert, we investigate the impacts of the major regulatory changes, including:

- Proposed limits on the expenses of management of a life insurer based on the exposure draft issued recently
  - Based on our analysis, a number of companies incurred expenses in 2015 in excess of the proposed regulatory limits, and will not be able to continue to charge expenses at current levels to their participating funds.
  - Participating business appears to be very much on the regulatory agenda.
- Proposal to change the distributor commission structures for various products, including for protection business
  - The proposed regulations and initiatives by the government may prove to be a bonus for protection business (e.g., term assurance).
  - However, companies will need to invest in effective distribution capabilities to capitalise on the potentially improved environment.
- Proposed alignment of insurance accounting with IFRS
  - The Indian equivalent of IFRS will place a huge burden on financial reporting and actuarial teams in insurance companies.
  - 'Industrialisation' of processes and better analysis will be essential in order to meet the challenge.
- Final regulations on corporate agencies (including bancassurance and open-architecture)
  - No groundbreaking changes in the bancassurance distribution framework, as was anticipated earlier.
  - Formal limits on business placement with a single insurer dropped in favour of the requirement to produce a business plan to 'address the manner of adopting the philosophy of open architecture.'

1. Exposure Draft – Regulations on expenses of management and participating business – December 2015

Imposing caps on the maximum amount of commission and expenses life insurers can incur

The exposure draft (which is the third version of the draft) circulated recently for comments covers the following:

- The enforcement of caps on expenses similar to those under the erstwhile Rule 17D of the Insurance Rules, but with lower expense allowances—both as a percentage of renewal premium and first-year premium written (except for individual term assurances, where the expense allowances are significantly higher).

- While limits must be satisfied by the insurers at the company level, the limits will also be assessed by line of business (at a 'segment level'). Any amounts in excess of the limits in each segment must be charged to the shareholders' account.

The proposed limits on expenses of management of life insurers will pose serious challenges for many private sector life insurance companies and their participating business in particular. We have analysed the March 2015 annual reports of 16 private sector life insurance companies, where segmental revenue accounts and expenses were readily available, to determine whether their expenses were within the proposed limits.

Methodology adopted in our analysis

Based on the proposed regulations, we determined an estimated allowance for expenses of management for each company, both at an aggregate level and for participating business only. In determining these figures, we gave a credit of:
- 70% of first-year premium for individual business
- 12% of renewal premium for individual business
- 5% of group business premium and annuity premium

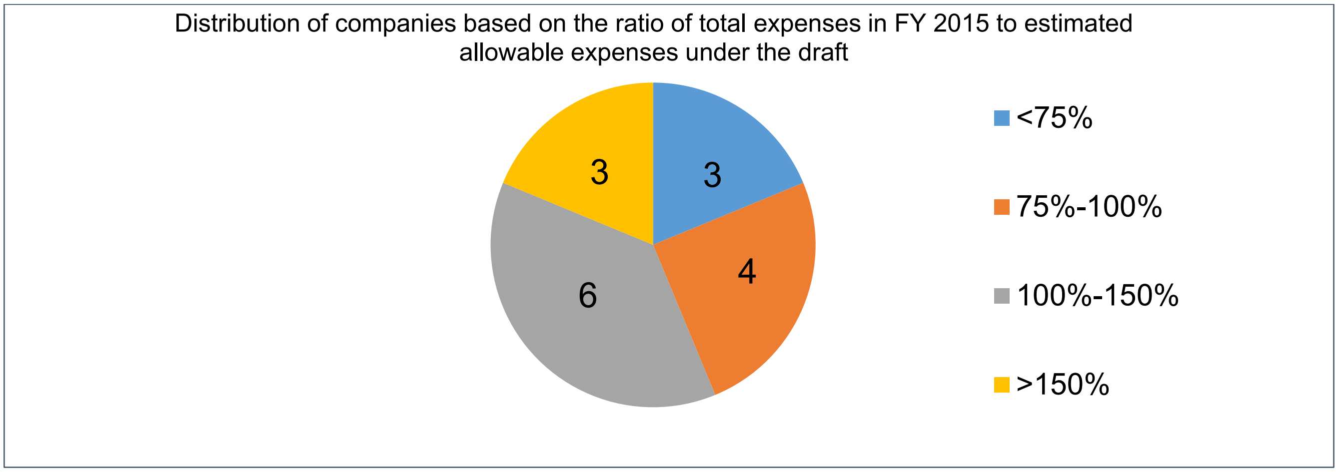
This allowance is likely to be higher than a company's allowance in practice, given that the proposed allowance on first-year premium is 50% to 70% based on the premium paying term of the business, and while group protection business has an allowance of 5%, the group funds business has an allowance of only 1% of premium. However, the estimate may be understated given that we have ignored:

- Short-pay policies which are still in force, but for which no further premium is due
- Term assurance business where the allowances are as much as 100% of first-year premiums and 25% of renewal premiums

These components have been ignored, as they are expected to be minor in the context of overall expense allowances.

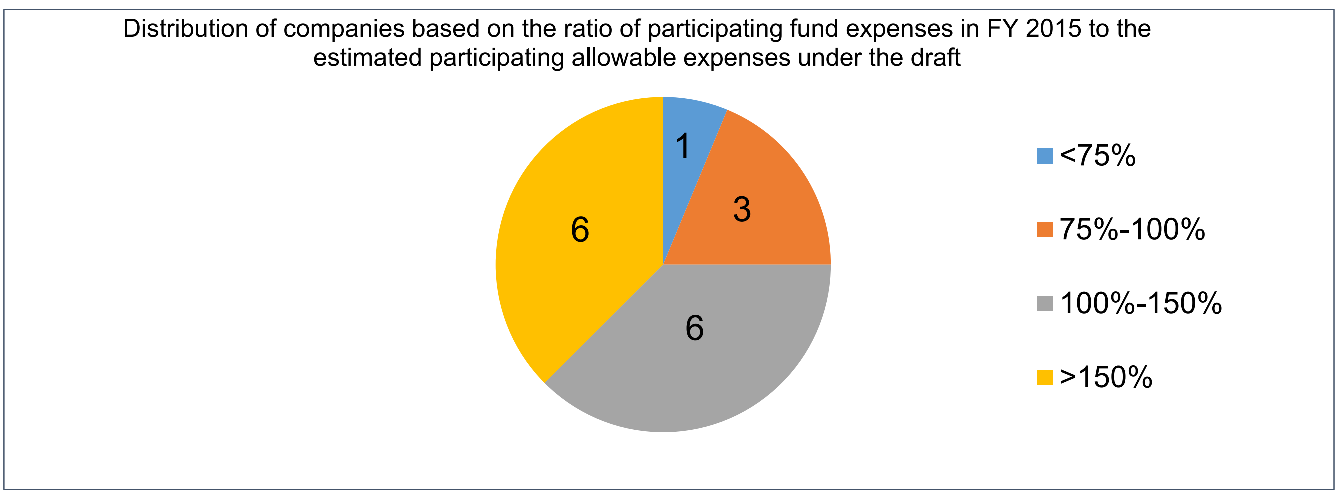
Results of our analysis

At the company level, nine of the companies analysed breached the estimated allowable expenses:



The real issue, however, arises when looking at the segmental expense allowances. Companies compliant at an aggregate level may not be compliant within each of the business segments. This is allowed as per the proposed regulations, but could be an important issue for participating business, as any expenses in excess of the proposed limits, which were previously shared with the policyholder in the ratio of 90/10, will now be borne fully by the shareholders. Out of the companies analysed, 12 breached the limit in their participating segment and all but one had expenses in excess of 75% of their estimated allowance.

Given that the expense allowance we have determined is intended to be at the very top end of the proposed allowance, it appears that almost all companies will have to charge some expenses from participating business to the shareholders fund, based on segment-wise allocations in 2015.



Conclusions

The proposed regulatory limits on expenses appear challenging for many companies.

Those who are not able to meet these limits are liable for restrictions on executive pay and opening of new branches, and may even have business segments closed to new business. Because many insurers would be relying on their scale of operations to bring down their expense ratios, this could lead to a downward spiral where increasing levels of punishment push insurers further from compliance.

New business margins under participating business (which comprises around 70% of the annualised new business premium in FY 2015), could come down if shareholders bear a larger share of the costs incurred. In an industry where new business margins are already amongst the lowest in Asia and where insurers have turned to participating business as a relief from the stringent caps on expenses imposed on the previously popular unit-linked business, profitability may come under pressure again if the proposed regulations are implemented.

However, better cost efficiencies and lower charges to participating funds will, in the long run, hopefully lead to better policyholder returns and more innovative and efficient distribution models—a goal which has so far eluded many players over the past 15 years since the commencement of their operations. For those smaller insurers, where the economies of scale required are simply out of reach in the medium term, we may witness companies pulling back from participating business.

The regulator has also clearly singled out participating business as an area of focus with this proposed regulation, and given that participating governance was a feature of the industry consultation exercise in 2015 (see Section 6.2 later in this article), we believe this is an area that the IRDAI is paying special attention to. The committee of life insurance actuaries responded to the consultation by suggesting enhanced governance and controls on the management of participating policies, an area that is lacking as highlighted in a previous Milliman e-Alert on participating policy governance.[1]

The committee suggested solutions to concerns over transparency and fairness as follows:

- Need to enhance the powers of the 'with-profits committee' to include a broader review of participating policy behaviour and focus on policyholders' interest. Recommended the role of 'with-profits actuary'
- Need to formally lay down the principles and practices used to determine bonus rates, surrender values, terminal bonuses, etc.
- Enhanced disclosure at the point of sale and throughout the product life

2. Exposure Draft – Regulations on commissions including those on protection business – January 2016

Increasing the amount of commission payable for protection business

The exposure draft circulated recently for comments covers the following:

- Overriding commissions, on top of the base commissions, are allowed up to certain limits (20% of commission for agency and 40% for other intermediaries) where previously no such override was permitted.
- Commission on the individual protection business is increased to 40% to 50% of first-year premium and 10% of renewal premiums (previously up to 35% of first year premium and 5% in later years).
- First-year commission on limited premium payment policies are increased to be comparable with regular premium payment policies.
- Commissions on group one-year renewable term policies are increased significantly to 10% of premium (from 2% capped at INR 50,000).
- Group credit life products no longer have fixed Rupee caps on commission for single premium policies.

Our analysis and conclusions

Both in the exposure draft for the Expenses of Management discussed above and the latest draft on distributor compensation, individual protection business has received a boost. The commission rates on the term assurance business are proposed to be around 50% higher than for other products in the first year, and 100% higher in later years.

While both the Ministry of Finance report on mis-selling and incentives (i.e., the Bose Committee Report—Section 6.1) released a few months back recommended lower charges and fees for savings/investment-oriented business, and the exposure draft of regulations on Expenses of Management proposes to bring down the allowances for all other lines, various arms of government appear to agree that the protection business should be spared in order to close the huge protection gap in India.

Thirty million policyholders signed up to the government-promoted 'Pradhan Mantri Jeevan Jyoti Bima Yojana (PMJJBY)' scheme—a low-cost, easy-to-deliver life insurance solution for the masses, which further pushes the protection agenda.

[1] Participating business governance framework: Need to strengthen significantly (18 November 2014). Milliman e-Alert. Accessed 27 January 2016, at http://www.milliman.com/uploadedFiles/insight/Periodicals/asia-ealert/india-par-fund-survey.pdf.

Indian life insurers have traditionally been much more focussed on selling savings/investment-oriented plans, rather than plans that provide safeguards against mortality and morbidity risks. In 2015, pure protection was recognised as both a harder sell and deserving of special attention.

However, the biggest challenge will still be training and truly incentivising a sales force to sell the relatively smaller premium term assurance and other protection-oriented products as a viable alternative to the sale of unit-linked and other savings/investment-oriented products.

3. Exposure Draft - Convergence of the current Indian accounting regime to Ind-AS/IFRS – December 2015

The IRDAI has released an exposure draft on a broad framework to be adopted to converge the current insurance accounting with Ind-AS (and therefore with IFRS) once the IFRS 4 (Insurance Contracts) Phase II is complete. In a recent communication, the government has stated that India will adopt Ind-AS accounting standards that reflect the IFRS framework with effect from 1 April 2018.

Because IFRS 4 Phase II is slated for completion in 2016, and implementation expected in 2019, insurance companies will soon need to start looking at how the financial reporting process will change under the new standards. While the final IFRS standards are not yet complete, the broad direction is quite clear in many areas, and reveals some key challenges already:

- **Increased scrutiny of actuarial estimates.** Actuarial departments will need to be responsible for a lot more than just the balance sheet reserves in this new reporting cycle. Profit and initial expenditure are 'locked in' at the inception of groups of contracts, and released using actuarial estimates of the run-off of the business. When, and by how much, profit can be 'un-locked' relies on an understanding of where and how these profits arise. Actuarial 'best estimates' need to be robust and consistent from year to year, much more so than in prudent, statutory reserves. Actuaries will not have the luxury of being excessively cautious in setting assumptions where risks are less well understood. In addition, very few companies will have ever produced external reporting with such a vast array of actuarial estimates before.

- **More demand on the skills of actuaries.** As the reach of figures produced by the actuaries extends further and further into the business, insurance companies will certainly need to hire more, and rely much more on their actuaries to explain why financial statements look the way they do, and how they will look going forward. There will certainly need to be much more integration of actuarial skills into the finance departments of insurers.

- **Increased pressure on timelines and need for 'industrialisation'** We have already seen a shortening of the timelines for regulatory reporting in the latest draft of the Actuarial Report and Abstract regulations, which need to be produced within 15 days of their approval by the board of the company, rather than up to 30 June previously. The Ind-AS/IFRS will add another layer of completely separate model results and revenue accounts. Numbers will need to be produced more quickly and, as mentioned above, after more interaction with other parts of the business. Given that many insurers still generate their actuarial reports using a network of interconnected spreadsheets and actuarial software, the need to rationalise systems and reduce human intervention where automation can be performed through a 'system industrialisation' framework is becoming more essential than ever. This is necessary not just to meet deadlines, but to make sure that the results have been discussed and analysed fully before their release. Financial reporting teams will be used to highly 'locked-down' processes with minimal scope for human error, and the actuarial results will surely need to pass this test as well.

4. Final regulations on Corporate Agencies (including Bancassurance and 'Open-Architecture') – September 2015

New regulations on corporate agents – Impacting bancassurance and 'open-architecture'

The regulation covers the following:

- No specific limits or quotas on the amount of business corporate agents must place with any insurer
- Corporate agents required to submit a business plan each year, however, detailing how their plans conform to the over-arching principle of 'open-architecture,' i.e., that customers should be able to choose from the products of a variety of insurers when receiving financial advice from the agent

Our comments

Many exposure drafts over a number of years culminated with the final regulations on corporate agents—the main form in which banks are registered to sell insurance products. Given the high new business volumes achieved by some of the top-ranking life insurers through their bank partners, many life insurers see this channel as a driver of growth in the future. Naturally, competition over distribution tie-ups with banks has been fierce.

Previous drafts of this regulation had proposed that there would be mandatory caps on the amount of business a bank can sell from any one insurer. This was intended to encourage banks to offer products from more than one insurer, with the aim of increasing choice and helping customers find the best fit for their needs. These mandatory caps have been dropped in the final version, but with the express intention that a bank's business plans would be scrutinised by the IRDAI to determine how it has made efforts to give customers a wider choice of insurers to choose from when being advised on insurance matters.

It appears that the anticipated fundamental shift in bancassurance has not materialised, to the dismay of those insurers who were hoping to capitalise on new distributor avenues for their products. What is yet unclear, however, is how a business plan to 'address the manner of adopting the philosophy of open architecture' will be demonstrated. We will need to see to what extent, and in what form, banks will demonstrate that they are moving to a more open architecture.

5. Summary of other regulations/exposure drafts issued in the past few months

5.1 Regulations allowing issuance of other forms of capital – November 2015

Issuance of preference shares and subordinated debt

The regulation covers the following:

- Companies are now allowed to raise funds through issuance of preference shares and subordinated debt instruments, subject to the following:
  - They must be fully paid up and unsecured, and sub-ordinated to policyholders and creditors.
  - The maturity/redemption period is not less than 10 years.
- Other forms of capital cannot contain a put option. Call options may be issued (but can only be exercised after five years).
- One insurer can invest in these instruments issued by another insurer, subject to investment norms.
- Other forms of capital may not exceed 25% of total equity share capital and share premium.
- For the calculation of solvency margin, outstanding balances are written down on a straight-line basis during the last five years.

5.2 Regulations on issuance of capital by insurers through IPO – December 2015

Amendments to the existing regulations for initial public offering (IPO) of shares

The regulation covers the following:

- The company is allowed to issue partly paid-up shares (must become fully paid up within a year).
- An insurer does not need to be in business for 10 years before an IPO (but this may be a consideration at the time of approval by the IRDAI).
- While an independent actuary is still required to prepare the embedded value report, a second independent actuary is no longer required to peer review the embedded value report, as was the case previously.
- The embedded value of the insurer does not need to be more than two times the paid-up equity capital for IPO approval, as required earlier.

5.3 Regulations allowing reinsurance branches – October 2015

'Go-ahead' for foreign reinsurance branches

The regulation covers the following:

- The regulation lays down the framework for approval of the opening of a branch by a foreign reinsurer in India, including the requirements of minimum capital amounts, credit ratings and annual fees.
- The branch office must be capable of underwriting risks and settling claims.

5.4 Other regulations in recent months

- Regulations to move the rules pertaining to the calculation of surrender and paid-up values from the Insurance Act to the IRDAI regulations – October 2015
- Regulations pertaining to the minimum rural and social business requirements, under the new Act – September 2015

5.5 Others exposure drafts in recent months

- Covering the remuneration of the chief executive officers/whole-time director/managing director of insurers (CEOs) – September 2015
- Covering the preparation of the Actuarial Report and Abstract, simplifying and amending some of the reporting requirements, including some recommendations of the committee set up for this purpose (See Section 6.2) – November 2015
- Covering the valuation of assets, liabilities and solvency margin under the new Act, including clarifications and amendments to the existing rules based on the recommendations of the committee set up for this purpose – November 2015
- Covering investment norms – July 2015
- Covering the preparation of financial statements – November 2015

6. Other developments

6.1 A report by a committee appointed by the Ministry of Finance to look into the mis-selling and incentives to distributors (Bose Committee) – August 2015

Proposals for rationalising incentives across consumer financial products

The Ministry of Finance set up a committee, as recommended by the Financial Stability and Development Council, with the following terms of reference:

- Study the prevailing incentive structure among various financial investment products.
- Suggest policy measures such that differential regulatory norms do not favour any particular financial product and prevent mis-selling. The study would also address issues with respect to hidden costs and identical financial products under different regulatory jurisdiction.
- Suggest measures to rationalize the incentive structure across financial products

The main recommended principles/practices under this report are set out below:

<u>Recommended principles</u>

- Products should be easily understood and disclosures should be enhanced.
- Costs across similar functions should be the same (for example, commissions, tax exemptions and charges might need to be the same for the investment part of unit-linked plans, and mutual funds).
- Power of withdrawal should be with the customer—consumers should not be tied into products through excessive surrender penalties.

<u>Recommended practices</u>

- Clear distinction should be made between the investment portion and protection portion of financial products.
- Up-front commissions for the investment portion should be phased out and replaced with a commission based on assets under management (AUM).
- After mortality charges, there should only be a fund management charge, and this should be capped.
- IRR to customer should be the only metric displayed for investments (not, for example, bonus as percentage of sum assured).
- For the protection portion, mortality charges should be displayed alongside a similar pure term assurance product.
- Surrender values should be expressed as an IRR throughout the tenure, and lapse profits should be banned.
- Benchmark 4% and 8% returns should be removed and only the risk rating of the fund and past record displayed, benchmarked against similar investments (e.g., fixed deposits, GSEC, Sensex).

6.2 Review of regulations – Life insurance – September 2015

Report of the committee of life insurance actuaries constituted by IRDAI to review specific regulations

The committee was to study and review the regulations for actuarial valuation, solvency and reporting requirements (or any other regulation) and recommend suitable changes in the regulatory system. The committee made the following recommendations:

- The committee recommended the used of risk-based capital metrics as a supplementary (and potentially replacement) method of solvency regulation.
- The concept of 'materiality' in the valuation was proposed as a way to avoid excessive accuracy in the computation of small components of the valuation.
- The IRDAI posed the question of whether caps on the total charges (expressed as a reduction in policyholder return on premiums paid) could be introduced for participating business, in a similar fashion to ULIP business. The committee did not believe this would be workable, and instead proposed enhanced governance controls as a way to ensure policyholders get a fair return on their policy.

Many of the changes proposed in the exposure draft on the Actuarial Report and Abstract, and Assets, Liabilities and Solvency margin, were based on recommendations made in this consultation paper.

7. Conclusions

The pace of regulatory change since the passage of the Act has been swift, with some areas of legislation rationalised and others moved from the Act to the IRDAI's purview—hopefully making regulation more reactive to changing environments.

Exposure drafts on expenses of management will be a hot topic over the coming months as the insurers determine how to meet the new guidelines. Even if the regulations do not pass in their current form, it is a good time for insurers to take stock of their distribution networks and participating business, as we expect some form of regulation here in the next year. As some insurers may have hoped, a fresh bancassurance channel is unlikely to provide the quick-fix solution.

In addition, through government promotion, increasing prominence of online sales and web aggregators, and increased investment, protection business may yet become a driver of growth for some players in the medium term. As participating business may become less profitable for the insurer, and with unit-linked margins already squeezed, the relatively high margins offered by term assurance plans may become attractive—surely a benefit for the overall social security of the nation.

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