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Many challenges and uncertainties remain, but long-term prospects remain good

Consensus amongst the Indian life insurance CEOs surveyed

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BACKGROUND

Given the significant regulatory changes in the industry over the past two years and the current level of uncertainty, over the last few weeks Milliman has been talking to CEOs across the life insurance industry to gauge their views on the current state of the sector and the outlook for the future.

A total of 11 CEOs participated in our survey through face-to-face discussions or telephone conversations. The CEOs represented:

- Five out of the top 10 private sector life insurance companies in India by new business market share as of YTD August 2012
- More than 61% of new business market share of the private sector until YTD August 2012
- A mix of companies focused on *agency distribution* and *bancassurance distribution*
- A mix of more established companies and companies that have entered the market in recent years

A summary of the responses provided to us is set out below.

1. Do you expect the current state of the industry to change for the better? By when?

More common views

Many CEOs are of the opinion that in the medium to long term, the industry's growth prospects are intact. However, in the short term (six to 12 months), CEOs are not expecting any sudden recovery.

The longer-term optimism was mainly based on a perception of strong fundamentals driving the life insurance industry. Some of the points made included:

- Given the need for *protection* and *pensions*, there will continue to be growing *demand* for life insurance products.
- The *high-interest, high-inflation* environment cannot continue for too long in an emerging market such as India. Given this, the gap between returns available on life insurance products and other savings instruments (e.g., fixed deposits) will narrow. This will help to ease the current demand-side constraints.
- On the supply side, the government/IRDA will be compelled to create an enabling environment considering that:
    1. Only the life insurance industry, given its reach and distribution network, can reach the masses and support the government to achieve its financial inclusion objectives.
    2. Only the life insurance industry can provide the much-needed support to the capital markets and provide longer-term funds for infrastructure funding.
    3. The government is interested in sending a *pro-reforms* message to the industry as well as to the corporate sector in general.

Divergent views

Some CEOs are less convinced about the timeline over which the industry can recover and revive itself. Although many are hopeful that the industry will revive ('*we should be hopeful*)', some are skeptical on how quickly this may happen for the following reasons:

- Any significant (positive) regulatory changes may not happen quickly.
- The current volatile macro-economic conditions, high-interest/high-inflation environment may continue for a longer period, and in such an environment, investors may be less keen to invest in life insurance products.
- Several issues affecting the consumers, such as product design and taxation, are still unclear. There may not be clarity on such areas for a long time and this may delay the turnaround of the industry.
- Given the challenges of developing the agency distribution channel, its decline may continue for a longer period. Although the bancassurance channel may not do too badly, it may not be sufficient to lower the impact of the decline in the agency channel.
- The industry is perceived to have little or no customer focus. Until that is achieved (which will take some time), although there may be some moderate growth, the industry cannot really go back to its previous high-growth trajectory.

Milliman view

We share the common view expressed by the CEOs. The long-term prospects for the industry are very much intact and the industry is bound to see a turnaround and revert to a sustainable growth trajectory again.

We are of the opinion that to achieve a sustainable longer-term growth trajectory, the industry needs to change from within, as well as be supported through external/regulatory interventions. Such an *internal* change may need to be transformational rather than incremental, and this may not be achieved over the next six to 12 months, given the legacy issues created within the industry over the past decade. The old top-line/market-share mindset, the inefficiencies of the agency distribution channel, and the resulting high-cost structure are some of the aspects in need of change.

Any growth achieved entirely based on external/regulatory support, therefore, may not be healthy and sustainable.

2. What enabling changes do you expect to happen before the industry will revive?

More common views

CEOs have cited several external enabling factors that are necessary for the revival of the industry. It is not surprising that most of these are regulatory-focused, given the industry's recent history.

1. Short-term factors:

   – Clarity and stability in product regulations and the product approval process.

   – Changes in product regulations covering pensions business. The removal of requirements to provide a guaranteed minimum investment return and annuitisation with the same company providing the accumulation benefit.

   – Macro-economic conditions to stabilize—stock markets to start showing an upward trend and interest rates to start easing.

2. Medium-long-term factors:

   – A need to move away from a *rules-based* approach to a *principles-based* approach to regulation.

   – The licensing of distributors to be streamlined and to be made relevant for the business being sold by the channel.

   – More flexibility in setting distributor compensation.

   – Fiscal incentives to the life insurance industry and life insurance policyholders under the Direct Tax Code (DTC).

   – Increasing the FDI cap in the insurance sector to access more capital.

Divergent views

The IRDA should further regulate products. It should allow companies to offer only *templated* or *tariffed* products, wherein the benefits and premiums/charges on various products are fixed as decided by the IRDA.

Having fixed the product pricing (along the same lines as done for the unit-linked business), the IRDA should then free up the distribution and operational areas from regulation.

Until there are constraints placed on all product categories, the industry will continue to find loopholes to exploit the consumer and this will not result in a healthy long-term growth of the industry.

Once the products are templated (and therefore policyholders' benefits are fixed and the policyholder is not charged for mis-selling by the distributors through high surrender penalties) and other areas are freed from regulatory intervention, the industry's revival would be healthy over the longer term.

Milliman view

We share the common view expressed by the CEOs. The development of a regulatory blueprint and vision over a five- or 10-year period (as is done by Bank Negara in Malaysia, for example) will help to give confidence to the industry. Separating the regulatory and development/growth functions within the IRDA may also lead to more balance in the approach taken.

We do not think it appropriate for the products to be *templated* by the IRDA. In our opinion, this would stifle the innovation in the industry and the choice available to the consumer.

Instead, to guard against the unhealthy practices in the industry, the IRDA should strengthen its vigilance and oversight mechanism and take timely corrective action.

3. What are the regulatory changes necessary to revive the industry in the following areas?

- Products
- Distribution
- Financial/capital

More common views

The views expressed in this section can be considered a *wish list* of the CEOs. Several CEOs were skeptical as to whether many of these suggestions would be accepted by the IRDA.

General

- Many CEOs said that it is important for the IRDA to significantly build its capacity/skillsets in regulating the industry. This would include hiring a senior actuary with international experience.

- Some CEOs also said that there should be a level playing field against the LIC. Currently the LIC is perceived by some to be enjoying sovereign guarantee and some immunity from IRDA action in areas such as not adhering to market conduct/sales illustration standards. A view was expressed that the IRDA should strengthen its oversight on the LIC as well, so that the private sector companies are not unduly disadvantaged.

- In general, CEOs were of the view that the IRDA should show flexibility in its approach and not impose regulatory standards that are more suitable for a more mature life insurance market.

- A view also expressed was that if the IRDA has any objection with certain practices of an insurance company, such issues should be dealt with on a bilateral basis rather than by issuing additional regulations than put constraints on all other insurance companies in the market.

Products

- Openness in approving innovative product ideas. A need to change the mindset against anything that is *market linked*.

- Faster product approvals are required.

- The IRDA should refrain from imposing additional product regulations as currently proposed. These include an increased level of guaranteed surrender values in traditional products and rules mandating the level of reinsurance retention in products, etc.

- For pension products, the IRDA should remove the requirement for compulsory annuitisation with the same company.

- A greater appreciation by the IRDA of the differences between *participating* products and *non-participating* products. For example the *interest-sensitive* products currently offered in the market are a legitimate route to offer attractive products to the consumer without being unduly constrained by the regulatory requirements of the 90/10 rule, and as such, these products should not be treated as *participating*.

- The IRDA should reconsider the 90/10 profit-sharing rule in participating products, and perhaps a 80/20 regime should be considered.

- For unit-linked products, the IRDA should reconsider the five-year lock-in period, which has failed to address high policy discontinuance. Also, the IRDA should reconsider the level of maximum surrender penalties in order to promote longer-term investment by the policyholders.

Distribution

- Relaxing the agent examination norms, which should not be made too difficult if the products being sold are simple.
- Flexibility in allowing a range of agency structures, including tiered agency structures.
- Flexibility in arranging distributor compensation—for example, being allowed to pay higher than the regulatory norms to high-performing distributors, and lower to low-performing distributors, so that on an average the compensation payable is within the rules.
- Increasing the cap on distributor compensation. In order to develop a professional distribution force, one should be able to offer a high level of compensation.
- Flexibility in arranging compensation on group schemes, where one should not be restricted by the 2% commission cap on group schemes.
- The tax deduction at source (TDS) requirement on agency commission should be reconsidered, given that the average agent commissions are already very low.

Financial/capital

- The minimum rating for credit investments should be reduced. This would enable insurers to earn a higher return for the benefit of the consumers.
- Derivative investment for hedging purposes should be allowed. This would help insurers offer innovative products that offer guarantees to consumers.
- Insurers should be allowed to offer third-party funds in their unit-linked contracts.
- Outsourcing of the investment function should be permitted. The requirement that insurers should set up in-house investment function should be removed, especially as it may put unnecessary burden on small- to medium-sized insurers.
- Investment in other asset classes, such as gold, should be permitted.
- Financial reinsurance should be allowed, which may help insurers utilize their capital more efficiently.

Disagreements

The views of the CEOs are very divergent when it comes to bancassurance distribution:

- Many believe that *open architecture* should be permitted, whereas some believe that it should not be permitted.
- Those in favour of open architecture in bancassurance are of the view that true bancassurance-oriented products will emerge only when open architecture in bancassurance is permitted. Until then, insurers will continue to sell *agency* products within the bancassurance environment.
- Some CEOs believe that, although open architecture should be allowed, it should not be required in the same manner as is currently drafted (i.e., zoning structure, number of partnerships, etc.) How many insurers a bank wishes to tie up with and in which areas, etc. should be left to the banks/insurers to decide.

- A few CEOs believe that *open architecture* in its current/any other form would do more harm than good for the reasons set out below:

  a. The banks' experiments selling multiple companies' mutual funds hasn't really been successful. So allowing banks to sell more than one insurer's products may not be successful.

  b. Bank staffs are already selling a variety of financial products. Burdening them with insurance products of more than one insurer would compromise the advice given to the consumers.

  c. Zoning structures would create operational issues.

  d. The bargaining power of the banks would significantly increase and this may not be in the best interest of the insurance industry.

Divergent views

Some divergent views on the product regulations include:

- For participating products, the profit-sharing arrangement should actually be changed to 95/5 (from the current 90/10). This is because LIC is subjected to 95/5 and the private sector should be expected to offer products that are better value for money to the customers than those offered by the LIC.

- As the industry is not mature, any relaxation on product/investments will be grossly misused by insurers.

- The flexibility in arranging commission to distributors and the removal of limits on commission are being sought for the wrong reasons, as a mechanism for paying high compensation to the distributors to generate high new business volumes. This would not be in the best long-term interest of the industry and as such should not be permitted.

- The industry should not ask for removal of the cap on commission in totality. Although there should be flexibility in arranging commission levels, the overall commission and expense outgo should be subjected to some sort of a cap (as in Rule 17D currently).

- There is no harm in having a rule-based regulatory structure, albeit with greater clarity and certainty than is available presently.

Milliman view

General
We share CEOs' views of the need to significantly build capacity within the IRDA's office.

Products
We are of the view that the IRDA should take steps to correct the issues pertaining to the distribution/market conduct area by strengthening its oversight in this area rather than putting excessive constraints on product design.

To this extent, we share the CEOs' views that the IRDA should revisit many of the existing/proposed new product regulations.

Distribution
We share the views of the CEOs that there should be some flexibility in arranging distribution structure and compensation within an overall cap. However, we also believe that the IRDA should strengthen its oversight in ensuring that erring insurers are penalized in a transparent and expeditious manner.

Although in our opinion, flexibility in commission levels to different distributors is important, we do not share the views of some of the CEOs that the existing caps on expenses plus commission (e.g., those in Rule 17D) should be raised.

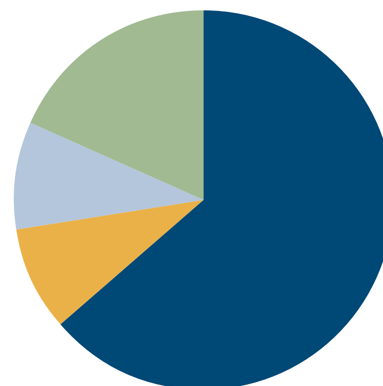
In many developed markets where open architecture is allowed, at a practical level it often gets restricted to distributing a couple of insurance companies' products. If the IRDA allows open architecture in bancassurance, we are of the view that the *zoning* structure would likely result in many operational issues that will over-complicate a model that actually needs to be simplified to ensure growth through this channel.

Financial/capital
We share the views expressed by the CEOs to allow the industry to outsource its investment function and to be able to offer external funds.

In our view, the other relaxations around investment regulation as sought by some of the CEOs may be permitted, provided the IRDA strengthens its governance mechanism, and also through appropriate disclosures by insurers.

4. What are your views on the valuations attributed to recent transactions?

Too high	7
High	1
About right	1
Low	0
Too low	0
No comments	2



More common views

This question has attracted interesting comments from the respondents.

1. One CEO suggested that although recent valuations may be very high for the *businesses* (i.e., not the intrinsic value of the businesses), it may not be high for the *transaction* (i.e., implying that due to the shortage of opportunities available for a foreign insurer to invest in the Indian life insurance sector, such high valuation would have been expected).

2. Another CEO suggested that recent valuations are high particularly since the investors do not appear to have anything tangible in return, for example, not have branding/visibility or management control, etc.

3. One CEO commented that it was not for him to comment on specific valuations.

4. Another view was that valuations are seen as *high* by some in light of the current regulatory environment. The longer-term picture and prospects are, however, very strong, justifying the level of valuations.

Milliman view

Valuation is a particularly difficult area in the current environment, with many issues to consider. The fact remains that there are very few opportunities for investors to buy into the existing market, and this may have influenced the recent prices that have been paid. The strong Japanese yen and the low hurdle rates of Japanese investors may also have influenced the pricing of some of the recent transactions.

5. What are your views on the recent trend by the IRDA in imposing fines on companies? Do you think these fines are adequate?

More common views

A few CEOs also expressed a view that the fines are currently being levied in a discriminatory manner (e.g., not fining all companies for the same offenses) and there needs to be consistency and fairness in the IRDA's approach in fining companies.

Several CEOs believe that the IRDA's fines are the outcome of the *rules-based* regime rather than *principles-based* regime. They believe that despite several companies having already been fined, there is still lack of clarity on certain aspects of the regulations.

One view suggested that the IRDA should take into account the needs of a young industry at a nascent stage and not impose rules that may be more suitable for a more mature industry.

Some believe that this may be a wrong approach for addressing issues in the industry and may actually be counterproductive. For example, companies may not take the fines too seriously if they are too frequent and small. In an extreme scenario (if the companies feel discriminated against), they may even go to the court to challenge the decisions of the IRDA.

Several CEOs expressed a view that the IRDA may wish to examine why all companies are being non-compliant in certain areas–for example, in the payment of compensation to distributors. In their view, the IRDA should recognize the business realities and allow companies to offer flexibility in arranging compensation to large distributors.

Divergent views

A few CEOs are of the view that India is not ready for a *principles-based* system of regulations. Given this, whatever the rules are, one needs to play by them and therefore non-adherence should attract regulatory fines.

Some CEOs are of the view that the IRDA should have started fining companies much earlier. One of the CEOs suggested that fines should be higher and should be levied more frequently.

One view was that the amount of fine doesn't really matter, but it is really the principle of fines and companies ought to take this seriously. A similar view suggested that the IRDA has already been considerate to the needs of the industry and has imposed fines only where there is no sense of proportionality or reasonableness in the level of excess payment to the distributors.

Another view was that as the IRDA has penalized companies for not adhering to existing regulations, there should also be a *positive intervention* by the IRDA–e.g., *rewarding* companies for being compliant through faster product approvals, etc.

Milliman view

It is not surprising to see that many CEOs have expressed concern over this issue, hoping that the IRDA will start to revisit its own regulations.

Our view is that given the regulations as they are (even if they are constraining in many respects), companies are expected to adhere to the same, both in letter and in spirit. Considering this, the IRDA's action of imposing fines on insurance companies is well justified, and should help to drive the right behaviour in the industry.

In fact, if the IRDA had taken such an action earlier, perhaps there would have been no need for some of the product-related restrictions, as the behaviour in the industry may have been very different.

6. How do you expect the industry to address the following issues:

- Low activity/productivity of distribution channels (agents in particular)
- Cut-throat competition for large distributors/banks
- Mis-selling/high policy lapse rates
- A negative perception about the life insurance industry
- Capital constraints

More common views

In summary, the views expressed suggested that the issues listed above can be addressed by the industry in the long term. However, CEOs are expecting some fundamental changes in regulations and in the business environment for this to be achieved. These include:

- A mindset or cultural change at all levels (including at the promoter level), moving away from the old *new business market share/market ranking* focus. Currently, the shareholders' investment horizon is too short-term-focused.

- CEOs believe that although such a mindset change is inevitable in the long term, it would be painstakingly slow to achieve given the *joint venture* structure of the industry.

- Achieving internal discipline and customer focus across the entire business is going to be difficult to achieve in the short term.

- Professionalisation of the tied agency distribution model, which is possible only if regulatory flexibility is allowed in structuring of the agency channel and compensation.

- A focus on customers, the segmentation of customers and mapping of customer needs with the right products is an important step in addressing the various issues.

- A lot of *positive stories* would be required to correct the negative perception about the industry that has developed over recent years.

Given these, several CEOs are of the view that these issues will continue for some time.

Divergent views

One person challenged the *issues* as set out above and also provided external reasons for some of the issues faced by the industry. In particular, this CEO had the following views:

- It is not right to say that all the business has been mis-sold over the past decade: 'One can't fool everybody all the time.'

- There has been a *motivated* campaign against the life insurance industry, which has resulted into a negative perception about the industry. It is not right to say that the industry has not put in efforts to correct this. However, the media/press are not equipped to understand the industry's point of view.

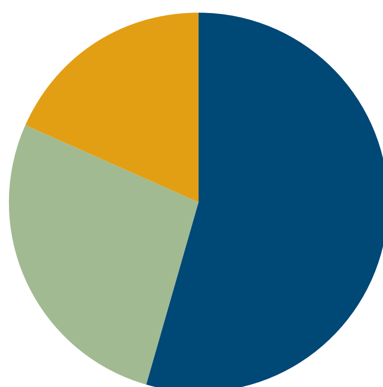
The issues faced in the industry are as a result of inexperienced domestic promoters, aggressive top-line targets, with less regard for bottom-line. Such issues will continue until the industry is given the freedom to price its products.

Milliman view

We share the views commonly expressed by the CEOs. Although the various issues faced by the industry can be addressed, there needs to be a mindset change across many levels within the key stakeholders of the industry.

7. Do you think an increase in FDI to 49% would change the state of the industry? Why?

Yes	6
No	3
Maybe	2



More common views

Many CEOs believe that a 49% FDI in life insurance would help change the current state of the industry for several reasons:

- It would help create positive sentiments and send the right signals.
- For some of the cash-strapped promoters, this would help raise additional capital to support the growth of the life insurance business.
- The industry will benefit from the *longer-term* perspective and would enhance the domain expertise of the foreign promoter (which is currently restricted somehow given the 26% ownership).
- This may enable some new foreign entrants.

Divergent views

However, some CEOs are less positive about 49% FDI. They believe:

- Currently, there is no difference in the performance of companies with or without the foreign promoter having operational/management control. Given this, there is no evidence to suggest that FDI at 49% would help the industry get the much needed *domain expertise*.
- There is not much difference between a 26% and 49% foreign ownership structure in terms of operational/management influence. Given this, 49% may not help the industry much, and may only lead to greater infighting between domestic and foreign promoters.
- Even under a 49% structure, not all foreign promoters will be able to increase their holdings beyond 26% immediately as it will be governed by the individual companies' shareholder agreements. Given this, in the immediate short term, 49% may not help to change the state of the industry.
- Given the current state of the industry, even if 49% FDI is allowed and the industry is able to raise additional capital, where would that capital be deployed? Currently, there are no avenues left for the industry to successfully deploy that capital.

Milliman view

Although we agree with the divergent views expressed by some CEOs, we also believe that from a longer-term perspective, a policy of 49% FDI in insurance would help the insurance industry seek the much-needed capital and domain expertise, which is currently in short supply.

8. What on the list below has the LIC ***done right***, which the private sector players have yet to emulate?

- Keeping costs at low level
- Maintaining agents' productivity
- Spreading the risks—having all types of products and not focusing on only one product segment
- Focusing on its core distribution strengths (agency channel) rather than going too much into a multi-channel distribution
- Other—please specify

More common views
Most of the CEOs agreed that the LIC has done a significant job in achieving its success in the various parameters as set out above. In addition, CEOs believe that the LIC has done a remarkable job in:

- Enhancing its customer service standards.
- Demonstrating its swiftness in adapting to a changed external environment (e.g., first to unit-linked and then back to a conventional product focus).
- Unlike the private sector, the agency channel of LIC is focused more on building a stream of renewal commission, thereby promoting loyalty to the organization.
- Perfecting the agency distribution model and achieving a customer focus.

Some also believe that the LIC has acted as a solid foundation for the industry and any disturbance to the LIC would perhaps affect the entire industry (including the private sector).

Divergent views
A few CEOs, however, believe that the LIC's remarkable performance is primarily driven by the following factors:

- The LIC has been able to achieve its superior performance over a very long time. It has almost perfected the tied agency distribution model over this period.
- Its sovereign guarantee and the *non-level playing field* accorded to the LIC by the applicable statute/regulations (e.g., inaction over sales illustrations [or lack of them], no cost of capital for the LIC, etc.).

The views expressed suggest that the LIC's current performance is really an outcome of its legacy. The *new* recruits (agents, development officers, etc.) within the LIC face the same issues as those faced by the private sector agency distribution channel.

The views expressed were also that one of the private sector companies has achieved an overall expense ratio that is lower than that of the LIC in a short span of 10 years. How can LIC, therefore, be seen to be doing everything *right*? Has the LIC successfully differentiated itself in a foreign country where it operated (where it may not enjoy the various privileges that it does in India)?

It was suggested that if the private sector is given the same advantages as the LIC and time at its disposal, it would do a better job than that demonstrated by the LIC.

Milliman view

We share the common views expressed by the CEOs. Although we understand that there are areas where the LIC may be enjoying certain advantages and it has achieved its success over a much longer period, this does not take away the credit it deserves for achieving its success.

In our opinion, there is a lot one can learn from the LIC in order to build efficiencies in the businesses in India.

9. What are the big achievements of the private sector industry over the past decade?

More common views

Despite the issues faced by the industry, several CEOs believe that the private sector has been successful in many areas as set out below:

- Helping to expand the insurance *pie*.
- Creating job opportunities.
- Product innovation—*If not for the private sector, the industry may still be selling the less transparent endowment and money-back plans*.
- Supporting the capital markets through ULIPs.
- Raising awareness about insurance amongst the consumers.
- Enhancing the level of *protection* (even though it is still low) in insurance products, with insurance products now seen as *insurance* products rather than *savings* products.
- Enabling a wider choice of products to the consumer at better value for money (e.g., through online term insurance protection plans).
- Enhancing the distribution spread and reach and the choice of channel for consumers.
- Helping the LIC improve its efficiency and performance levels, introducing the concept of turn-around times and risk management practices to the industry.
- Introducing the industry to new technology.

Divergent views

One of the CEOs was of the opinion that the private sector has missed the opportunity to make an impression in an industry which enjoyed tremendous goodwill at the time of opening up for private sector participation.

Milliman view

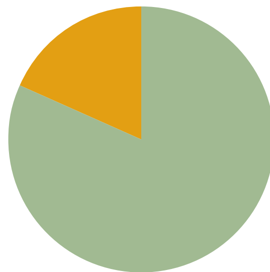
We share the common views expressed by the CEOs. There are many areas where the private sector has played a significant positive role in the development of the industry.

Unfortunately, some of the negative perceptions have masked the achievements of the private sector over the years.

10. Do you think the following frameworks would work in India in the current environment? Why?

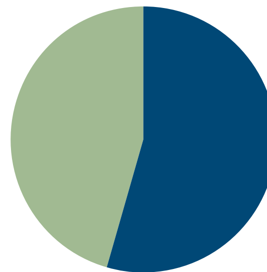
The answers provided by various CEOs are collated in the following graphs:

Fee-based intermediation



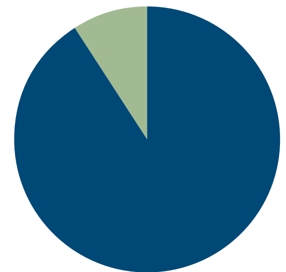
Yes	0
No	9
Maybe	2

Removal of caps on commission



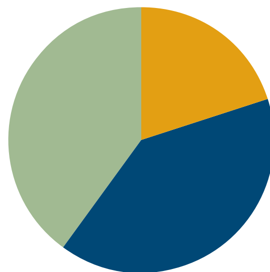
Yes	6
No	5

Flexibility in arranging commission



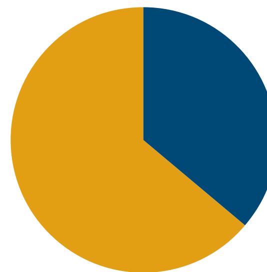
Yes	10
No	1

Use and File system



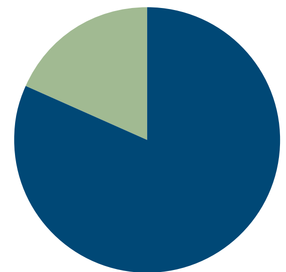
Yes, with conditions /undecided	2
Yes	4
No	4

Risk-based capital regime



Yes	4
Maybe / not yet	7
No	0

Open architecture in bancassurance



Yes	9
No	2

More common views

Some CEOs also offered the following comments in support of their views expressed above:

On *flexibility in commission/removal of caps on commission/Use and File* system

- One CEO suggested that one can't assume that all players/promoters are going to circumvent the system, so that more freedom with tougher penalties would work for an orderly growth over a longer term. Commercial compulsions would ensure that freedom (e.g., in pricing, commission payment) will not be misused beyond a certain point by the industry.

- One view was that products should be tariffed, including even mortality risk charges and guarantee charges within ULIPs, because currently, since they are not tariffed, companies misuse them. For example a view was expressed on why the premium rates for the online term plans are so cheap (where the risk of anti-selection is very high) as compared to the mortality risk charges in ULIPs? The CEO expressed a view that because the mortality risk charges in ULIPs fall outside the charge cap rules that even though the risk of anti-selection is lower, companies end up charging very high risk charges in these plans.

On the introduction of a *risk-based capital* regime

- One CEO suggested that India has to start somewhere, even if we aren't fully ready. The regulator should not micro-manage the industry, but at the same time, there should be an enhanced level of self-regulation.

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