INSTITUTE OF ACTUARIES OF INDIA

EXAMINATIONS

30th May 2024

CP3 - Communication Practice

Time allowed: 3 Hours 15 Minutes (09.30 – 12.45 Hours)

Total Marks: 100

The Indian economy is eyed globally for the potential it carries and with the "Insurance for all" vision, targeted to be achieved by 2047 there are tremendous growth opportunities across the sector. Many investors want to capitalize upon the potential growth of this sector and are keen on acquiring a stake in the existing insurance firms, hence the market is witnessing an increase in Merger & Acquisition activities.

The Chairman of XYZ Capital is keen on purchasing a 10% stake in ABC Health Insurance Company and has asked his Transaction Head for a high-level due diligence report on the company's reserves and solvency position. You are a practising consultant running your independent actuarial firm and the Transaction Head has appointed you to conduct this exercise.

Q. 1) Based on the information available to you about the company, you need to draft a short report for the Transaction Head (800 to 1000 words), highlighting the key findings of your analysis. Extract for preparation of your report is shared below. **[90]**

Q. 2) While drafting your response above what are some of the terms you considered as jargon and left out of your reply or explained in detail/ simple language so that a non-actuarial/ non-technical person can understand them? **[5]**

Q. 3) Given that the Transaction Head has asked you to prepare a summarised report, one way to make your communication effective is by leaving out some information which may not be relevant for the purpose of discussion. Explain what information you considered as irrelevant and did not use in the note. **[5]**

<u>Extract of high-level Information for preparation of report (please note that the information provided below has been created for the purpose of this examination and is fictitious with no reference to any company or individual) is provided below.</u>

Financial Year 2023 refers to the period 1st January 2023 to 31st December 2023. Similar definitions apply for previous financial years i.e. FY 2022 and FY 2021.

1. Post the COVID 19 pandemic, the Health Insurance Industry is witnessing a boom globally as people are becoming more aware of the importance of health insurance which provides financial security to the family of the insured impacted by any illness/ disease.

2. ABC Health Insurance is one of the leading stand-alone health insurance companies in India with a market share of 4.7% of the total health insurance industry in Financial Year 2023 (FY 2023). The company has been in existence for 14 years in the Indian market since its inception in 2010.

3. Company's management is spearheaded by the CEO Mr. Bulgaria who has been holding this position for the last 5 years. Company's Key Management Personnel saw a significant change in 2023 with appointment of:

   a) Mr. Austria as the Chief Financial Officer – He has over 20 years of experience holding Senior level position at two of the largest non-life insurers. He is known to be a very sharp and blunt person with good control over the financial management of the company.

b) Ms. Greece as the Chief Investment Officer – She carries over two decades of experience in the Financial Markets and it's her first stint with an insurance firm. She is razor sharp and leverages the market dynamics well to maximise returns on large size portfolios.

c) Ms. Ireland as the Appointed Actuary in 2023 – She has total experience of 15 years with 7 years of post-qualification experience. She is known for her innovative contributions to the industry in the area of Product design and business strategy. She also has good control over Reserve & Solvency management and has a good reputation in the market.

These sharp hires from the market have created a lot of buzz as change in management is expected to bring in changes to the policies and processes of running the business.

4. The Non -Life Industry's Gross Written Premium (GWP) grew at 16% and stand-alone health insurance players grew at 33% in FY 2023. Company (i.e. ABC Health Insurance) Gross Written Premium grew at 27% in FY 2023 with the split by line of business illustrated in the table below.

Table 1: Gross Written Premium (in Crores)

Line of business/ Financial Year	2021	2022	2023	Growth 2021 – 22	Growth 2022 - 23
Indemnity	2,500	3,000	3,800	20%	27%
Personal Accident	45	53	63	18%	19%
Travel	2.5	3	4.5	20%	50%
Total	2,548	3,056	3,868	20%	27%

a) Company primarily sells Indemnity products i.e. 98% of the total portfolio with Personal Accident & Travel constituting the remainder 2%. Indemnity products are those which cover for the medical expenses of the insured – inpatient and outpatient costs. Personal Accident provides financial indemnity to the Insured's beneficiary in case of accidental death and Travel Insurance covers the medical expenses of the insured incurred during travel – domestic & international.

b) Within the Indemnity product company sells 65% of its business to the Retail Customers via Aggregator platforms, Direct Sales Forces and Agents, while Group business is primarily sold by Corporate Agents/ Brokers or Company's Direct Sales Force.

c) The Indemnity products offered by the company cover the insured for a period of 1 year only and are renewable every year at the then prevailing premium rates. The premium rates vary by age of the insured and the coverage options selected by the insured.

d) Company has launched many sales campaigns through social and digital media to strengthen its brand among the customers in order to increase its premium volume.

5. **Business Retention:**

a) Net Written premium is defined as the Gross Written Premium minus the Premium ceded to the reinsurer.

b) Company has reinsured 20% of its portfolio with reinsurers which are rated A and above.

c) Company has entered in proportional quota share arrangement with the reinsurer.

Table 2: Net Written Premium (in Crores)					
Line of business/ Financial Year	2021	2022	2023	Growth 2021 – 22	Growth 2022 – 23
Indemnity	2,000	2,400	3,040	20%	27%
PA	36	42	50	18%	19%
Travel	2	2	4	20%	50%
Total	2,038	2,445	3,094	20%	27%

6. Company writes more business in the second half of the year which is reflected in the Earned Premium for the financial year.

Table 3: Net Earned Premium (in Crores)					
Line of business/ Financial Year	2021	2022	2023	Growth 2021 – 22	Growth 2022 – 23
Indemnity	1,798	2,124	2,662	20%	27%
PA	33	38	46	18%	19%
Travel	2	2	3	20%	50%
Total	1,833	2,164	2,710	20%	27%

7. Company's Expense Ratio as a percentage of Gross Written Premium stands at 25% in FY 2023 reporting a drop from FY 2022 illustrating efficiencies of expense management. The average expense ratio for other stand-alone health insurers stood at 26% in FY 2023 indicating better expense management against other stand-alone players in the market.

a) Company's major proportion of the expenses are spent in meeting the salaries of its employees which is ~65%.

b) Marketing and Advertisement spends constitute ~15% of the expenses incurred by the company.

c) Remaining is spent on travel, printing & stationery, legal & professional charges, and others.

Table 4: Expense as a % of Gross Written Premium			
Financial Year	2021	2022	2023
Expense Ratio	28%	26%	25%

8. Company's Commission Ratio as a percentage of Gross Written Premium stands at 6.5% in FY 2023 which is in line with the industry average of 6 % for other stand-alone health insurers. The company's Commission ratio has improved on account of moving to Direct selling channels thereby reducing the commission payouts.

a) Company has good relationships with its Corporate Agents/ Brokers and offers them high payouts to ensure high business volumes.

b) Company also has strong reinsurance partnerships giving it payouts as reinsurance commission.

Table 5: Gross Commission as a % of Gross Written Premium			
Financial Year	2021	2022	2023
Commission Ratio	7%	8%	6.5%

9. Reserve profile of the company is illustrated in the table below:

Table 6: Net Reserves reported			
Financial Year	2021	2022	2023
Net Unearned Premium Reserve	1,223	1,504	1,887
Net Outstanding Claims Reserve	385	454	341
Net Incurred but Not Reported Reserve	165	195	146
Net Premium Deficiency Reserve	-	-	-

a) Company writes higher volumes of business in the second half of the year, and this is reflected in the Unearned Premium reserves booked by the company which is set on a straight-line basis.

b) The outstanding claims reserve set by the company are based on full reported claims amount to the company. However, the experience has shown that only 70% of the money is utilized to settle those outstanding claims. Recently the company aligned the outstanding claims reserve policy to its actual experience to allow for the impact of final settlement amounts so that reserves are not set on the prudent side. This is visible in the reduction of the Outstanding claims reserve as a percentage of the Net Earned Premium which has dropped from 21% in FY 2021 to 13% in FY 2023. While the prior approach was prudent of keeping the full reported amounts, the second approach is based on the actual experience and hence needs close monitoring.

c) The Incurred but Not Reported (IBNR)Reserve are calculated using the Chain Ladder method, Bornhuetter Ferguson Method, Loss Ratio method on Paid and Incurred triangles. It is also observed that the company has optimised its IBNR as it shows a reduction from 9% of the Net Earned Premium in FY 2021 to 5% in FY 2023. This appears to be significantly low in comparison to the industry benchmarks which lie between 8% to 15%.

d) It appears that company has optimised both Outstanding and IBNR reserves which has resulted in profits in the FY 2023.

10. The net incurred claims as a percentage of the net earned premiums are illustrated in the table below:

Table 7: Net Incurred Claims as a % of Net Earned Premium			
Financial Year	2021	2022	2023
Claims Ratio	64%	66%	55%

a) Net Incurred Claims = Claims Paid + Change in Reserves. The claims paid proportion over the years has not changed much i.e. remained at 61% of the Net Earned Premiums for the last two years.

b) We observe a significant drop in the claims ratio which is on account of the drop in reserves as explained above.

c) There have been no changes in the claim settlement processes set by the company i.e. there has been no reduction in claim reporting or claim payment period.

11. Because of the above reported changes, it is observed that the company turned profitable in FY 2023 while reporting a marginal underwriting profit of INR 4 Crores.

12. The Investment return of the company in FY 2023 stand at ~7% which is a little below the industry average of ~7.8% thereby providing scope of making better investment choices for the company.

13. Company's solvency ratio stands at 174% in FY 2023 which is above the regulatory requirement of 150%.

a) However, this is sustained on account of additional capital of INR 150 Crores which was pumped in FY 2022 to help company sustain its solvency position. In case this capital was not injected by the shareholders, the solvency ratio of the company would have marginally met the regulatory requirement of 150%.

b) Also, the inadmissible assets which do not contribute to the Available Solvency capital has increased in the last two years on account of increase in receivables greater than 180 days resulting in lowering of the available capital.

Table 8: Solvency Ratio			
Financial Year	2021	2022	2023
Required Solvency Capital	400	480	608
Available Solvency Capital	877	873	1,056
Solvency Ratio	219%	182%	174%

c) As a major step to transition towards the Risk Based Capital, the regulator had initiated Quantitative Impact Study to analyse the impact of model on the capital and solvency position of each insurance company. The results of this exercise illustrated a drop in solvency ratio across the insurers which is illustrated in the table below:

Table 8: Impact Assessment solvency ratio as at 31st December 2023			
Company	ABC Health Insurance	Other standalone Health Insurers	Overall insurance market
Solvency Ratio – Existing Methodology	174%	212%	183%
Solvency Ratio – Risk Based Capital approach	155%	189%	163%

- While it is observed that the Solvency ratio for all the players in the market dropped under the Risk Based approach, the companies are still well capitalised to meet the regulatory requirement of 150%.

- The solvency ratio for ABC Health Insurance is way below other standalone Health Insurers i.e. 174% vs. 212%. The impact of Risk Based approach is more pronounced on the other standalone Health Insurers i.e. a drop of 23% vs. a drop of 19% for ABC Health Insurance.

At an overall level, while the company is one of the oldest stand-alone health insurers in the market, the company is putting in concerted efforts to drive efficiencies across all its domains i.e. expense management, claims management, sales enhancement through different channels and many other initiatives to make this venture the insurer of choice for both policyholders and shareholders.

It is believed that change in management has been a strategic move to bring in the above-mentioned efficiencies to improve the topline and bottom-line. Company has aggressive growth plans for FY 2024 and projects to grow at 35% in order to increase its market share. The company plans to reprice some of its marquee products to allow for the reduced claims and expense ratio thereby making it competitive in the market. Management believes this will add volume and increase both topline and bottom-line.

Company had not reported any regulatory issues in the past and has a good reputation in the market.

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