# Distribution of life insurance products in India and inherent risks

By Gulati, Aastha,
Maheshwari, Kunj Behari
& Sharma, Shobhna

**Abstract**

The purpose of this paper is to trigger discussion on risks inherent in the sales and distribution strategies of life insurance companies currently operating in India with a view to highlight potential financial implications of these risks. As the insurance industry continues to make progress towards fair value reporting and risk based capital, we highlight some practical implications of the risks identified in distribution of insurance products in the context of determining the appropriate level of capital requirements.

**Keywords**

Distribution, Agency, Bancassurance, Mis-selling, Risk based capital

## 1 Introduction

**1.1** The purpose of this paper is to trigger discussion on risks inherent in the sales and distribution strategies of life insurance companies currently operating in India with a view to highlight potential financial implications of these risks. As the insurance industry continues to make progress towards fair value reporting and risk based capital ("RBC"), we highlight some practical implications of the risks identified in the distribution of insurance products in the context of determining the appropriate level of capital requirements. This aspect of the paper is intended to be a starting reference point for future discussion on such implications for RBC and should be treated as such.

**1.2** In recently forming a high level committee to review the functioning of various distribution channels, the Insurance Regulatory and Development Authority ("IRDA") has recognised that "there is a need for a study to be undertaken to ascertain the manner in which [distribution] channels have been functioning; their efficacy; their cost effectiveness; their weaknesses and make recommendations on the changes to be made ...". This is a welcome development as there is clear thrust towards recognising and resolving the issues involved in the distribution of insurance products. However, whilst the terms of reference of the committee focus on the operational aspects of distribution channels, potential financial risks facing insurers and implications for RBC requirements seem to have been transgressed.

**1.3** Most life insurance companies currently in India seem to be aiming at an aggressive "top line growth" strategy. Many of the companies seem to be in a "sales mode" rather than a "financial management mode" – arguably, to their own peril! In light of this, the case for a RBC regime has been highlighted at various forums. Insurers need to recognise the risks they face and provide appropriately for them so as to meet any future shortfalls. Significant among these are risks inherent in the sales and distribution models in operation currently in India. There is a need to not only identify and mitigate these on the operational front but also adequately provide for them in financial terms where there is likely to be significant exposure.

**1.4** Risks faced by an insurer through its unique distribution structure is conditioned by the fact that distributors have a key role in

- Quality of advise offered on the product
- Servicing of policy following the sale
- Speedy settlement of valid claims
- Quality of target customer

We discuss implications of these characteristics in detail later in our paper.

**Layout of this paper**

**1.5** Section two of this paper, provides an overview of the current distribution strategies of life insurance companies in India along with a brief comment on historical developments of the sales and distribution structures. We recognise that there is currently a skewed emphasis on selling of unit linked insurance plans ("ULIPs"). In section three, we have highlighted the key risks that the industry faces inherent in the current operations of the sales models as discussed in section two. We lay emphasis on mis-selling of ULIPs and draw on recent experiences of the insurance industry in the UK for Indian insurers to bear in mind. We further discuss certain operational challenges in the choice of a particular distribution channel.

**1.6** The case for a risk based capital regime in India is discussed briefly in section four. This is strengthened by the fact that such a risk based capital approach is able to readily incorporate the risks highlighted in section three. We offer some practical implications using the framework in other countries, where the risk based capital regime is relatively well established. While the form and details of the risk based capital approach for India is still being discussed, such examples are intended to only provide ideas as to how the risks identified in section three may be quantified under the RBC regime. Finally, we conclude highlighting the key themes emerging through our paper.

## 2 Overview of distribution strategies in respect of life insurance products in India

**2.1** In today's scenario, insurance companies must move from merely selling insurance to marketing it as an essential financial product. The distributors play a dual role – as trusted financial advisors for the clients and trusted business associates for the insurance companies.

**2.2** An insurer needs to think about the appropriate distribution channel to reach its target customer as well as the product that it is going to sell. The choice of customer and the nature of product will influence the distribution structure. However in India, joint ventures are formed such that distribution structures are often pre-determined by the nature of partners. For instance, if one of the partners in a tie-up is a bank, the focus is commonly on bancassurance whereas if the joint venture is one with a corporate house, invariably the majority business is through the agency channel. This implies that the insurer's decision on product features; pricing and target market will necessarily be influenced by the distribution structure that the joint venture is endowed with.

**2.3** Given that the distribution structure directly influences the target market and the 'quality' of business, the basic insurance risks of mortality, persistency etc. necessarily get conditioned by the sales strategy adopted by the insurance company. This calls for leveraging multiple distribution channels in a cost effective and customer friendly manner.

**2.4** Two distinct forms of distribution systems may be recognised viz. personal distribution systems and direct response systems. Personal distribution systems include channels like agencies, bancassurance and work site marketing. Direct response distribution systems are methods whereby the client purchases the insurance directly. This segment, which utilizes various media such as the internet, telemarketing, direct mail, call centres etc., is just beginning to grow.

**2.5** Traditionally, tied agency has been the primary channel for insurance distribution in the Indian market. Whilst this continues, there is increasing contribution by bancassurance and an emergence of other channels such as Direct Marketing/Tele Marketing, brokers, call centres and mall-assurance.

**Historic emphasis on Agency**

**2.6** Agency, as a channel of insurance distribution involves selling insurance policies through tied agents which are hired by insurance companies on a commission basis. Prior to 2000, the Life Insurance Corporation of India ("LIC") was the only player in the Indian insurance market and it emphasised on hiring agents to sell its insurance policies. At that time, LIC had around 800,000 agents across the country. Therefore it was not surprising that agency was the core distribution channel in the insurance market, when the market was opened up to new entrants.

**2.7** With over 2,000 branches and one million agents to distribute its policies at present, LIC's distribution structure is still agency dominated. It emphasises on hiring local agents in every locality, which helps build credibility of the agents with the customers and provides a sense of security to the policyholders while buying the policies.

**2.8** With the liberalisation of insurance sector in 2000, many private insurers emerged in the market. This also saw an emergence of alternative distribution channels besides agency, such as bancassurance, tele-marketing, corporate agents etc.

**2.9** However, agency still forms an important part of the distribution network for many companies given that this had been a "tried and tested" distribution channel in the past and albeit at a cost, this channel is seen to deliver a top-line growth. It accounts for about 70% of new business across the industry. In all, the industry employs over 1.9 million agents and this figure is expected to grow further in the coming years. Companies such as Max New York Life ("MNYL"), Bajaj Allianz have majority of their new business from tied agents. About 70%-80% of MNYL's new business is from the agency channel and the company has over 25,000 agents as on March 2007.

**2.10** Important as it is, tied agency is expected to continue to be a dominant channel of insurance distribution in the coming years. It provides an opportunity to develop a good distribution network quickly across the country, including rural areas. Many companies are constantly increasing their agency force in order to capture a larger market. Reliance Life follows an aggressive agency expansion strategy, with its agency force increasing five-fold during FY2007. It has been widely reported that the company receives most of its new business premium from the agency channel.

**2.11** Even within the channel, companies are looking at innovations to improve the low productivity of agents, which has been a cause of concern for long. There have been suggestions in the media that productivity levels have been low because of companies focussing more on head count expansion rather than improving productivity as well as due

to relatively lower levels of commissions. Some companies are now beginning to understand the social needs and attitudes of the consumers and are accordingly sensitising their agents. For instance, there is a considerable respect for age in Indian society and a general belief that an older person knows better. Playing on such sentiments, there may be a case for recruiting some older people to sell products such as pensions and annuities. To increase penetration in rural areas, some companies have found it beneficial to recruit more female agents in rural areas, with whom women customers can relate, e.g. nurses, gram sevikas, and thus target the female segment of the population more effectively. MNYL has adopted a version of this strategy by appointing gram sahayaks to sell and service the rural customers.

**2.12** Similar to India, other Asian markets like China, Indonesia also have agency dominated distribution channels. In China, tied agency contributes approximately 50-55% of the new business, with bancassurance and other channels developing simultaneously. Due to the recent deregulation of bancassurance in many countries such as India, China, Japan and South Korea, the growth of agents has become modest.

**2.13** As in other markets, development of agency in India is not without its challenges:

- There is a dearth of qualified candidates willing to enter an agency career on a full-time basis. As most of the agents are part timers, the productivity levels are very low due to their low levels of commitment and involvement. Some companies like MNYL are reported to have relatively high productivity levels. The company claims to have increased its agent advisor productivity to 3 cases per month, usually companies with aggressively expanding agency channel have productivity levels of one or even less than one policy sale per agent per month.

- There are difficulties in imparting agency training and education in remote parts of the country and in addition to this, there are costs involved in retaining agents, lowering agent turnover and retraining them.

- An issue of contention in India has been the levels of commission provided to agents. Even the IRDA has recognised that the current levels of agency commissions may be creating situations where agents try to sell larger numbers of policies, without necessarily considering the needs of the policyholders. This leads to high lapse rates of policies – reported to be in the range of 25% to 40% in the first year for some companies.

**2.14** The above issues – along with a need to beat the competition – have made it necessary for insurers to diversify into alternative channels of distribution.

**Emergence of bancassurance**

**2.15** Bancassurance, as the name suggests, refers to sale of insurance policies through the bank's established branch network. It is basically selling insurance products and services by leveraging the large customer base of a bank and fulfilling, both, the banking and insurance needs of the customer at the same time.

**2.16** With the entry of private players in the Indian insurance market, bancassurance emerged as an important channel of distribution for insurance products. Within four years since the end of 2000, life insurance companies secured approximately 50 bancassurance relationships, over 550 relationships with corporate agents in addition to the emergence of other smaller

channels, such as Non-Government Organisations ("NGOs") and voluntary bodies. Even LIC has followed suit, with over 12 bancassurance relationships and 4 corporate agency tie-ups.

**2.17** Banks have emerged as the preferred alternative distribution channel in the last 3 to 4 years. India has close to 69,000 bank branches spread over rural and urban locations, offering a good network for potential insurance penetration. According to the Watson Wyatt India Bancassurance Benchmarking study, well over 100 bancassurance relationships had already emerged by 2006-07 with state owned banks becoming attractive targets because of their large branch network and customer base.

**2.18** For the private insurers, bancassurance channel contributes about 20% to 30% of the business volumes. It is estimated that by 2008, bancassurance would generate around 35% of private insurers' new premium income. ICICI Prudential has one of the largest network of bancassurance distribution relationships and for a few companies such as Aviva Life and SBI Life, this channel contributed more than half of the new business premium last year.

**2.19** There are many reasons for such a rapid growth of bancassurance in India. Private insurers want to capitalise on the "first mover advantage" in this relatively new channel of distribution. There is also a realisation amongst the banks of the value added by insurance, in maximising the potential income from their consumer bases.

**2.20** In addition to the above reasons, India has been one of the few countries to encourage bancassurance through regulations which give more flexibility to insurers to develop alternative channels with a view of reaching customers in rural regions. In past, persons possessing the Certified Associateship of Indian Institute of Bankers ("CAIIB") have been required to put in only 50 hours of training as against 100 hours for corporate agents. Whilst the requirement for corporate agents has also been recently reduced to 50 hours, it is hoped that this will lead to well educated, professional officers offering financial and insurance advice.

**2.21** Banks in India have all the right ingredients to make Bancassurance a success story. They have large branch network, huge customer base, enjoy customer confidence and have an experience in selling non-banking products.

**2.22** Bancassurance as a channel of distribution is also often considered to be more profitable than agency. The primary advantage offered by banks as compared to the other channels is the customer relationships and a relative cost advantage. Events that trigger sales of banking products generate a potential customer to cross-sell the insurance products too. This reduces the cost per sales lead and improves the productivity of bancassurance. The average productivity in bancassurance is estimated to be around 5 to 10 cases per sales-person per month.

**2.23** However, the late entrants in the market face a major problem, as the number of banks with no prior commitments is limited. This has also caused the cost of acquiring the bancassurance deals to increase.

**2.24** Even the existing bancassurance relationships maybe loaded with significant risks as these banks may start their own joint venture, as they gain more experience. For instance, Aviva Life has bancassurance tie-ups with ABN Amro, American Express, Canara Bank amongst others. Of these banks, Canara Bank is now set to establish a joint venture insurance company with HSBC. HSBC too has been in a distribution tie-up with Tata AIG. This may ultimately mean a loss of business for the insurance companies and also in terms of their

investment in staff training etc. and such a risk appears to be rather high in the bancassurance distribution relationships.

**2.25** Besides the above issues, there are other operational challenges in this channel:

- There is a strain on insurers to develop many customised products
- Bancassurance tie ups in the more recent times demand a high upfront payment owing to the supply – demand dynamics, creating problems for the insurer in terms of capital requirement which is already quite high in India.
- Success in a bancassurance venture requires change in approach, thinking and work culture at the banks. In India, there is always a tendency to resist any change whether its impact is favourable or not. Sometimes non-response from the target customers due to insecurity of a relatively new channel becomes a possible risk.

**2.26** However, in spite of the above issues, the future outlook of this channel seems promising. It is currently being discussed whether the regulations may be changed and a bank may be allowed to sell products of more than one insurance company. If the bank employees can be imparted with good training, this channel would be a huge success in terms of premium earned as it has a widespread reach – rural and urban masses and a great potential for selling group products.

**Other alternative distribution channels**

**2.27** Many insurers, in order to gain an edge over the others and capture a larger market share are beginning to use alternative distribution channels such as corporate agency, brokers, direct mail, tele-marketing etc.

**2.28** Corporate agency refers to any third party corporate/firm licensed by the IRDA as a "corporate agent" to distribute life insurance business. Current and potential corporate agents range from multi-level marketing companies to finance and Non-Banking Finance Companies ("NBFCs"), stock brokers and so on. Most insurers have tied-up with NBFCs to provide extra leverage on distribution.

**2.29** Individual Financial Advisor ("IFA") is another potential channel for insurance distribution, though presently it is virtually non-existent in India. IFAs are independent professionals who offer unbiased advice on financial matters. In the UK, the term IFA was coined to describe advisors working independently for their clients, rather than representing an insurance company. As of now life insurance business written through IFAs is relatively low in India, but looking at the experience of other developed markets, this channel's potential cannot be ruled out.

**2.30** Another set of channels, which are undeveloped in India are Direct Mail ("DM") and Tele Marketing ("TM"). This mainly refers to marketing of insurance policies via the mail or over the phone. The reason for underdevelopment is the complex nature of products which makes it difficult for the consumers to comprehend and a general distrust of people in telemarketing. Such a channel of distribution is more suited for simple products. Insurance companies could even follow the practice of combining tele-marketing with a closure meeting. Some insurers are already planning to sell simple health plans through tele-marketing. There have been further suggestions that the sale over phone may even be completed by payment through credit card. However, there is limited experience of the same. Additional policies/features may be easier to sell to existing policyholders through this channel.

**2.31** ICICI Prudential has already set up a direct marketing team to generate leads through target database acquisition and communicating customised product information through e-mails, tele-marketing and innovative direct mailers.

**2.32** There are also certain regulatory issues concerning DM/TM, such as the quality of advice given to customers, training of the tele-calling staff and data protection/security in banks, if their customer data is used. There is still a great deal of mistrust and apathy for tele-marketing and there has been a "Do Not Call" facility being proposed by the government to reduce tele-marketing calls.

**2.33** Experience in other markets has shown that the various channels are mutually reinforcing and can complement one another. For instance, if a bancassurer is selling a specific product, then direct mail or tele-sales beforehand, may prompt the customer to ask about the product when he visits the branch subsequently. Hence, simultaneous use of more than one distribution channel can help in tapping more potential customers.

**Recent Innovations**

**2.34** Besides the above channels, companies are also diversifying to new innovative channels to beat the competition in the Indian insurance market. Bharti AXA Life is planning to launch "Telecassurance" targeting Bharti Airtel's 40 million strong customer base. This involves providing life insurance services and advice on financial protection at Bharti Airtel's relationship centres across the country.

**2.35** Following the success in many countries like UK and Indonesia, new entrants such as Bharti and Future Generali are also reportedly contemplating selling insurance with retail products. This is known as "Shopassurance" that would facilitate "over the counter" sales of insurance products. However, this may create a sense of insecurity in the minds of the consumers, due to the absence of an insurance specialist to consult while buying the product.

**Product-mix and distribution channels**

**2.36** There are various kinds of products available in the Indian market including ULIPs, participating endowments, participating whole-life, term and creditor products. ULIPs currently form a majority of the business written by life insurance companies.

**2.37** Historically, participating endowments were the most popular products being sold by the LIC. However, due to a fall in interest rates a few years ago, these products came under profitability pressure. It still comprises a significant proportion of LIC's new business volume.

**2.38** Over the last few years the business from traditional products has reduced considerably, ULIPs have gained popularity in the Indian insurance market, as they offer a good investment option along with life cover and their popularity is further pushed up by the bullish stock markets. The market share of linked business, in terms of individual business first year premiums, has significantly increased to 84% (including LIC) in the half year ended September 2007, up from 61% in the same period last year.

**2.39** ICICI Prudential which has one of the largest bancassurance distribution network is reported to have almost 80% of its new business through sales of ULIPs and is gradually entering the health insurance market. On the other hand, Reliance Life, whose primary distribution channel is agency, also earned almost 90% of its new premiums from ULIPs. MNYL has a

mix of ULIPs and traditional products. It began by offering "whole-life policies", but now ULIPs have a more significant contribution in the product mix.

## 3 Key risks in distribution of insurance products

**3.1** Insurance products and the market for their distribution have certain unique features that introduce imperfections and asymmetry in the market from both the insurers' as well as the consumers' point of view. It is these features that underlie the potential risks faced by the insurers and the consumers while selling/purchasing insurance products: [1]

**i.** Many insurance products tend to have complex charging structures and it is often not clear how benefits accrue to the policyholders. An average consumer purchases insurance policies relatively infrequently, so has little knowledge or experience to draw on. The consumer tends to find the risks and commitment involved hard to understand and the 'price' of the product hard to determine. The low level of financial literacy among many consumers, together with a lack of interest and engagement, means that consumers do not act as a strong force in this industry.

**ii.** Consequently, many consumers rely heavily on advisers through whom insurance is sold. Insurance companies remunerate these advisers - whether in the form of commission or otherwise - and there can be a mis-alignment of advisers' interests with those of consumers, adding to the risks of consumer detriment. But such problems are not just limited to commission-based sales. For instance, when products and services are sold directly, incentives for staff to achieve target sales levels, or penalties for not doing so, can lead to poor outcomes for consumers if the risks are badly managed. Remuneration-driven sales can also lead to inappropriate advice to switch between different products in order to generate income for advisers, often resulting in high levels of early termination of these long term products. The costs of this low product 'persistency' are borne mainly by providers but may ultimately be passed back to consumers.

**iii.** It may be many years before poor quality advice, or problems with the performance of a product relative to what the consumer was led to believe become apparent. The result of this can be uncertainty for consumers, and mean potential claims against those who supplied the product or gave advice, many years after the original purchase. And by the time these claims come to light, those that gave the advice may no longer be in business, leaving others in the industry to meet the costs of compensation to the affected policyholders.

**iv.** Those providing advice do so with relatively little training and testing when compared to other professions. So one reason why the problems of consumer understanding set out above may be occurring is because the provider of the services cannot explain the benefits, risks and costs of the services sufficiently clearly.

### Mis-selling

**3.2** In the main, these factors lead to a widespread risk of mis-selling by insurance intermediaries resulting from conflict in the dual role of insurance intermediaries as advisors to customers and sales channels for insurance companies. Furthermore, innovations in

[1] Adapted from Financial Services Authority's (UK) Review of Retail Distribution, Discussion Paper 07/1, June 2007

designing of certain ULIPs further add to the risk of mis-selling as was seen in the case of actuarially funded unit linked plans in India – these were seen to be more complex products that not many customers or even sales intermediaries fully understood. There are already a growing number of cases of anecdotal resentment as apparent from recent press reports around the sale of ULIPs to consumers in India, who perhaps may need a different type of insurance cover.

**3.3** Clearly, mis-selling has a direct negative outcome for the policyholder who purchases the insurance policy under false impressions of charges involved or benefits payable or both. Whether this is due to the consumer's lack of interest/ability in understanding the details of the policy at the time of purchase or due to poor guidance provided by the advisor selling the policy, the outcome at the time of realising that the policy has been mis-sold is almost always likely to be a desire to exit from the policy. In many instances, charges levied by insurance companies for exiting may be such that exiting from the insurance scheme is indeed costlier than persevering with it – but this is also with no less detriment to the consumers. From the insurers' perspective, such experiences would necessarily hamper its goodwill in the market and possibly reduce policy persistency.

**3.4** In certain countries where the regulator has conducted retrospective reviews of mis-sold products and penalised insurers where found guilty, the financial liability of mis-selling for insurance companies has been far in excess of the cost of lower new business volumes and higher rates of withdrawal due to a dented goodwill. Should the consumer upheaval in India force the regulator to take similar actions, life insurers may well face a financial crisis due to the arising claims. There are serious industry wide ramifications if widespread mis-selling leads to a long term loss of trust and confidence by the general populace.

**3.5** We discuss below the recent case of widespread mis-selling in the UK of mortgage endowments, subsequent regulator actions and resulting financial liabilities for insurance companies. There is a lesson to be learnt from this UK experience for the Indian insurance industry to ensure that its customers understand fully the products they are buying to avoid future adversities of similar nature.

**UK industry experience with mortgage endowments**

**3.6** Through the late 1900s, mortgage endowments were a common way of repaying a loan used to purchase property in the UK. The way it worked in practice was that regular payments were made to cover the accrued interest on the loan and at the same time premiums were paid into an endowment policy in the hope that the maturity proceeds from the policy would be sufficient to repay the capital component of the loan. The endowment premiums were invested in asset classes that usually had high equity content.

**3.7** Faced with a high interest, high inflation economy and a bright outlook for the equity markets for most part of the 1980s mortgage endowments were 'advised' by many insurance intermediaries as sound financial planning by house holders. Indeed, benefit illustrations that were provided at the time of selling these policies – even when using regulator prescribed illustration basis - showed handsome possible future returns. Consumers, who bought the policies, did so with the expectations of the high returns that were advocated during the sale process. However, as investment conditions changed and interest rates fell, it became apparent by the late 1990s that the illustrated returns would not materialise.

**3.8** Even though the insurance companies had offered no guarantees and were under no contractual obligation to provide the returns mentioned on policy illustrations, the authorities

maintained that "people who were not warned of the possibility that endowment payouts may be insufficient to repay the mortgage might be entitled to compensation of a return of premiums plus interest."[2]

**3.9** Subsequently, among other actions, heavy fines – some as much as £1million – were levied on companies found to be guilty of mis-selling and many life offices were forced to offer compensations to disgruntled consumers. The onus of justifying their sales practices, internal controls and training and competence procedures to ensure suitable advice lay with the insurance companies rather than the consumers. Following re-projections, many of the compensations paid out by the insurance companies were a result of retrospective reviews by the regulator. In the final analysis, many companies faced serious financial losses as a result of mis-selling – not only by agents but also independent financial advisors – driven by unsuitable advice and high expected returns.

**3.10** Although, the market dynamics and product features in the UK and in India are significantly different, the above experience illustrates at least a few stark similarities – and those that have potential for a similar backlash due to consumer grievances in India. Similar to the UK in the 1980s, the Indian economy is currently a high interest, high inflation economy. The stock markets are booming and most projections point to a further growth in equity returns. Many "financial advisors" seem confident that the bullish returns on investments will be sustained over the next five to ten years. Even the IRDA has acknowledged that some agents are using misleading sales literature on ULIPs with some leaflets projecting growth as high as 25% per annum over a 20 year period!

**3.11** Faced with a positive outlook for the economy, life insurance companies in India are making impressive sales of ULIPs – and indeed the returns on some of the funds have been impressive in the last couple of years. Agents and sales intermediaries impress upon their customers that these products will easily meet their future financial needs – whether for children's further education, retirement or other bulk expenditures foreseen for the future. From the point of view of financial security, ULIPs are perhaps not the best-suited insurance product for many of the customers who buy them on the advice of insurance intermediaries. They continue to invest their savings in ULIPs with the expectation that the illustrated returns will indeed materialise. Even though all offer documents state that the investment risks lie with the customers, not many customers understand the implications of this and very few advisors convey this properly to their clients.

**3.12** Consequently, there is a significant risk of consumer backlash if the expected returns do not materialise and many customers find that their hard earned savings are not giving them the returns that they thought were "promised" by the agents at the time of sale of these ULIPs. As pointed out above that it may be many years before the problems with the performance of a product relative to what the consumer was led to believe become apparent. It is likely that if consumers decide to go to judicial courts in the name of public interest litigations, insurance companies may face serious legal charges. The regulator may also decide to conduct retrospective reviews as in the UK and sales practices of companies lacking 'best advice' may well face regulatory sanctions.

**3.13** Whilst it is recognised that these are "what if" scenarios, given the current sales trends, high incidence of part time agents who may not necessarily fully understand the products they are selling themselves, perverse incentives created by high commission and non-commission

[2] Tony Holland, the Personal Investment Authority Ombudsman.

support to sales intermediaries against true need based selling and a customer base that heavily relies on such 'financial advisers', the above mentioned outcomes of mis-selling do not seem unrealistic. For industry wide mis-selling the final responsibility must not only lie with the sales intermediaries but also on the regulator, the insurance companies as well as the customers themselves. However, the arising financial liability either be borne by the customers or more likely, if there is intervention of litigations/regulations then by the insurance companies.

**3.14** Even though the private sector life insurance sector in India is still in its infancy, we have already seen retrospective regulations and hard actions by the regulators in the case of actuarially funded unit linked products. Even though IRDA had earlier approved such products and these were being sold in the market for many years, in August 2007 in a landmark ruling the IRDA asked insurance companies to withdraw these products. Whilst there was "technically nothing wrong with the actuarially funded products" it was recognised that these be phased out since they may not be easily understood by the customers. Although this change in stance by the IRDA did not affect most of the life insurers, some companies were faced with significant difficulties.

**3.15** Should the situation of mis-selling of ULIPs aggravate and consumer grievances escalate in India, it is likely that there may be further retrospective regulations and the IRDA may well come down harder on the insurers if necessary.

**3.16** There has been much debate in the insurance distribution practice on integrity of sales intermediaries, necessity of 'need based selling' and a 'best advice' approach to sales of financial products such as insurance. These require a high standard of professionalism in the industry and a regulatory framework that ensures that these are maintained. Three key areas may be recognised to deliver workable solutions for ensuring better advice[3]:

- Standards of professionalism that reflect and clarify the services being offered to customers
- Regulatory standards that are consistent with firms' risks from current business activities and that also encourage better management of liabilities from past activities
- Remuneration structures that are transparent, understandable and do not conflict with acting in the best interest of consumers

**3.17** Recent developments and press reports suggest that the IRDA has made it mandatory for agents selling ULIPs to get customers and agents to sign a "certificate" of approval and satisfaction showing that they fully understand the product. Moreover, all charges within the ULIP are required to be made explicit. Whilst this is seen as a move to ensure the prevailing mis-selling of ULIPs is moderated, it remains to be seen how successful such a policy would be in future.

**Lapse and persistency**

**3.18** Related to and often as a result of mis-selling, insurance companies face the risk of variable lapse rates and persistency experience. These ratios may be highly correlated with the sales and distribution strategies of the insurer as the sales function directly influence target market

[3] Financial Services Authority's (UK) Review of Retail Distribution, Discussion Paper 07/1, June 2007

and the 'quality' of business. The more robust a sales structure and distribution network, the more can a company's policy persistency be controlled.

**3.19** Correlations between the lapse rates and distribution strategies also derive from the fact that incidence of lapses are a good indicator of customers' brand loyalty, marketing of the insurance industry and the overall goodwill of the firm as well as the industry. The IRDA has recently expressed its concern around the high lapse experience of Indian insurers – reported to be as high as 30%. It has already been suggested that such low persistency is linked to the sales practices of the distributors and therefore, the structure of distributor commission be amended to be directly linked to the persistency rates of insurance policies to ensure only viable applicants are issued policies.

**3.20** Although in theory, the cost of lapses to insurance firms may be passed back on to the customers through appropriate pricing assumptions and charging structures, the companies may face significant shortfalls in projected premiums should the persistency be unexpectedly low. Moreover, there may be issues with competitiveness of products and limits on how much of this cost the insurer may practically be able to pass on to the customers.

**3.21** Should insurance companies be faced with unfavourable persistency experience, there are at least two significant operational dimensions that they would need to invest in. First, there would be a need for a larger policy retention/conservation team and an entire department within the insurance companies to prevent customers from continually surrendering their policies and to ensure regular premiums are paid on time. Secondly, more time and effort would be required to ensure that the sales processes are more robust – such that the customers who are purchasing new policies understand fully their insurance plans and are less likely to lapse their policies in the future.

**3.22** If the sales function is already geared to fully equip customers with sufficient knowledge regarding their insurance plan, it is likely that the insurer is able to significantly control its exposure to high level of policy lapses and the requirement for a larger policy retention team may not even arise. For this to be a reality, it is necessary that insurance companies review their distribution models from time to time, recognise objectively the inherent risks and shortcomings, if any and take appropriate action to resolve these – mostly internally.

### Other operational dimensions

**3.23** We can further recognise some operational costs and potential risks that may arise for insurance companies due to their specific distribution structures. Firstly, there are the obvious costs of recruitment, training and retention of sales force in India. High agency attrition rates, paucity of large banks for new insurers to tie up with and pressure on existing companies to retain their bancassurance distribution agreements, regulatory training requirements etc are just some of the challenges we have already mentioned in section two while discussing the different distribution channels in India.

**3.24** There is a further dynamic aspect to distribution that directly affects the traditional insurance risks of mortality and morbidity faced by insurance companies. In choosing a particular sales strategy and target market, the insurer would have implicitly also chosen its desired consumer base. Given the diverse demographic profile across various regions and socio-economic sub-divisions of the society, the mortality experience of a life insurer will necessarily be conditioned by the distribution area where the policies are sold. It is important for life companies to recognise this additional element of high correlation with distribution in analysing its mortality experience so that products may be priced appropriately and reserves

## 4 Implications within the Risk Based Capital framework

**4.1** The RBC frameworks demand that companies hold a level of capital commensurate with the risks inherent in the business they conduct. Typical RBC rules aim to calculate capital requirements following an assessment of risks that can affect the potential variability in liability and asset values. More complex frameworks can be developed with the aim to capture areas more difficult to quantify, such as operational risk.

**4.2** Overtime, capital requirements in the financial industry has evolved from being based on simple formula approach to more complex stochastic approach. The formula approach is not entirely reflective of the risk facing the company since risks faced by every company are different depending on various management decisions, which are different for each company. For example a simpler approach of calculating solvency capital as a percentage of statutory reserves is not dependent on the specific risks taken by each company. Hence, the risk-based regime has evolved,, which allows for the specific risks faced by each company and provide regulators with a better tool to regulate the companies.

**4.3** Within the life insurance industry globally, capital requirements are being revised in many territories. The unprecedented volatility in equity markets and low interest rate regimes prompted this coordinated reaction by the regulators over the world. In India with convergence of financial products and the banking sector moving towards risk-based capital, the IRDA is also contemplating to move beyond the traditional required solvency margin regime.

**4.4** Across the globe the key focus within the RBC regime are risks like underwriting risks (insurance risks), pure market risk, credit risk and Asset Liability Management ("ALM") risks which are all covered by regulators where RBC regime has been put in practice like the US, UK, Singapore and Australia. These are more developed markets and may not be as exposed to risks in distribution as is a country like India in its growth stage is, with its wide geographic and economic diversity. The RBC regime introduced elsewhere has detailed discussions about products with built in guarantees due to the risk associated with the same. This however may not be a very relevant issue in India as such products are relatively less popular, the most widely sold products here being the unit linked plans, which are not traditionally considered to be a potential risk for companies.

**4.5** Indian insurers have lately been advocating the RBC regime so as to ensure efficient and optimum use of capital, argument being that companies whose portfolio of products is dominated with unit linked business where the investment risk lies with the policyholder should be keeping lower capital requirements and in effect be providing only for mortality risk associated with the unit linked product. For example, under the new RBC framework in Singapore, the regulator announced a reduction in the minimum level of paid-up capital from S$25 million to S$5 million for an insurer writing solely investment-linked business. The rationale being that the ongoing capital for a company will be based on its own underlying risks, making the minimum capital requirement less important. Thus it is very important that if and when the RBC regime is introduced in India, the insurers have a good understanding and realisation of the risks that their company is exposed to.

**4.6** Whilst there is a widespread acceptance on the need for a RBC framework for insurance companies, and most companies seem to be supporting its introduction, it is important that

companies are able to correctly identify and quantify the risks they face in order for any RBC framework in India to be able to successfully achieve what it is intended to. Significant among these are risks within distribution structures already identified in the earlier sections. It is essential that life insurance companies in India are able to acknowledge these for themselves where they exist and provide for them appropriately within an RBC regime.

**4.7** Mis-selling of ULIPs as discussed in the previous section and unreasonable expectations of the policyholders from the product, which when not fulfilled could lead to:

- Mass surrenders
- Lower than expected new business
- Reputation loss and litigations

**4.8** Thus the currently prevalent mis-selling could lead to considerable impact on capital requirements of a company which has ULIPs as a significant proportion of its business. It is important that in a risk-based regime in India, emphasis is placed on additional capital to be held in line with company's distribution structure. We discuss below a possible scenario using the RBC framework in the UK and see how it may be applied to insurance companies in India – if similar rules were to be implemented – and specifically how risks conditioned by distribution structures as identified above may be incorporated to ensure that the resulting capital requirement adequately reflects these.

**Illustration using RBC framework in the UK**

**4.9** In the UK the overall structure of the new solvency regime is often described as being supported by two pillars. Pillar I represents explicit requirements for technical provisions and capital requirements. Pillar II is the supervisory review process and Individual Capital Guidance ("ICG"). The regulator FSA, has also introduced Individual Capital Assessment ("ICA") which forms a part of the Pillar II capital requirement. It is a more risk-sensitive assessment of the capital buffer needed to protect the policyholders for all types of life insurance business. Under this all material risks must be considered explicitly and the stress tests are not prescribed but are for the insurer to determine individually according to its risk profile, ensuring a 99.5% probability that the value of firm's assets will exceed its liabilities over a year.

**4.10** Considering a similar sort of set up for India, let us identify risks for an insurer as applicable with its unique product and distribution mix. ICA stresses involve changing the realistic basis assumptions to reflect the risks to which the company is exposed. Say the mortality experienced by a company is 90% of the LIC table, then under an ICA stress this may be taken to be say 95% of the LIC table for non annuity type products to identify the excess capital required in case of an experience other than expected or under some catastrophe.

**4.11** Now lets take an example of two insurance companies - A and B, each having considerable contribution (50% or more) to its sales from bancassurance distribution channel. Company A has a public sector bank as its bancassurance partner with its branches spread all over the country including both rural and urban locations; most of its business involves middle-class segment from semi-urban locations. Whereas Company B has a foreign bank as its bancassurance partner with branches mostly in urban centres and gets high net worth individuals business for the insurance company. Now one would expect mortality to be different across rural – urban / socio-economic classes/ etc and in case of a "mortality shock" akin to catastrophe/epidemic shock in ICAs it is likely that this would be more severe for rural/semi urban centres with lesser medical reach than in urban centres. Thus while doing

an ICA, the company would need to take into account its unique distribution network, the nature of risks that it is exposed to, and derive stresses appropriately.

**4.12** A similar case stands for the assumed levels of persistency. The lapse rates vary by distribution channel for a product. Broadly it holds that companies experience higher lapses through agency as compared to bancassurance. So allowance for the same should be made when capital is being set aside for lapse stress under the ICA. Such an approach leads to a more effective utilisation of capital and gives the regulator a clear picture of the potential risks that an insurer may have to face and its capital strength to bear the same.

**4.13** Further stresses would need to be applied to cover 'operational risks' faced by the insurance company. These would necessarily need to include potential costs of mis-selling, legal claims, potential costs if a bancassurance distribution partner is 'lost' to competition and other such aspects. Indeed many life insurance companies in the UK are specifically quantifying the risk of mis-selling as specific to that insurer and including the stress as part of the ICA requirement. Correlations between lapse, expense, mortality and operational aspects are also taken into account while aggregating the capital requirement from individual stresses.

**4.14** Such an exercise is important from the point of view of Indian life insurance companies where they can judiciously recognise risks they face and provide for them. Within the regime prevalent in the UK, if the regulator is not satisfied that the insurer has indeed incorporated the risks appropriately an additional ICG may be loaded on top of the ICA capital calculated by the insurer.

**Potential discussion items under other emerging RBC frameworks**

**4.15** As part of Solvency II, the European Commission has commissioned a number of quantitative impact studies (QIS) to help calibrate the new solvency regime and understand the impact of its proposals. The solvency capital requirement in QIS3 requires that a capital charge is made in respect of catastrophic lapses for unit linked policies using the assumption that 75% of such policies lapse. Though there is a general feeling that this is calibrated too severely, supported by the fact that actual observed lapse experience of some insurers who have been subject to severe reputation damage due to events that involved closing to new business has been much less than 75%. Similar or worse situations in India may lead to additional capital burden for the life insurance companies.

**4.16** The management of the insurance company while finalising the capital required should ensure that it is sufficiently equipped to handle situations like those stated above and as such operational risks are duly accounted for.

**4.17** Under the RBC regime insurers would quantify risks in distribution channels and hold capital to allow for the same, this may lead to insurers adopting different types of distribution channels and practices. For example, in Singapore, experience of RBC has led to more active involvement of IFAs, since the case size and persistency level were found to be higher through this channel.

## 5 Conclusion

**5.1** As we conclude our paper, we recognise that identifying and quantifying the risks involved within distribution channels may necessarily involve a certain element of subjectivity. However, in the light of potential implications, it may well be worth considering for Indian

insurance companies the extent to which they face such risks and what they need to do to ensure that the financial impact is minimal if these were to materialise.

**5.2** The discussion on risks and plausible applications within the RBC frameworks is intended to be only a starting reference point and to encourage life insurance companies to consider the underlying issues. Through our paper we have attempted to first identify the prevalent distribution scenario and then discuss issues that may arise for a specific life insurance company.

**5.3** All life insurance companies in India are seen to adopt a multi-channel distribution network. Whilst agency is predominant, the focus is shifting to alternative channels as well, as new private insurers come into the market and existing ones strive to remain competitive. In forming insurance joint ventures, access to particular distribution channels through the Indian partner is often seen as an important strategic move and the overall sales strategies of the new insurer is influenced significantly by the underlying nature of the joint venture. This exposes insurance companies to certain risks depending on the nature of distribution channel it has been endowed with or subsequently adopted.

**5.4** Furthermore, we have shown that the current emphasis on selling ULIPs and incentives generated for insurance intermediaries may be acting to the detriment of the industry as widespread cases of mis-selling may emerge. There may be strong linkages with the adopted sales strategy which insurance companies need to identify for themselves. Other related risks discussed include lower than expected persistency and excessive operational costs.

**5.5** Major theme emerging from our paper is the need for insurance companies to quantify these risks they face. This may be achieved through an RBC framework and devising appropriate regulations. We illustrate this through an example of ICAs as prevalent in the UK. There may be other ways of incorporating these risks and discussion on the subject is welcome as it is necessary for prudent management of the life insurance industry in India.

**References:**


**1** "Insurance distribution in India- a perspective"- A paper by Sreedevi Lakshmikutty and Sridharan Baskar, Domain Competency Group (Insurance), Infosys Technologies Limited

**2** "The Emergence of Alternative Distribution in India" by Graham Morris and R. Krishnamurthy, Watson Wyatt Worldwide

**3** "Bancassurance- an emerging concept in India"- A paper by Naveen Sethi

**4** "Risk Based Capital for Life Insurers: A Review" – A paper by Rajesh Dalmia, Karan Gupta, Udbhav Gupta and Shobhna Sharma, Watson Wyatt Worldwide

**5** "The New Risk-Based Capital Framework in Singapore" by Richard Holloway, Watson Wyatt Worldwide

**6** Watson Wyatt India Bancassurance Benchmarking study

**7** Sigma No 5/2007 Bancassurance: emerging trends, opportunities and challenges, Swiss Re

**8** "A review of retail distribution", Discussion Paper 07/01, Financial Services Authority

**9** "(Mis) selling through agents" by Roman Inderst and Marco Ottaviani

**10** "Progress report on mortgage endowments", Financial Services Authority, October 2000

**11** "Endowment Mortgages - The Next Mis-Selling scandal?" by Simon Spencer, Barnett-Waddingham

**12** "Profiting from bancassurance: choosing the right route" by Peter V Burdon, Britannia Life Limited

**13** http://www.allbankingsolutions.com/bancassurance.htm

**14** Various press releases and articles

**15** www.irdaindia.org

**16** http://www.lifeinscouncil.org/

**17** IRDA Annual Report, 2006

**18** Company websites:

- http://www.maxnewyorklife.com
- http://www.reliancelife.co.in
- http://www.birlasunlife.com
- http://www.sbilife.co.in
- http://www.iciciprulife.com
- http://www.bharti-axalife.com
- http://www.avivaindia.com
- http://tata-aig-life.com


**Disclaimer:** All implicit or explicit views expressed in this paper are of the authors and not necessarily those of our employer, Watson Wyatt.

**About the authors:**

**Aastha Gulati**
Aastha joined Watson Wyatt in July, 2007. She has completed her graduation from Lady Shri Ram College in the year 2007 in B.Com (Hons). She is a member of the Institute of Actuaries of India and pursing CT series exams.
Aastha is currently undergoing training as a consultant in Watson Wyatt Worldwide and has been involved with statutory valuations for clients and market analysis and research of Asian life insurance markets since joining Watson Wyatt.
Email : Aastha.Gulati@watsonwyatt.com

**Kunj Behari Maheshwari**
Kunj joined Watson Wyatt in July 2006, after graduating in economics at Shri Ram College of Commerce, Delhi. He is currently pursuing CT series exams of the Institute of Actuaries of India.
Since joining Watson Wyatt, Kunj has undergone training on life insurance valuation and reserving and has been involved in a number of statutory valuation and individual capital assessment projects. He has also been involved in carrying out monthly projection work for clients, as well as market analysis of the life insurance industry in the Middle East and Asia. Recently, he has been involved with developing business plans and financial projections for some Indian life insurance joint ventures.
Email : Kunj.Maheshwari@watsonwyatt.com

**Shobhna Sharma**
Shobhna is a consultant with Watson Wyatt's Insurance and Financial Services practice since July 2006. Prior to joining Watson Wyatt, she graduated in Statistics from Lady Shri Ram College, University of Delhi. She is currently pursuing CT series exams of the Institute of Actuaries of India.
Since joining Watson Wyatt, Shobhna has been involved in statutory valuation, embedded value reporting and individual capital assessment for its UK clients. She has also worked on research reports on the insurance market in India and other Asian countries.
Email :Shobhna.Sharma@watsonwyatt.com