Project

Changing Product Dynamics in Indian Market

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Agenda

- **Role of Actuaries in product development**
- **A look at the past (post liberalisation)**
  - Emergence of ULIPs
  - Issues with ULIPs (including learnings for Actuaries)
  - Regulatory changes around ULIPs
- **Understanding the current**
  - Product regulations – ULIPs
  - Pension regulations
  - Newly emerged trends (NAV guarantee, G Sec linked Non Par, etc)
- **Peeping into future - New proposed product guidelines**
- **Conclusion – expectation from actuaries**

Statutory obligations..

- As per IRDA (AA) Regulations 2000, Appointed Actuary duties and obligations include **giving actuarial advice to insurers in the areas of product design, pricing and drafting of insurance contracts**.

- The Appointed Actuary is also required to **certify that premium rates** of the insurance products are fair.

- As per “File and use” procedure, Appointed Actuary should sign off products’ terms and conditions along with point of sales literatures before submitting these with IRDA for product approval.

- IRDA now requires a declaration from Appointed Actuary that policy document issued to the policyholder truly reflect all features as per “File and Use” submitted.

- Appointed Actuary should ensure that all product features are complaint with Protection of Policyholders’ Interests regulations 2002.

Professional guidance…

As per APS 1, Appointed Actuary should ensure that the life insurance business of the company is conducted in sound financial lines and he/she has regards to Policyholders' Reasonable Expectations (PRE)

- In order to conduct business on sound financial lines, Actuary should ensure premium / charges are appropriate making the product financially viable and generate acceptable level of profitability.
- In order to manage PRE, Actuary should ensure new policyholders are not misled and premium / charges are in line with market price of risk covered.
- Actuary should ensure that point of sale documents assist prospective policyholder to understand features of products and flow of benefits.

Actuary and Firms

Current Indian regime relies significantly on the Actuarial Profession to ensure customers are treated fairly. In order to treat customers fairly, an Actuary should:

- ensure that process is in place to identify the needs of the customers for whom they are designing, manufacturing and/or distributing products
- understands the financial capabilities of its customers and the impact and effectiveness of communications on their ability to understand sometimes complex issues
- provides clear, fair and not misleading advertising, marketing and disclosure materials as well as communications after the point of sale

Actuary and Firms (Cont.)

- recommend a balance between increasing sales and not exposing customers to inappropriate risks, particularly in the design and marketing of new products
- measures, monitors, controls and reviews the risks arising from products for both existing and potential new customers
- find a way to "stress test" possible risks to the firm arising from its retail business taking into account product types, sales methods and after sales requirements
- provides timely, informative and relevant management information to monitor the effectiveness of the strategy

Actuary and Policyholders

Actuarial profession has an obligation to serve public interest by influencing those with power to protect and enhance public interest.

Actuary should ensure that

- policyholder feel confident that they are being treated fairly
- products are marketed and sold to target market identified
- policyholders are provided with clear information and are kept appropriately informed before, during and after the point of sale
- any advice given is suitable and takes account of their circumstances
- policyholder should not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

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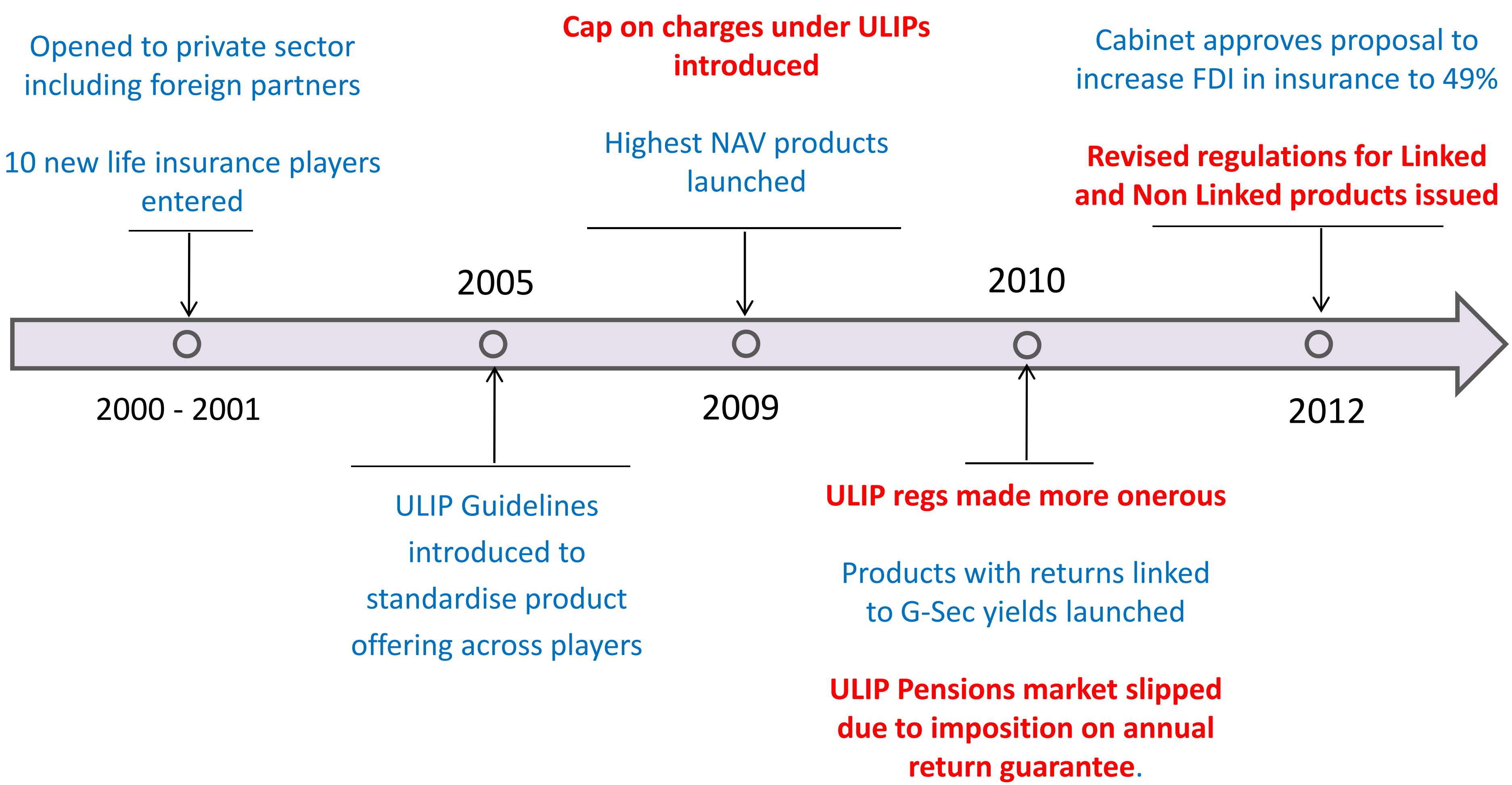
Historical Developments



Liberalization of insurance sector

- In year 2000, Indian Insurance Industry was opened to private players.
- Reasons for liberalization:
  - Increased competition for better customer service and help improve range, quality and price of insurance products
  - Increase insurance penetration
- Most of initial private companies were joint venture between Indian banks and foreign insurance companies
- Initial products offered were similar to LIC i.e. endowments and money back plans.

Introduction of ULIPs

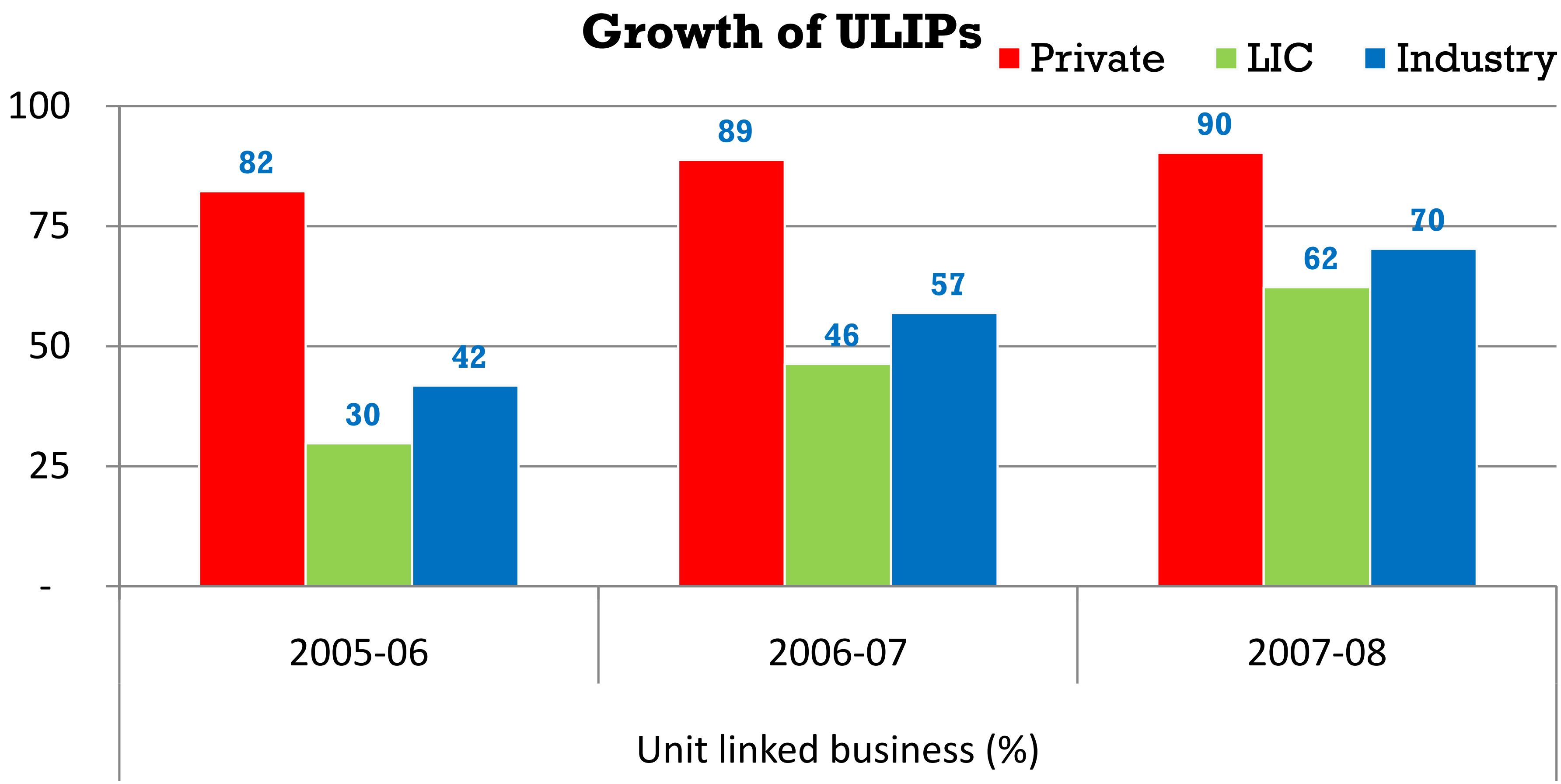
- First successful product innovation by private insurance companies – introduction of ULIPs!
- ULIP gave benefit of:
  - Unbundling
  - Choice of funds and option to switch between funds
  - Choice of life cover
  - Equity linked returns
  - Transparency
  - Flexibility
  - Liquidity
- Apart from above features, bull run of the equity markets between 2004 and 2007 increased attractiveness of ULIPs
- LIC also decided to change its strategy to focus more on ULIPs

Why preference for ULIPs?

Industry preferred unit linked products given:

- **Investment risk borne by the policyholder**. Hence, overall risk and capital requirements lower under ULIPs compared to non-linked contracts.
- **Transparency** in charges and added **flexibility** to policyholders
- Good value for money for policyholders compared to non linked products over long term
- **Easy to explain** and simple design for sales force and prospective policyholders
- Target market required cost effective **equity linked** insurance product

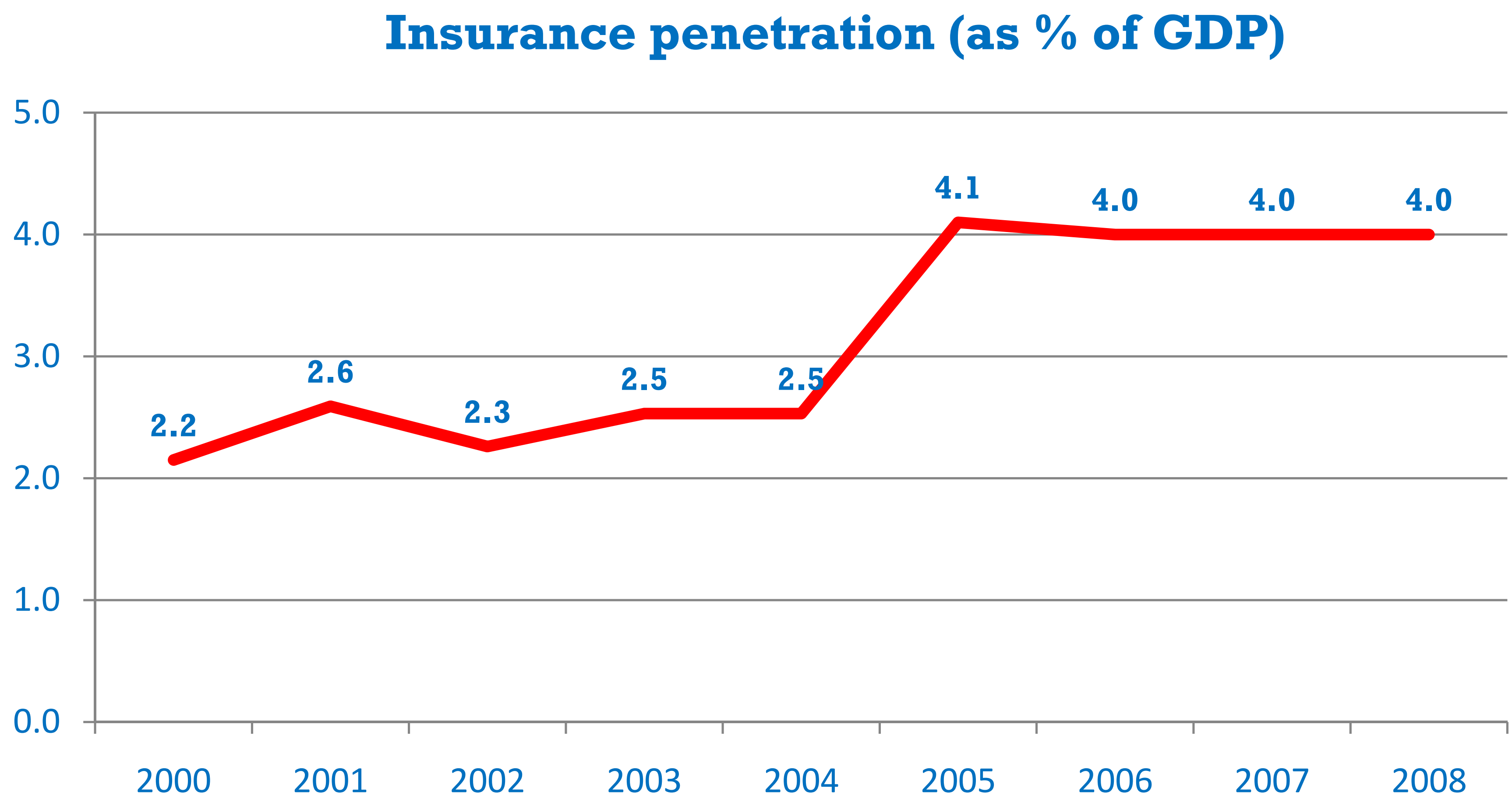
Growth of ULIPs



Market shaped into an overwhelmingly linked products market largely driven by attractiveness of equity returns.

Source: IRDA annual reports

A look at Insurance Penetration



ULIPs also helped in increasing insurance penetration which close to doubled post introduction of ULIPs

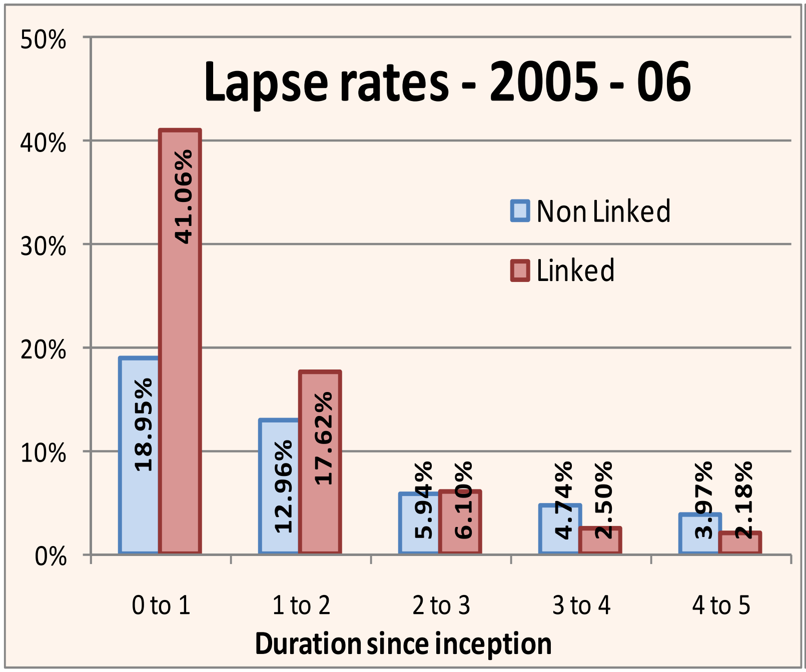
Source: IRDA Insurance statistics; defined as ratio of premium to GDP

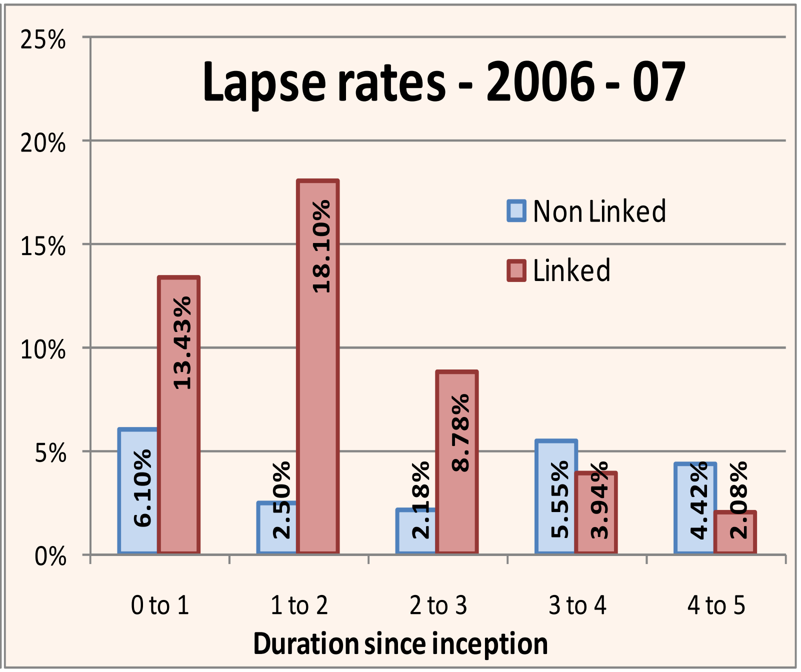
Issues with ULIPs

- Companies focused on chasing high new business sales
- Agents were highly incentivised to achieve new business sales and gain market share
- Sales in pursuit of higher commissions, had concentrated more on selling rather than ‘need-based’ selling
- Some of the wrong premises for selling ULIPs included:
  - Ignoring customer’s risk appetite
  - level of charges not explained at point of sale (e.g. 100% allocation rate products, with heavy administration charges, started picking up)
  - Contract features such as premium term not explained
  - Sales based on past years’ high returns
  - Positioning ULIP as a short term avenue
  - Encouraging churning and non payment of premium

ULIPs and Persistency

- Lack of need based selling also affecting persistency…
  - ULIP products experienced high lapse rates – more than 40% policies lapsing during first three years.
  - Lapse rates much higher for linked than non linked products - reflecting policies being sold as short tenor products or not meeting needs of policyholder.





Source: Life Conference and Exhibition 2009

ULIPs regulations

- Mutual fund companies were unhappy with high commissions to agents for marketing and prompting these products especially after abolition of entry load on their products
- Regulator had to step in to address existence of market distortion and mis-selling practices
- Regulatory supervision and scrutiny got more severe in later years
- Still a big challenge for industry and Actuaries to develop & encourage best selling practices to mitigate mis-selling risks

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Current ULIP guidelines

- **Cap on overall charges** through reduction in yield requirements – not only at maturity but also at earlier durations.
- **Cap on surrender charges**, exposing insurers to persistency risk
- **Increase in lock-in period** from 3 to 5 years
- Increase in risk component / death benefit
- Requirement for even distribution of charges, further increasing new business strain
- **Minimum guaranteed return for pension products** (discussed in detail below)

In short – an open expense challenge thrown at insurers!

Current ULIP guidelines vs. other countries

In India the recent regulatory interventions are unprecedented in their scope

Country	Cap on charges[1]	Cap on surrender charges	Minimum sum assured	Minimum lock-in period	Minimum guaranteed return[2]
India	✓	✓	✓	✓	✓
China	✓	✗	✗	✗	✗
UK	✓ (effective 2012)	✗	✗	✗	✗
US	✗	✗	✗	✗	✗

1. Includes allocation, fund management and other charges
2 Only for pension products;

ULIP regulations in India more onerous than other countries!

In India, regulator is considering additional regulation on sales force (e.g, minimum policies, persistency)

Pension market negatively impacted

- IRDA imposed an annual return guarantee of fixed 4.5% on unit-linked pension plans launched after September 2010, although this was modified to positive non zero guarantee recently.
- Insurers became understandably reluctant to adhere to such guarantees and very few private players launched unit-linked pension plan after September 2010.
- Most private insurers content with single premium unit-linked pension policies.
- **The imposition of the guarantees dissuaded insurers from offering pension products or under-investing in equities to reduce guarantee risks in the event that they do.**
- **One insurer remarked that the IRDA has effectively killed off 30% of the pension market.**

Shift away from ULIPs

- Cap on charges regulation made ULIPs more cost effective and transparent for policyholders but **exposed companies to additional risks (mainly expenses and persistency) along with reduced profitability.**

- In order to protect margins and continue to pay reasonable commissions, the **Industry:**

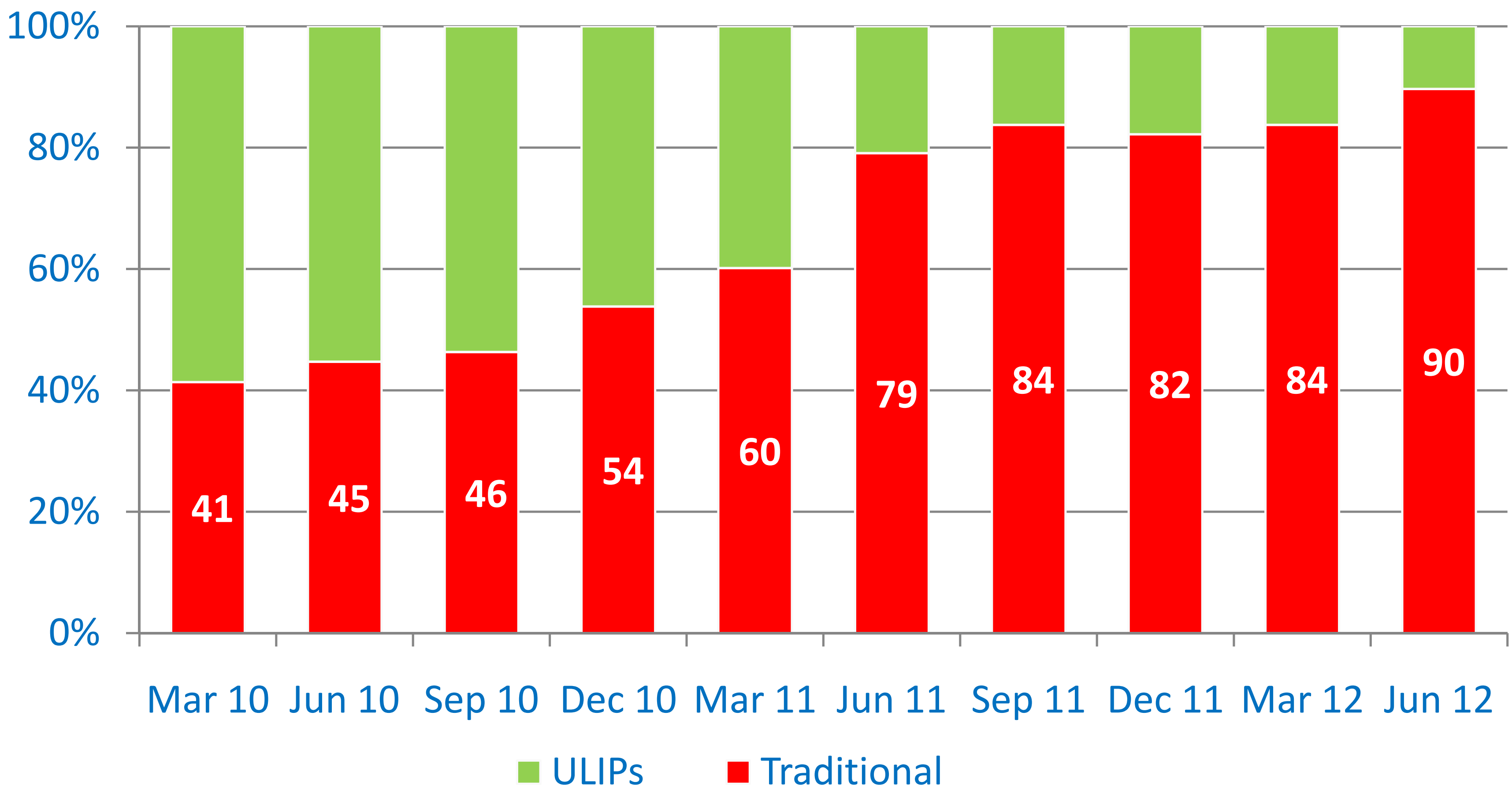
  - **reduced volume of ULIPs** and migrated towards traditional business

  - **Stopped writing ULIP pension products** in order to restrict writing of higher guarantee business

  - renewed focus on persistency of past ULIPs instead of business growth to manage persistency risk

  - Lower sales payouts and **expense restructuring** (industry went through a phase of Opex cuts)

Changing product segments – move away from ULIPs



Increase in non linked product segment clearly visible in FY 2011 -12 post cap on ULIP charges regulations

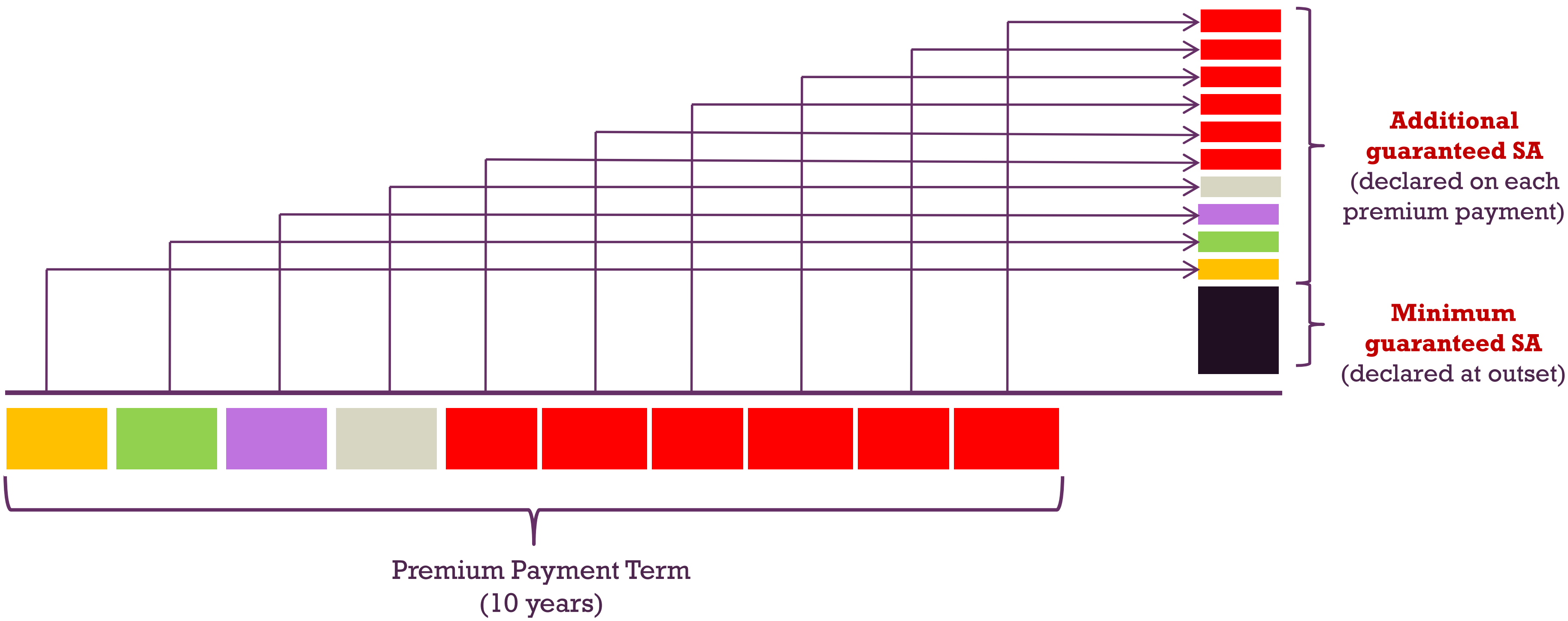
Source: IRDA segment wise QTD first year premium; Individual non single premium only

G Sec linked Non Par Plans

- Regulatory changes concerning ULIPs has hit shareholders’ profitability and distributors’ viability.
- Companies looking to diversify away from ULIPs into traditional products.
- But Industry was vary of taking high investment risk on their balance sheets
- **Many companies launched non par traditional products, which:**
  - **Guaranteed low returns at the outset (perhaps just return of premium)**
  - **Provided Guaranteed Additions (GA) to Sum Assured each time premium is paid, where GA is linked to G Sec yields prevailing at time of premium payment.**

G Sec linked Non Par Plans (Cont.)

- Offers Guaranteed Additions (GA) to Sum Assured on each payment of premium.



- GA based on benchmark yield –e.g. 5 year G Sec yield.
- This feature helps to reduce exposure to reinvestment risk and permits better returns to policyholder.

G Sec linked Non Par Plans (Cont.)

Better Profitability & capital efficiency, driven by:

- Higher charges in absolute terms (as not affected by ULIP regulations)
- Surrender / lapse profits significantly higher (as not having surrender penalty caps)
- Also, **less exposed to vagaries of interest rates** (compared to high guarantee non par).
- Also supported **higher commissions** compared to ULIPs

G Sec linked Non Par Plans (Cont.)

Did offer **better value to customers looking for traditional products**, as:

- **Possibility of higher returns** – if interest rates go up (though returns would be lower of interest rates fall).
- **Conservatism due to reinvestment risk not there**.
- Not exposed to volatilities of equity markets.
- Net of tax returns - comparable to fixed deposits (liquidity traded for insurance benefit).

ULIPs with guarantees – Highest NAV Guarantee

- Post equity market fall in 2008, many companies started offering ULIPs with embedded guarantees, in particular - highest NAV Guarantee

- Such guarantees applied on Maturity (and not on early surrender / lapse or death).

- Such products garnered huge success in the market and some insurers still continue to sell (though likely to be closed in new proposed guidelines).

- Issues with such products from policyholders' & market perspective:

  - **Mis-selling risk:** Set wrong expectations i.e. could be sold as 100% equity products with underlying guarantee!

  - **Can compound market volatility**

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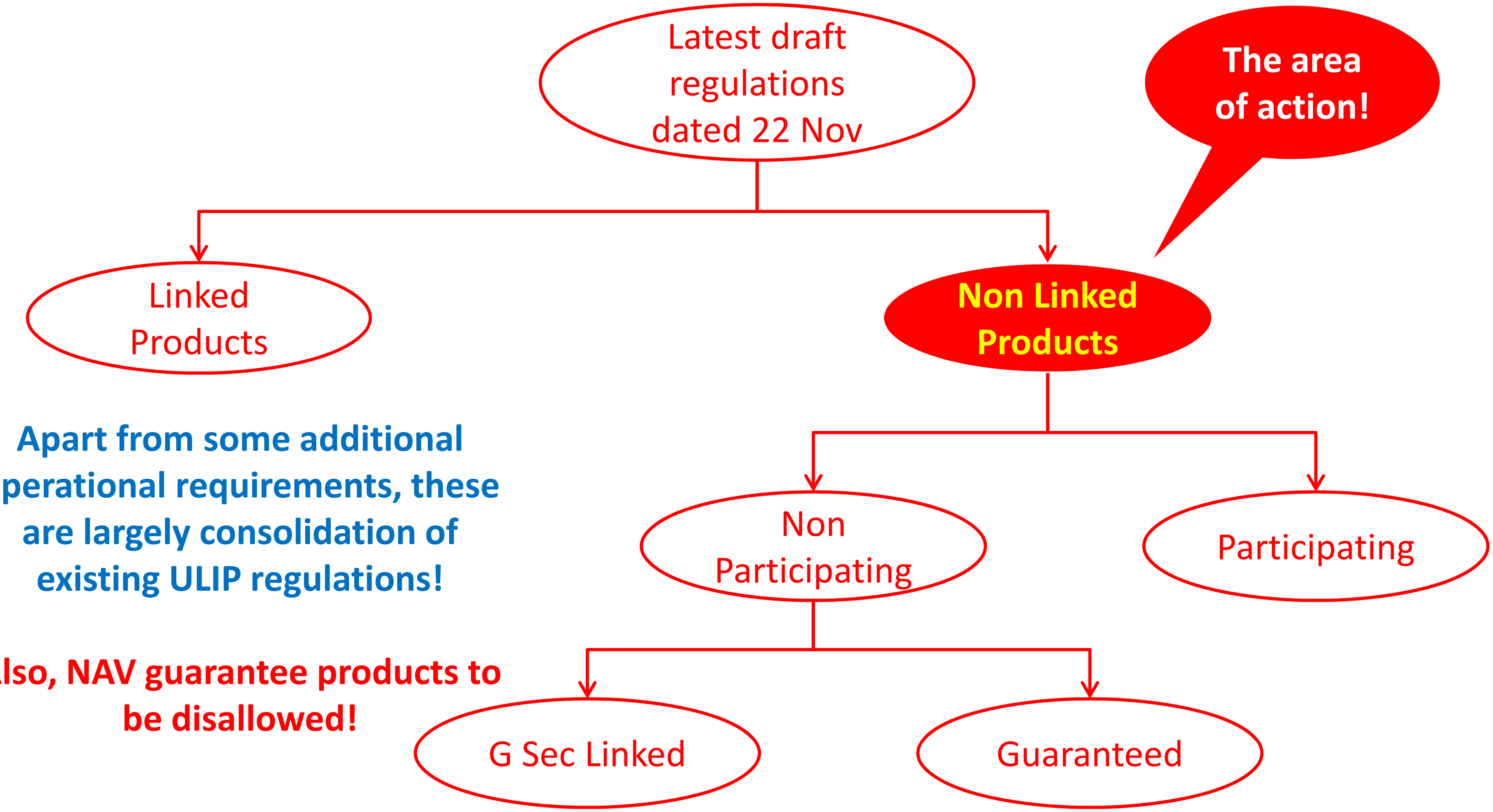
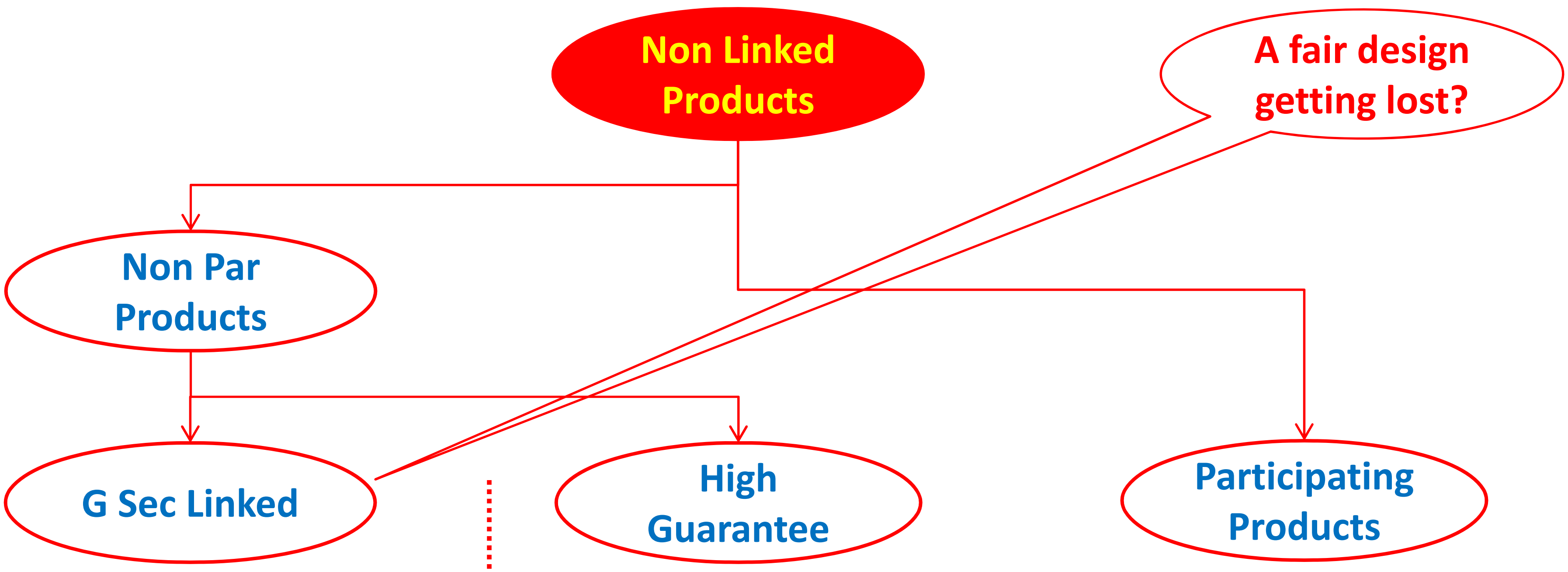
Exposure draft on product guidelines



Apart from some additional operational requirements, these are largely consolidation of existing ULIP regulations!

Also, NAV guarantee products to be disallowed!

Exposure draft on product guidelines



Proposed to be **classified as Linked business under the Variable Insurance Products** guidelines.

The VIP Guidelines propose **cap on charges in line with the existing unit-linked products**.

Death benefit proposed to be increased in line with ULIPs.

Commissions limits based on 17D principles, with cap at **@3% * PPT**

Increased Surrender Values - GSV scale increased & SSV to reflect asset shares.

Future Margin Driver – Non Par with high guarantees?

- With G Sec linked non par products proposed to be subjected to cap on charges, Industry is going to look to other avenue to:
  - Enable paying higher commissions
  - Boost shareholder margins
- **So the key question – what will be the future margin driver**?
- Looking at initial trends suggest that **Non Par products with high guarantees can be the flavor of the season**!

Company	Guaranteed Customer IRR
Bharti Axa	4.5%
Aviva	5.5%
Birla Sunlife	4.25%
Tata AIA	4%

Non Par with high guarantees - issues

- Whilst such products may enable higher margins, issues / concerns that we need to answer:
  - Are these products, which provide returns comparable to savings account interest, **meeting customers' needs**?
  - Are these products 'tontine' i.e. **Lapse supported**?
  - Is it **fair to offer policyholder such low surrender values** (with breakeven happening beyond 10^{th} policy year)?
  - Is such **high investment risk worth the margins on offer**?
  - Are we **going too far to drive margins** and / or keep giving high distributor compensation?
  - Are **proper pricing of risks being done before offering such guarantees**? Have proper economic capital assessments been done?

Exposure draft on product guidelines – Pension Plans

Latest Pension guidelines, key features to discuss:

- **Explicitly defined assured benefit on death and vesting** – i.e. guarantees so small exposure to equities
- **Commutation from the same insurer**
- Extend accumulation period within the same policy, if individual within 55 years

Issues:

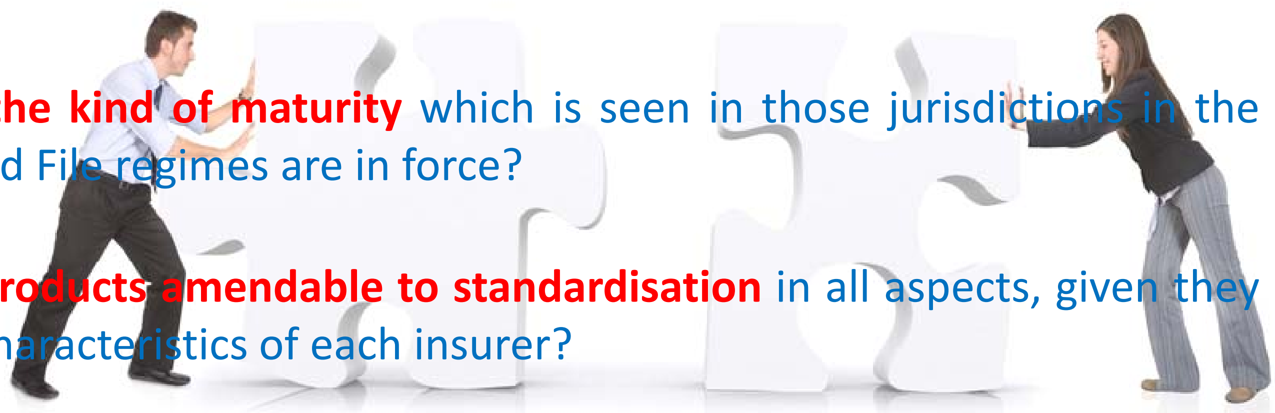
- Is giving low equity exposure on long term pension accumulation plans doing justice to customer needs?
- Is forcing policyholder to buy annuity from same insurer making policyholder devoid of options?

Standard Products

- The IRDA Chairman's Letter to the Life Council suggested that **a regime of Standard Products be envisaged for different product categories** which may be introduced in the market through a **'Use and File' system instead of the 'File and Use' system**.

- Proposal designed primarily to ease out difficulties being experienced with regard to the **slow clearance of products under File and Use system**.

- While this may ease the product development process, the questions we need to ask are:



  - **Have we attained the kind of maturity** which is seen in those jurisdictions in the world where Use and File regimes are in force?

  - **Are life insurance products amendable to standardisation** in all aspects, given they reflect the unique characteristics of each insurer?

  - Is the proposal **anti-competitive and will reduce innovation** in the industry?

LI through Internet - Journey so far!

- Online insurance sales started in India with an experiment by one Insurance Company in the market – but **is becoming a phenomenon**!
- Online term insurance gained momentum for this Company and other companies followed
- The market has continued to develop and average sum assured has increased significantly and the **rates have become highly competitive**
- Anecdotal evidence suggests that **annually more than 100,000 term life insurance policies are being sold** online and this is only likely to grow at a healthy rate.
- Some Companies also making full range of products available online.
- Distributor driven sales are also gaining momentum.

LI through Internet - Journey so far!

S. No.	Company	Participant Since	Term & other protection	Endowment	Annuity
1	**Ageon**	**Q3 2009**	**Yes**	**Yes**	**No**
2	Kotak	Q2 2010	Yes	Yes	No
3	**Ipru**	**Q3 2010**	**Yes**	**Yes**	**No**
4	Metlife	Q3 2010	Yes	No	No
5	Aviva	Q1 2011	Yes	No	No
6	**SBI**	**Q3 2011**	**Yes**	**No**	**No**
7	Bajaj	Q4 2011	Yes	Yes	No
8	**HDFC**	**Q4 2011**	**Yes**	**Yes**	**No**
9	Bharti	Q1 2012	Yes	No	No
10	India First	Q1 2012	Yes	Yes	No
11	LIC	Q2 2012	No	No	Yes
12	IDBI	Q2 2012	Yes	No	No
13	Reliance	Q2 2012	Yes	No	No

Most players have entered the market through term insurance product

Price has been the source of competitiveness so far…

Internet – understanding the market

Factor	Comments
Socio Economic Profile	• **Well educated** (graduate and above) • Mostly salaried • **Middle income and above** (annual salary of Rs. 5 lacs & above)
Behavioral Dynamics	• **Financially aware** (internet used to acquire knowledge and research) • Budget and value for money conscious • **Time conscious** (wants to spend minimum time in buying) • **Service conscious** (may drop out on poor website experience) • **Wants to bypass intermediaries**
Convenience	• Easy access to website • Easy payment process • Medical examination at home • **Minimal touch points**
Wet signatures	• Initially required, now dispensed with!

Internet – key considerations

- Many things to consider such as channel issues and synergies, operational and technological issues, funnel management etc. From products perspective, following may be relevant:
  - Should one sell **same products through all channels or internet specific products**?
  - Are these products **low cost and basic or feature rich and mostly costly**?
  - How can products be **differentiated when the market is extremely price sensitive**?
  - Can one charge a **higher premium because of good brand**?
  - What will be the **selection approach** e.g. Cotinine Test, medical underwriting, etc
  - Which part of process to be automated and what should be the **cost loading**?
  - Will **only basic protection products** be sold through internet **or savings products also?**

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Future product designed

- Due to changing regulatory and market environment, Actuaries and companies need to revisit their product design strategy.

- Important factors that can play increased role in product design are
  - Reinsurance including financial reinsurance

    Fin Re currently not allowed in India but could help insurers design capital intensive products
  - Embedded value

    Post IPO guidelines, Companies are increasing their focus on EV and hence products are designed to preserve and enhance EV
  - Risk management

    Increased focus on risk management in business planning
  - Direct Tax Code (DTC)

    Proposed DTC could have significant negative impact on LI

Reinsurance and Products

- Reinsurance can assist in product innovation by providing data required for pricing, assist in product design, terms & conditions and underwriting guidelines along with appropriate risk transfer
- Financial reinsurance currently not allowed. Need regulation considering Legitimate-Risk transfer principles, accounting principles and disclosure requirements
- Given higher capital risk on new products, financial reinsurance can be used to raise the additional capital
- Fin Re can also allow risk transfer opportunities and more flexibility given tailor made contracts
- Overall we may see more reinsurance participation in product design

Embedded Value and Products

- After IPO guidelines issued by IRDA, Companies now have additional focus on embedded value
- Actuaries need to consider return on embedded value of new product design by performing scenario and stress testing on volumes and future assumptions
- Any product design recommended should avoid the option of lapse and re-entry. Embedded value is reduced due to churning of business by sales force
- Higher capital requirements increases frictional cost of capital and hence return on embedded value. Recommendation on new products should be based on available free capital
- In near future, we expect more product designed in order to enhance or preserve embedded value

Actuary & Risk Management

- Actuaries manage risks faced by the company and design or recommend product in line with their risk appetite
- Increased focus on risk management
  - Persistency
  - Expense
  - Operational
  - Liquidity
  - Regulatory
- All these risks should highlighted by Actuaries in Financial Condition Report (FCR) as per APS 3
- Separate verticals to manage persistency risk and establish feedback loop for new product design
- New cost effective distribution channels (e.g. online sales) to manage expense risk

Actuary & Tax

APS 1 recommends that Actuary should consider impact of taxation in order to arrive at appropriateness of premium rates

- Proposed DTC could have significant negative impact on the Indian insurance industry
- Reduces the policyholder tax advantage on ULIPs
- Proposes accrual-based taxation in accumulation phase
- Proposes lower tax deductibility for insurance premiums
- Increase in corporate tax rate from 14% to 30%

Actuaries need to consider impact of proposed tax changes in product design

Role of Actuaries

- Professional code of conduct states that as a member of actuarial profession actuaries has an obligation to serve the public interest.
- Firms will look to actuaries for detailed knowledge of the intricacies of pricing and product management. Actuaries should ensure that advice given considers impact on treating customer fairly.
- Actuaries should contribute in firms’ management decision making process such that these decisions protect and enhance public interest.
- Actuaries should proactively ensure that future product designs are simple, are sourced to target customer segment identified, produce the right level of disclosure and design robust process for reviews.

The Way Forward

- All stakeholders, in particular actuarial profession, need to come forward and **help shaping regulations** which help improve:
  - Transparency and value to consumer,
  - profitability and return on capital employed,
  - Whilst maintaining reasonable level of distributor commission
- **Encourage** development of products after **extensive consumer research** to understand consumer needs and preferences
- Need to further integrate **risk management as key element in product design** (increase in FDI might help insurers to raise capital required for certain capital intensive product innovations)
- **Lobby with government to increase tax benefits** available on long term insurance products and design products to tap these benefits

Any Questions?

Thank you!