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February 2012

Indian life insurance industry - developments since September 2010

Introduction

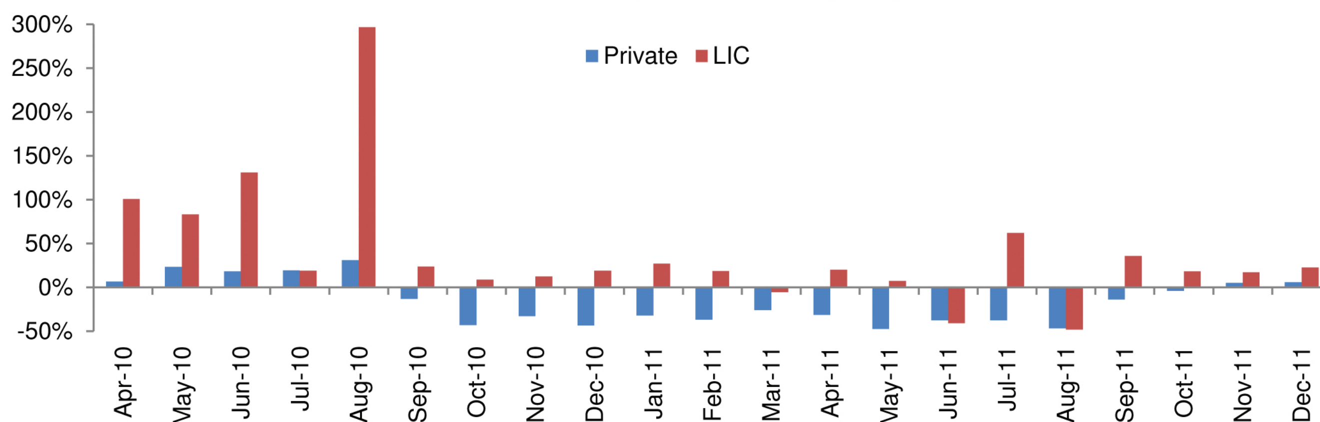
It is close to a year and a half since the Insurance Regulatory and Development Authority (IRDA) issued guidelines in September 2010 restricting the design and pricing of unit linked insurance plans (ULIPs) with the introduction of caps on charges (including surrender penalties). The IRDA followed this up with restrictions on the product design and pricing of universal life plans (known as Variable Insurance Plans or VIPs) through a circular issued in November 2010.

Given the significance of these changes, all life insurance companies in India have been revising their strategies in response to this new environment. It is still too early to assess the longer term impact of these changes. However, severe reductions in new business volumes and the depressed mood in the industry in the face of these challenges are a stark contrast to the excitement of the initial growth phase of the market.

In this article, we highlight some of the more noticeable developments that have emerged over the past year and discuss how the industry may evolve in the near future.

The immediate fallout

Decline in new business volumes: There has been a significant fall in new business volumes since September 2010. Tight caps on ULIP charges have led to a significant reduction in the level of commission payments. ULIPs have become much less attractive for distributors (especially tied agents) with sales of ULIPs waning considerably as a consequence. The adverse media coverage about the high level of charges on ULIPs in the past and the depressed stock market conditions over the past year have also contributed to the problems. As a result, the industry excluding the Life Insurance Corporation of India ('LIC') saw a fall of 17% in weighted new premium collections over FY 2010-11, while ULIPs sales fell by nearly 35%.



Source: IRDA statistics
Growth rates are calculated based on weighted new business premium from individual business in each month as compared to the same month in previous year

The reduction in ULIP sales has been most noticeable for the tied agency channel. The bancassurance distribution channel is relatively less affected due to the reduced commission level on ULIPs given the relative attractiveness of the sale of ULIPs vs. mutual funds (on which no commission is now payable) and also given the channel's lower infrastructure costs in general.

As a result, private sector life insurance companies that rely heavily on the tied agency channel, with no access to a significant bancassurance distribution channel are amongst the worst hit. For such companies relying primarily on the tied agency channel, weighted new business premium for FY 2010-11 is down by nearly 28%. However, it is interesting to see that the performance of companies that do have access to significant bancassurance distribution relationships is also not encouraging. Even for these companies, weighted new business premium for FY 2010-11 has reduced by nearly 5%.

Changing product mix: The new ULIP regulations have led to a dramatic switch in product mix for many companies. Prior to the regulatory changes, ULIPs contributed around 80% to 90% of the top line for most life insurers. Companies are now selling a significant proportion of traditional products (which still allow a higher level of distributor compensation than ULIPs but normally have a lower case size), with some having managed to increase the proportion of new traditional business sales from 10% - 20% to nearly 40% - 50% or more. The increase in sales of traditional participating products has generally been more significant than for non-participating products.

Examples of the changing new business product mix are presented in the table below:

NEW BUSINESS PRODUCT MIX FOR INDIVIDUAL REGULAR PREMIUM BUSINESS			
	Linked	Traditional participating	Traditional non-participating
ICICI Prudential			
H1 2010-11	96.0%	3.5%	0.5%
H1 2011-12	49.6%	20.8%	29.6%
Max New York Life			
H1 2010-11	71.7%	22.5%	5.8%
H1 2011-12	14.7%	80.7%	4.6%
HDFC Life			
H1 2010-11	89.2%	10.1%	0.7%
H1 2011-12	66.2%	33.2%	0.6%
Industry total			
H1 2010-11	54.2%	40.0%	5.8%
H1 2011-12	19.9%	72.2%	7.9%

Source: Company public disclosures, IRDA quarterly reports

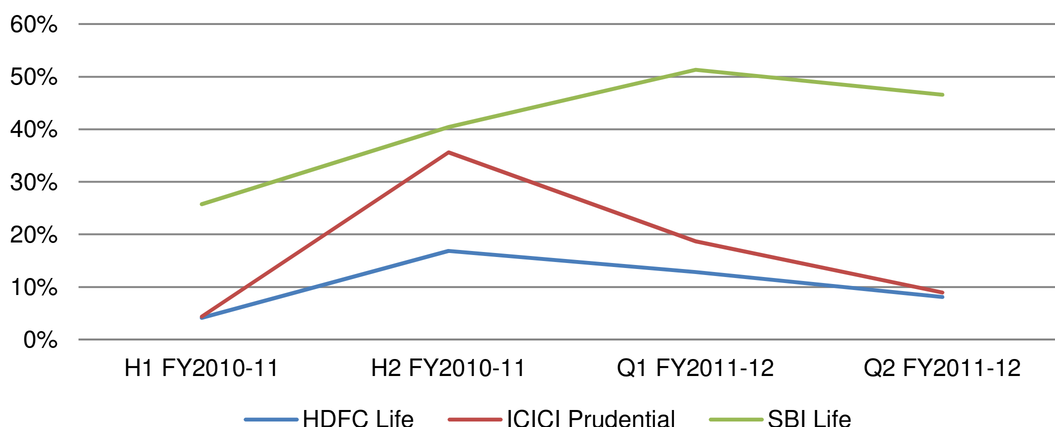
Single premium business as a tactical move: As a consequence of the new charge caps on ULIPs, first year commission rates now do not differ significantly between single and regular premium plans. Many distributors now find single premium plans more attractive than regular premium plans due to their higher average case sizes. As a result, there has been an increase in the proportion of single premium business from H2FY10-11. Other reasons for a higher proportion of single premium business include:

- Companies see single premium policies to carry less persistency risk (as under the new guidelines, policyholders cannot surrender their policies for five years); and

- Single premium business is seen to be providing top-line support in the immediate short term until companies fully adapt their strategies to the new regulatory environment.

The contribution from single premium policies was approximately 14% of unweighted individual new business premiums for private players in H1FY10-11 prior to the introduction of the September 2010 ULIP guidelines. This rose to 38% in H2FY10-11 after the guidelines were introduced. However, more recently, insurers are seen to be restricting the

proportion of single premium business, which reduced to 16% in H1FY11-12, given the issues related to managing the high expenses if a single premium business strategy were to be adopted.



Source: Company public disclosures

Lower profitability: As expected, the cap on ULIP charges has put considerable pressure on new business profit margins. It is widely believed that profit margins on ULIPs have approximately halved from their previous levels.

A shift in product mix towards traditional non-participating plans (that typically provide higher profit margins) has helped some insurers absorb some of the impact due to the reduced profitability on ULIPs. However, the proportion of traditional non-participating business is still small, leading to limited impact on the overall profit margins.

A material shift towards traditional participating business (that typically provides lower profit margins than non-participating business) by some insurers has helped preserve new premium income to some extent, but generally does not contribute as much to profitability.

For companies that disclose results, the profit margins generally reduced in FY 2010-11, although this period only partially reflects the impact of the new ULIP guidelines which became effective from 1 September 2010. The only exception appears to be Birla Sun Life that disclosed an improvement in profit margin in FY2010-11, where it appears that the successful re-alignment of product strategy from ULIP to non-participating traditional products contributed positively to the overall margin.

It is important to note that companies use different definitions of, and different assumptions and methodologies to calculate, the new business margins and as such the margins for different companies may not be comparable. However, the disclosed new business profit margins are set out in the table below:

NEW BUSINESS PROFIT MARGINS		
	FY 2009-10	**FY 2010-11**
ICICI Prudential	19.0%	17.9%
Max New York Life	20.0%	19.6%
Bajaj Allianz Life	18.4%	16.6%
Birla Sun Life	22.5%	27.5%
Reliance Life	19.1%	16.7%
HDFC Life	25.8%	18.8%

Source: Company disclosures

Notes:
New business margin is most commonly defined as the Present Value of Future Profits divided by Annual Premium Equivalent (APE= the sum of 100% of regular premium and 10% of single premium sold in the

period)

While not stated explicitly in some cases, the reported profit margins are believed to be before any adjustment for expense overruns.

The combined impact of a decline in new business volumes, changing product mix with an increased proportion of traditional business that have lower average premium levels, and the tactical shift towards single premium products has resulted in several companies further extending their target year to eliminate expense overruns by another two to three years or more.

The industry response

Changing distribution strategy: While tied agency may continue to be an important distribution channel in India in the longer term, following the introduction of the ULIP guidelines in September 2010, it is clear that the channel has lost some of its original appeal. Even before the new guidelines came into effect, questions were being raised about the efficiency of the tied agency distribution model in India, due to the high costs associated with this model.

For example, the model results in salaried sales managers contributing to 'fixed costs'; high infrastructure costs related to setting up of and running sales branches; as well as costs associated with recruitment and training of agents. The productivity of the tied agency channel has been very low in the industry, with most of the agents operating on a 'part-time' basis. Agent turnover has also been high, which in turn, has adversely affected persistency of the business.

The lower commission level on ULIPs has only exacerbated the situation in the short term. Besides aiming for a sharp decline in the number of agents, companies are now focusing a lot more on the underlying issues and challenges associated with the development of a better quality tied agency distribution model. Many companies have taken steps to reduce cost (with the closure of many branches), improve policy persistency and improve productivity of the agency channel.

In this environment bancassurance (and especially "captive" or "shareholder bank" partnerships) is seen to be the favoured channel for many insurers with its readily available infrastructure, expected lower cost of operation and direct access to a large customer base. For insurers that have banks as joint venture partners, there is also greater scope to adjust and align commission levels for bank sales in the new environment which allows a lower level of ULIP commission than before. In general, the insurance joint ventures having bank distribution partners are seen to be more successful at maintaining sales volumes relative to their peers, especially in the immediate aftermath of the September 2010 ULIP guidelines.

ANNUAL GROWTH IN NEW BUSINESS PREMIUMS OVER FY 2010-11			
Companies with "captive" bank partners		**Companies without "captive" bank partners**	
ICICI Prudential	(3%)	Bajaj Allianz	(34%)
HDFC Life	13%	Birla Sun Life	(30%)
Max New York Life	8%	Tata AIG	(12%)
ING Vysya	1%	Aviva	(11%)

Source: Company disclosures to IRDA

The attractiveness of banks as joint venture partners has increased significantly, as can be evidenced by the overwhelming response to the proposal from Punjab National Bank (PNB) and the current process involving Syndicate Bank. Met Life has reportedly offered PNB a 30% equity stake, while Syndicate Bank is yet to announce its decision (with an equity stake in an existing insurer a possible outcome).

Max New York Life (MNYL) was the first private life insurer without a captive bank partner to announce a sale of equity stake to acquire exclusive bank distribution. Given the pressure of agency business, its partnership with AXIS Bank (that was given a 4% equity stake in MNYL) has helped the company to diversify and hold up its new business sales levels.

However, the recently announced draft proposals for 'open architecture' in bancassurance may have some adverse implications on such bancassurance deals. In their current form, the draft guidelines issued by the IRDA in November 2011 restrict bancassurance partnerships by geographical region. If they are implemented as currently drafted, the rules would prevent insurers from leveraging fully the pan-India distribution reach of large banks, but would create distribution opportunities for some of the insurers that currently do not have large bank partners.

Focus on profitability: Clearly, profitability has come under significant pressure since 1 September 2010. However, as a consequence of the high surrender charges on ULIPs sold prior to 1 September 2010 (which is possibly one of the reasons why ULIPs came under media scrutiny), many companies can still utilise surrender profits from historical ULIPs for some time, possibly another year or two.

The table below presents the statutory profits disclosed recently by some companies. This is, however, believed to be only a temporary measure and companies still need to come to terms with the current 'lower profit margin' environment that places increased pressure on the need to control costs, improve agent productivity and increase persistency levels.

REPORTED STATUTORY PROFITS IN SHAREHOLDER P&L ACCOUNT			
Company	**FY2009-10**	**FY2010-11**	**H1 FY2011-12**
HDFC Life	(2,752)	(990)*	214*
ICICI Prudential	2,580	8,076	6,892
Max New York Life	(209)	1,941	391
Birla Sun Life	(4,355)	3,050	2,415
Bajaj Allianz Life	5,423	10,570	1,101
SBI Life	2,765	3,663	2,002

Figures in INR Million
Source: Public disclosures
**Unlike other companies, for HDFC Life, an amount of INR 1,693 million and INR 1730 million representing the deficit in the policyholder account as at FY2010-11 and HY FY2011-12 respectively are carried forward to the Balance Sheet. Given this, these numbers may not be comparable across companies*

While most companies have already made significant reductions in costs, expense ratios continue to be high for many, as shown in the table below. A large proportion of the reported profits (that are attributed to the surrender profits from old ULIPs) will not be available in the future as the old ULIPs run off. Thus, to maintain profitability over the medium to long term, we would expect many companies to:

- ✓ target a leaner and more productive tied agency force;
- ✓ adopt branch consolidation and headcount rationalisation;
- ✓ target more cost-efficient distribution tie ups with banks or third party distributors; and
- ✓ seek significantly improved levels of policy persistency across all channels.

EXPENSE RATIOS ARE STILL HIGH			
	FY 2008-09	**FY 2009-10**	**FY 2010-11**
ICICI Prudential	17.8%	15.5%	12.2%
Max New York Life	41.7%	31.0%	24.8%
Bajaj Allianz Life	17.7%	15.5%	16.7%
Birla Sun Life	25.1%	24.1%	21.2%
Reliance Life	39.0%	24.8%	23.8%
HDFC Life	31.6%	21.5%	16.6%

Source: Public disclosures

Changing product focus: In a bid to restore profit margins, companies have been developing and introducing products with relatively higher levels of profitability. These include:

- Higher margin traditional non-participating savings products;
- ULIPs with high minimum premium requirements; and
- ULIPs with guarantees (e.g. highest NAV guarantee), allowing the charge for the guarantees (which falls outside the charge cap rules) to be used to contribute to the overall profit margin

Companies with existing traditional participating portfolios have also revived the sale of such products. Although the regulatory restrictions on profit participation (10/90) in such plans is still seen as a deterrent for companies to launch / revive participating business, such business can help minimise capital requirements in the short to medium term, given the low new business strains on these plans. There is a risk, however, that IRDA may consider imposing some restrictions on the traditional participating business as well, as has been done in case of ULIPs.

More recently, the IRDA has issued guidelines on pension products that remove the earlier requirement to offer a minimum 4.5%p.a. investment return guarantee. However, the guidelines impose other restrictions such as the requirement of a surrender value guarantee, compulsory annuitisation with the same provider etc. As a result, the new guidelines are likely to result in a lukewarm response from the industry.

Attempts at customer segmentation: The industry has been showing some signs of moving away from a ‘one product fits all’ model to some level of customer segmentation. Customer segmentation is assuming greater importance as there is greater need to reach out to all social and economic classes with appropriately designed product offerings. Earlier, ULIPs were sold to customer segments from all social-economic background, with minimum regular premiums as low as Rs 5,000 per policy. In the new regulatory environment, ULIPs are now offered mainly to the mass-affluent customer segments, with traditional products increasingly aimed at mass markets.

Some companies have also launched products that are specifically targeted to high net worth customers, with minimum case sizes of Rs.200,000 per policy or Rs.400,000 per policy etc.

Has the IRDA met its objectives?

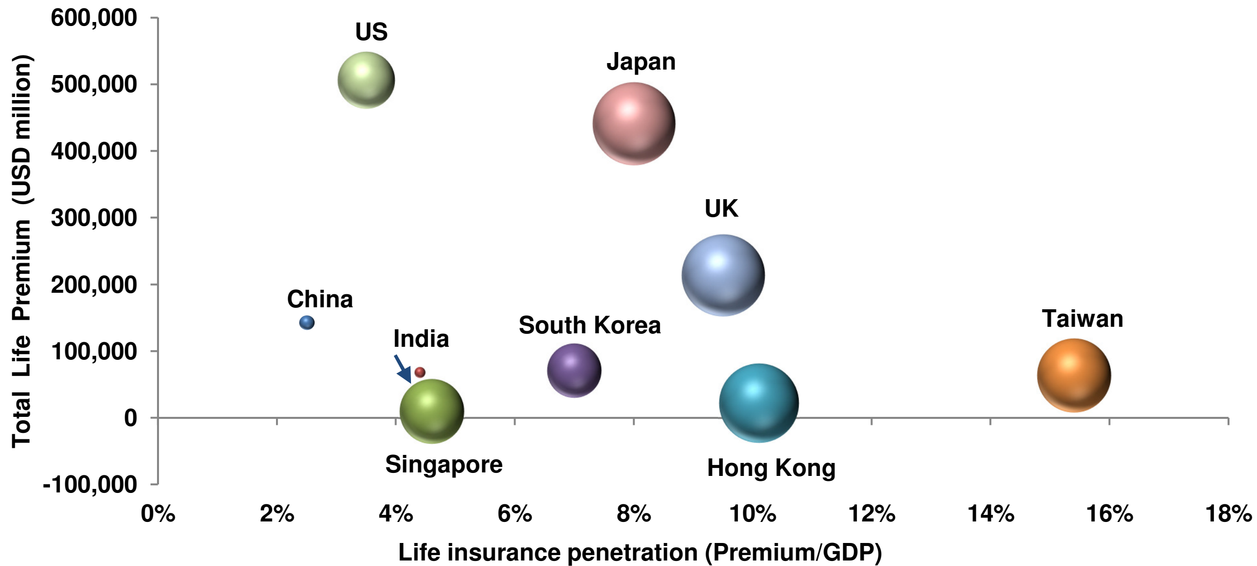
The severity of the regulatory changes in September 2010 has meant that India has suddenly come to be regarded as one of the most stringent regulatory regimes in the Asia Pacific region. It has been difficult for the Indian life insurance industry to react to the many and frequent changes in regulations, several of which have been very hard to predict.

The IRDA, in issuing the ULIP and VIP guidelines in 2010, has certainly been trying to address the prevalent unhealthy sales practices and to protect the policyholders’ interests (including those of the surrendering policyholders). However, considering the experience of the industry over the past year, it would appear that the impact of the guidelines may have fallen short of fulfilling these underlying objectives, and may have introduced further areas of concerns for the industry, such as:

- Rather than regulating through tighter oversight of distribution practices adopted by insurers, the IRDA has chosen to regulate the product charges instead. The industry view is that the limits on ULIP charges are somewhat extreme and have resulted in insurers being unable to remunerate the distributors appropriately, resulting in severe reductions in agent numbers and new business volumes across the industry.
- Companies are now selling more traditional participating and non-participating products, primarily given the higher levels of commissions that can be paid on these products and, in the case of non-participating products, higher margins that can be priced into the products. Traditional products also typically offer low surrender values with companies booking surrender profits in the event of lapsation. Although there is likely to be a certain section of the market that may prefer such products over ULIPs, the lack of transparency and the investment restrictions on such products may lead to lower overall returns to policyholders, which may again not be in their best interest.
- The policy lapse / discontinuance rates in the industry continue to be high (at around 35% - 40% in the first year). The charge caps on ULIPs do not appear to have addressed the unhealthy sales practices in the industry.
- Pensions business has suffered significantly, which is disappointing given the absence of a robust social security system in India. The new pension guidelines may also not seen a healthy revival of the pensions business.

- Significant pressure on cost management has led to many companies paying more attention on improving 'agent productivity'. However, there still does not seem to be sufficient investment in improving the training provided to the agents.

In a country like India where the mass population is grossly underinsured, there is a compelling need for the regulator to promote growth of the insurance sector. Insurance penetration levels in India are very low relative to other countries (see graph below) and it is disappointing to see recent measures leading to a decline in new business volumes.



Size of bubble is life insurance premium per capita.
The data for India, South Korea and Japan are for financial year 1 April 2010 for premi 2011.
Data for rest of the countries is for calendar year 2010.
Source: Swiss Re

The future outlook

Despite the very challenging environment, the long term growth prospects for the industry remain promising, based on:

- the demographic profile of India (approximately 65% of India's population is in the age bracket of 15 – 64, *Source: World Bank*) is expected to support the country's economic growth for the next decade or two;
- the need for insurance protection in the country has never been greater;
- long term retirement provision remains grossly unaddressed; and
- the growing middle class with high savings potential means that life insurance should play an important role in the overall savings / investment decisions of the population.

Given this macro environment, many multinational companies still consider India to be a country of long term opportunity. However, if the current uncertain regulatory environment persists, it may be hard for companies to see through the challenges and retain levels of long-term optimism for the sector. In view of this, it is perhaps not inconceivable that some companies (Indian promoters or foreign companies) may lose appetite and leave the sector. Some companies may even face the option of closing to new business, if capital is not forthcoming or new business cannot be issued on attractive terms.

In conclusion, the life insurance industry is in need of some impetus to help revive and restore confidence. While 2010 will be remembered as the year of increased regulatory intervention and oversight and 2011 has been a year for restructuring, we hope that from 2012, changes can be made to provide a much needed boost to the industry.

There is, no doubt, that the IRDA had good intentions around improving poor sales practices. Many, however, argue that the steps to slash ULIPs charges have gone too far to the detriment of the distributor and ultimately, to that of the

customers. The Indian macro picture remains compelling, but can only be realised if the industry finds the right alignment between customers, distributors and shareholders. Closer dialogue between the industry and the regulator may ensure a more effective and sustainable solution that is in the best interests of all parties; ranging from the rural farmer to the shareholder.