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Case Study : Expense of Management Regulations

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About the Guide: Mr.Venkatakrishna Narayana

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- Mr.Venkatakrishna Narayana is a Qualified Actuary and a Fellow Member of Institute of Actuaries of India.
- He Started his career in Life Insurance Corporation of India in the year 1990.
- He worked in several organisations during the span of around 34 years
- He worked as CRO in Bajaj Allianz Life Insurance
- He has started his own consultancy from the year 2019 and currently he is involved in his consultancy job.

Agenda

- Case Study
- Brief Description of applicable Regulation and APS
- Possible Implication of Regulatory Change
- Role of Valuation Actuary, With Profit Actuary and Peer Reviewer
- Discussion on Case Study scenarios
- Summary

Life Insurance Technical Case Study

- As part of regulatory changes, the commission limits are made part of overall expense limits and removed specific commission limits. As a result, these limits are now set by the Company through a Policy.
- With these changes following scenarios are feasible:
  - ✓ Scenario 1 : no changes to commission or expenses
  - ✓ Scenario 2 : increase commission with corresponding reduction in expenses
  - ✓ Scenario 3 : increase in commission with no change in expenses
  - ✓ Scenario 4 : different commission / expenses for different channels

Life Insurance Technical Case Study (contd.)

- These may have an impact on actuarial assumptions, asset share calculations and so on.
- Issues to be covered are Technical as well as professional aspects from the perspectives of
  - ✓ Valuation Actuary
  - ✓ Independent Actuary of WPC
  - ✓ Peer reviewing Actuary

Applicable Regulations and APS

- Applicable Regulations:
  - ✓ IRDAI Expense of Management, including commissions of Insurers Regulations, 2024
  - ✓ IRDAI Actuarial, Finance and Investment Functions of Insurers Regulations, 2024
  - ✓ Master Circular on Actuarial, Finance and Investment Functions of Insurers
- Applicable Actuarial Practice Standard/Guidance Note:
  - ✓ Actuarial Practice Standard (APS 1)
  - ✓ Actuarial Practice Standard (APS 2)
  - ✓ Actuarial Practice Standard (APS 4)
  - ✓ Actuarial Practice Standard (APS 7)
  - ✓ Guidance Note (GN 6)

Regulatory Change - Expense of Management

- IRDAI amended regulations pertaining to expenses of management (EoM) and payment of commissions in March 2023 & April 2024.
- Replacement of earlier cap on commission payments with an overall cap on Expenses of Management
- Amendments aimed to strike balance between operational flexibility and regulatory oversight
- Streamline monitoring process for life insurance
- Every insurer shall have board approved policy for
  - ✓ Expenses of Management
  - ✓ Payment of commissions
  - ✓ Business plan prior to the commencement of the FY

Key Regulatory Provisions under IRDAI (EoM, including commission of Insurer) Regulations, 2024

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- EOM policy shall specify manner of allocation and appropriation of expenses amongst various business segments
- AA and CFO shall be responsible for the allocation and appropriation of the EOM in accordance with Board approved policy.
- Revision of EOM policy along with its implications on various segments shall be disclosed under note to accounts
- Board approved Business Plan prior to the FY at the minimum cover projections of capital requirement, solvency margin and expense of management for the next financial year
- Total actual EOM during the FY is sum of
  - amount of commission paid in respect of business transacted in the FY;
  - commission and operating expenses reimbursed on Reinsurance inward;
  - operating expenses of life insurance business

Life Insurance Business - EOM Limits

Product Type	Single Premium / First Year premium	Renewal Premium/ Annuities / SA
Immediate Annuity - Single Premium	5% of Single Premium (SP)	0.75% of annuities
Deferred Annuity - Single Premium	5% of SP	0.75% of annuities
Pure Risk Policies - Single Premium	Individual - 14% of SP Group – 10 % of SP	
Deferred Annuity & Pensions – More than one premium	15% of First Year Premium	6% of Premium of RP 0.75% of annuities
Regular premium pure risk business	With PPT >=10 : 100% of FY Premium	25% of Premium of RP
	With PPT<10 : 7.5 times of number of whole years	
Other Individual Product	With PPT >=10 : 80% of FY Premium	17.5% of Premium of RP
	With PPT<10: 7.5 times of number of whole years	
1 year renewable group plan	15% of Premium	
Group Fund Based Plan (Avg. AUM)	AUM<=10000 Cr: 1% of AUM	
	AUM>10000 Cr : 0.8% of AUM	
Paid up policies	One-tenth of one per cent of the average of the total SA	
Lapsed policy under the revival period	One-fiftieth of one per cent of the average of the total SA	

Key Regulatory Provisions under IRDAI (EoM, including commission of Insurer) Regulations, 2024

- Allocation of allowable expenses:
  - ✓ Insurtech expenses and insurance awareness expenses to the extent of 5% of allowable EOM
  - ✓ Additional limit up to 15% of the incremental premium over previous year towards Rural sector business, PMJJBY or any other schemes as specified by Authority.
  - ✓ Additional allowable expenses not exceeding 5% of Gross direct premium written outsider India through branch office or having IFSC insurance office
- Insurers shall ensure EOM are within the allowable limits on the Participating and Non-Participating policies on overall basis respectively.
- Overrun above overall limits of expenses of management for Participating and Non-Participating policies shall be charged to Profit & Loss Account.

Applicable Provisions as per IRDAI(Actuarial, Finance and Investment Functions of Insurers) Regulations 2024

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- Mathematical Reserves shall be determined for each contract by a prospective method of valuation.
- GPV method of valuation shall discount future Policy cash flows including Commission & remuneration payable and Policy maintenance expenses in respect of a policy at an appropriate rate of interest
- Valuation Parameter - Policy maintenance expenses
  - ✓ Shall have regard to the actual expenses experience
  - ✓ All expenses shall be increased in future year for inflation
  - ✓ The rate of inflation shall be consistent with the valuation interest
  - ✓ Appropriate additional shall be made if actual experience has not been considered in the valuation

Applicable Provisions as per IRDAI(Actuarial, Finance and Investment Functions of Insurers) Regulations 2024

- The value of each such parameter shall be based on the insurer's expected experience and shall include an appropriate MAD
- Level of MAD dependent on the degree of confidence in the expected level
- MAD in each parameter shall be based on the Actuarial Practice Standards
- Prudent assumptions of all relevant parameters

Key Actuarial Practice Standard/Guidance Note

As per Actuarial Practice Standard 2:

- Provided there is MAD in valuation interest rate, then it is sufficient for AA to ensure that there is MAD in difference between valuation interest rate and valuation inflation rate

As per Actuarial Practice Standard 7:

- Actuary is required to exercise professional judgment in determining the appropriate level of MADs, with prime consideration as protection of interest of existing policyholder, including reasonable PRE
- Actuary should consider the past experience of the company concerned
- Minimum Adverse scenario: Management expenses are 10% more than the best estimate assumptions and increase at a rate, which is consistent with the assumed interest rate on new money

Key Actuarial Practice Standard/Guidance Note(contd.)

As per Guidance Note 6:

Expense Allocation :

- The amount of expenses charged to the participating funds
  - ✓ Expenses allocation would be straightforward for certain items, such as commissions
  - ✓ Appropriation of many other expenses items will be subjective, in that case AA should judge whether the basis of the allocation adopted is reasonable, given the nature of the expense.
  - ✓ Document the basis of allocation of expenses
  - ✓ Basis of allocations shall not be subject to arbitrary changes from year to year.

Key Actuarial Practice Standard/Guidance Note(contd.)

- The amount of expenses charged to the historical asset share of policies
  - ✓ Level of expenses allocated to asset shares consistent with PRE
  - ✓ Acquisition expenses known with greater certainty, less scope to depart from the level of expenses implicit in any BI. AA shall document any such departure.
  - ✓ Where the expenses allocated to the fund exceed those allocated to the asset shares, AA should consider the reasons for this, and be satisfied that the approach:
    - is sustainable;
    - is not, by its effect on the estate, expected to affect PRE adversely and materially; and
    - is appropriately reflected in the expenses assumed in the statutory valuation of liabilities.

Possible Implication of Regulatory Change

- Possible changes due to the change in Regulations:
  - ✓ Company's business strategy
  - ✓ Product Design & Pricing
  - ✓ Commission and expenses structure
  - ✓ Allocation and appropriation of expenses
  - ✓ New business mix and business volume
  - ✓ Persistency experience
  - ✓ Valuation assumptions and Reserves
  - ✓ Basis for Asset share computation
  - ✓ Asset share
  - ✓ Benefit Illustration
  - ✓ Profit Margin
  - ✓ Available and Required Capital & Solvency Margin
  - ✓ Ease of compliance with the Regulations

Role of Valuation Actuary

- The job of Valuation Actuary may be to facilitate Appointed Actuary in discharging his/her duties related to valuation exercise
- Relating to Expense of Management, the responsibilities of Valuation Actuary entails:
  - ✓ Ensuring credibility and correctness of data
  - ✓ Investigation to validation the expense allocation and apportionment of expenses
  - ✓ Policy maintenance expenses shall have regard to the actual expense experience of the insurer and shall be increased in future years with inflation
  - ✓ Setting the best estimate expense assumption including expense inflation
  - ✓ Determination of Margins for Adverse Deviation (MAD) in compliance with APS7
  - ✓ Grouping of policies for the purpose of bonus investigation and declaration
  - ✓ Assist Appointed Actuary in rendering actuarial advice in respect of expense of management of the insurer
- **Facilitate Appointed Actuary in preparing actuarial report and abstract and also other returns**

With-Profit Committee

WPC requirement as per IRDAI(Actuarial Functions) Master Circular

- With-Profits committee shall be constituted with at least the following members: One Independent Director of the Board, the CEO, the CFO, the Appointed Actuary and an Independent Actuary.
- Role of Independent Actuary of WPC related to expense of management involves review of the following:
  - ✓ Appropriateness of the Methodology and basis used in calculation of asset shares as mentioned
  - ✓ Assess the expense debited to with profit fund and hence expense basis in the asset share calculation and justification of any change
  - ✓ Assessment of impact of expense of management on bonus earning capacity
  - ✓ Sensitivity analysis of bonus rates and basis as appropriate
  - ✓ Understanding impact of expense on PRE
  - ✓ Any change in special surrender value (SSV) with justification
  - ✓ Plausible impact on FFA

Peer Reviewing Actuary – APS4

- The role of Peer Reviewing Actuary is defined in Actuarial Practice Standard 4 (APS 4).
- The work being reviewed is carried out in order to meet regulatory requirement for which Appointed Actuary holds Certificate of Practice.
- Peer review is intended to be of high level
- Peer review could be confined to reviewing results for reasonableness rather than carrying out specific checks
- Scope of Peer Reviewer:

  Related of expense of management, the peer review to cover all relevant and significant aspects of the actuarial work relating to the annual statutory actuarial valuation, including **review of**

  - ✓ data collection and verification,
  - ✓ selection of assumptions,
  - ✓ selection of analytical methods,
  - ✓ calculations, results and conclusions
  - ✓ Further, the aspects relating the systems, processes and controls adopted in the above matter also should be covered.

Scenario 1: No Change in commission or expenses

Perspective of Valuation Actuary:

- Validation of data should confirm no change in commission and expenses
- Allocation and apportionment of expense may remain same
- Commission rate for each policies should be as per the actual commission payable
- Best estimate assumption for expense may remain same
- Since no change in Best estimate expense assumption, MAD might not require update and needs to be in compliance with APS2 & APS7
- Reserve per policy might not see material impact

Scenario 1: No Change in commission or expenses (contd.)

Perspective of Valuation Actuary:

- Expenses deducted from asset share may not change
- With no change in expense and commission, BEC may not require change
- May not have much impact on Reserving and Capital Requirement

Scenario 1: No Change in commission or expenses (contd.)

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Perspective of Independent Actuary of WPC:

- The expenses debited from with profit fund may remain same
- Expense in the asset share calculation may not change
- Asset share movement may remain same, as no change in commission and expense
- Due to above BEC may remain same
- PRE is expected to be remain at the same level
- SSV should remain same
- May not have much impact on FFA

Scenario 1: No Change in commission or expenses (contd.)

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Perspective of Peer Reviewing Actuary:

- Level of commission and expense should be validated from the data
- Commission and expense should be consistent with company's Board approved expense and commission policy
- Best estimate assumption for expense to reflect the current proposition
- Reserving method may remain same
- System, process and control adopted may not change

Scenario 2: Increase commission with corresponding reduction in expenses

Perspective of Valuation Actuary:

- Data validation should confirm the proposition
- Increase in commission may lead to surge in business volume (assuming Premium rate remains same as the total expenses remains unchanged)
- Economies of scale might be achieved from increased business scale
- Persistency may improve if tail based commission rate is increased
- Renewal expense may reduce leading to reduction in policy cashflow
- Increased commission to be reflected in policy cashflow

Scenario 2: Increase commission with corresponding reduction in expenses(contd.)

Perspective of Valuation Actuary:

- Best estimate expense assumption would be reviewed in light of reduction in expenses and emerging experience
- MAD for expense required to be set in compliance with APS2 & APS 7 considering for cushion required over changed Best estimate expenses and emerging experience
- MAD could either remain same or increased due to uncertainty
- Reserve might increase due to prudent assumptions for expense and increased persistency

Scenario 2: Increase commission with corresponding reduction in expenses (contd.)

Perspective of Valuation Actuary:

- Overall capital requirement may increase if number of policies in book increase
- Solvency ratio could reduce from increased NB volume because of prudent assumption in reserve
- Solvency might improve in future
- Increase in commission and corresponding reduction in expenses may have impact on asset share movement
- BEC may increase or decrease depending on the level of asset share, reserve and capital requirement

Scenario 2: Increase commission with corresponding reduction in expenses (contd.)

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Perspective of Independent Actuary of WPC:

- There may be change in apportionment of unallocated expenses from increased sales leading to change of expense under with profit line of business
- Expense allocation in asset share calculation may change in light of reduction in expenses
- However, asset share could increase or decrease from impact of apportionment of unallocated expenses for With Profit Business
- The commission debited from Asset Share should reflect the increase in commission

Scenario 2: Increase commission with corresponding reduction in expenses (contd.)

Perspective of Independent Actuary of WPC:

- Bonus Earning Capacity might be impacted with the change in expenses
- PRE consistent with BEC may be set at new level for the new products
- SSV may change and should reflect the current asset share movement
- FFA may change depending on the quantum of available With profit fund and reserve

Scenario 2: Increase commission with corresponding reduction in expenses

Perspective of Peer Reviewing Actuary :

- Data should validate the increased commission and reduced expense
- Best estimate assumption for expense should reflect reduced expenses
- Reserve cashflow should show increased commission
- Mathematical model and reserving methodology may remain same
- System, process and controls adopted should justify the current scenario

Scenario 3: Increase in commission with no change in expenses

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Perspective of Valuation Actuary :

- Data should validate the proposition
- Increase in commission (with no change in expense) may result in higher business volume
- If tail based commission is increased, the persistency experience may improve
- However, increased commission may lead to increase in premium rates unless profit margin is reduced
- This may have adverse impact on the business volume
- Apportionment of unallocated expense may change depending on the growth or reduction in business volume across line of business

Scenario 3: Increase in commission with no change in expenses(contd.)

Perspective of Valuation Actuary :

- Best estimate expense assumption in the subsequent valuation may decrease if business volume increase
- Or Best estimate expense assumption may increase if there is reduction in business volume
- Per policy expense inflation assumption in the subsequent valuation may also change upwards/downwards
- Long term experience after the change of regulation may not have emerged due to which cushion required over and above the best estimate expense assumption may change

Scenario 3: Increase in commission with no change in expenses(contd.)

Perspective of Valuation Actuary :

- Hence, need to exercise judgement in setting MAD in compliance with APS 7 and APS 2
- Reserve per policy may increase if renewal commission is increase. Reserve may further increase in future if the renewal expense assumption is increased and vice versa
- Reserve may also increase if persistency experience improves and vice versa
- Increase in reserve may lead to increase in capital strain
- Increase in commission (first year) may also lead to increase in capital strain
- Depending on the volume of business, the overall capital requirement may increase or decrease

Scenario 3: Increase in commission with no change in expenses(contd.)

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Perspective of Valuation Actuary :

- Commission level will increase in the asset share calculation
- First year/Renewal expense in the asset share may decrease if business volume grows and vice versa
- Overall, asset share movement may change
- BEC may increase or decrease depending on the level of asset share, reserve and capital requirement

Scenario 3: Increase in commission with no change in expenses (contd.)

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Perspective of Independent Actuary of WPC

- With profit business volume may increase or decrease as a result of the proposition
- Apportionment of unallocated expense may change leading to change of expense level under with profit line of business
- Best estimate expense assumption in the subsequent valuation may decrease if business volume increase and vice versa
- Per policy expense inflation assumption in the subsequent valuation may also change upwards/downwards

Scenario 3: Increase in commission with no change in expenses (contd.)

Perspective of Independent Actuary of WPC

- Accordingly, First year/Renewal expense in asset share calculation may change
- The commission debited from Asset Share should be consistent with the proposition
- Asset share movement may undergo change as a result of change in commission and possible change in expense
- Reserve may increase due to increase in renewal commission and it may further increase in future if the renewal expense assumption is increased or vice versa
- Capital requirement may change as result of increase in commission (first year) and change in reserve
- Change in asset share level, reserve and capital may lead to change in BEC

Scenario 3: Increase in commission with no change in expenses (contd.)

Perspective of Independent Actuary of WPC

- BEC may possibly increase if increase in commission may lead to surge in business and thereby disproportionate reduction in renewal expense as compared to increased commission or vice versa
- Sensitivity of the BEC with change in expense level may be performed to assess the impact of change in long term expense level on BEC
- PRE consistent with BEC may be set at new level for the new products
- SSV should reflect the current asset share movement
- FFA may change depending on the quantum of available with profit fund and reserve

Scenario 3: Increase in commission with no change in expenses (contd.)

Perspective of Peer Reviewing Actuary :

- Ensure that increased level of commissions are appropriately considered in the valuation
- Best estimate assumption for expense should reflect the proposition
- Reserving assumption shall reflect the increased commission and expense proposition
- Mathematical model and reserving methodology may remain same
- System may be may be checked to ensure increased level of commission is accommodated
- Process and controls adopted should reflect the proposition

Scenario 4: Different commission/expense for different channel

Perspective of Valuation Actuary :

- Validation of data should confirm the proposition
- Different commission/expense level for different channel may lead to different premium rates across different channel
- The business volume will vary widely across the channels
- Apportionment of unallocated expense may change
- Best estimate expense assumption in the subsequent valuation may increase or decrease depending on overall reduction or growth of the business volume across all channels

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Valuation Actuary :

- Per policy expense inflation in the subsequent valuation may also change upwards/downwards
- Long term experience after the change of regulation may not have emerged due to which cushion required over and above the best estimate expense assumption may change
- Hence, need to exercise judgement in setting MAD in compliance with APS 7 and APS 2
- Depending on overall change in renewal commission and renewal expense, reserve per policy may increase or decrease

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Valuation Actuary :

- Depending on the efficiency of the channel and level of tail based of commission persistency may vary across the channel
- Reserve may increase if persistency improves and vice versa
- Change in reserve may lead to changed capital requirement
- Different commission level(first year)/acquisition expense may also lead to different capital requirement
- Depending on the overall volume and mix of the business, the capital requirement may changes

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Valuation Actuary :

- Commission in the asset share calculation may change across various channel
- First year/renewal expense in the asset share may change
- Overall, asset share movement may change as result of this proposition
- BEC for the new product may be different depending on the level of asset share, reserve and capital requirement
- BEC variation across the channel may not be significant as expense deduction from asset share for a particular line of business may be same.
- PRE for the new product may be set at new level consistent with BEC

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Independent Actuary of WPC

- May have an impact on With profit business in terms of increase/decrease in volume
- Apportionment of unallocated expense may change leading to change of expense level under with profit line of business
- Best estimate expense assumption in the subsequent valuation may increase or decrease depending on overall reduction or growth of the business volume across the channels
- Per policy expense inflation in the subsequent valuation may also change upwards/downwards
- Reserve may also change due to possible change in renewal expense and also change in renewal commission

Scenario 4: Different commission/expense for different channel (contd.)

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Perspective of Independent Actuary of WPC

- Reserve may also change due to changed persistency experience across the channel
- The commission and expense debited from Asset Share should reflect channel wise variation
- Asset share movement may undergo change as a result of change in commission and possible change in expense
- Capital requirement may change as result of change in First year commission/Acquisition expense and change in reserve
- Change in asset share level, reserve and capital may lead to change in BEC

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Independent Actuary of WPC

- BEC may possibly increase if there is overall reduction in commission and channel efficiency lead to surge in business volume and thereby reduction in renewal expense
- Or it may be vice versa
- Sensitivity of the BEC with change in expense level may be performed to assess the impact of change in long term expense on BEC
- Variation of BEC across the channel may not be significant as the expense deduction from asset share for a particular line of business may remain same.

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Independent Actuary of WPC

- PRE for the new product may be set at new level consistent with BEC
- SSV should reflect the current asset share movement
- FFA may change depending on the level of available with profit fund and reserve

Scenario 4: Different commission/expense for different channel (contd.)

Perspective of Peer Reviewing Actuary:

- Ensure that channel wise commission structure are appropriately considered in the valuation
- Best estimate assumption for expense should reflect the proposition
- Cashflow of Reserve calculation shall reflect the channel wise commission and expense proposition
- Mathematical model and reserving methodology may remain same
- System may be checked to ensure that different level of commission is accommodated
- Process and controls adopted should reflect the proposition

Summary

General

- Relevant regulations and APS shall be complied with respect to valuation of liabilities along with its peer review
- Professional conduct standards issued by IAI shall be ensured while carrying out actuarial activities such as Actuarial valuation, peer review and role of independent Actuary of WPC.

Valuation Actuary

- The allocation and apportionment of the expenses needs to be reviewed in light of the change.
- Revision of best estimate expense assumptions based on emerging experience.
- Determination of MAD for expense should be appropriate taking into consideration the future uncertainty.
- Change in expenses and commissions shall be appropriately reflected in the estimation of Mathematical Reserve.
- Need to ensure asset share and BEC calculation reflect the proposition
- Need to review grouping of polices for ensuring equity
- Need to review the impact on SSV across various segments

Summary (contd.)

Independent Actuary of WPC

- The expense debited to the asset share should be reasonable.
- Asset share calculation and it’s movement should appropriately reflect the change in commission and expense.
- Any change in SSV should be justified.
- The grouping of policies, asset share calculation and BEC shall ensure PRE and equity between different groups of polices.
- Need to assess the impact on FFA will depend on the existing with profit funds and the reserves

Peer Reviewing Actuary

- Peer reviewer should ensure that the data reflects the proposition of the change in commission and expense
- Review the methodology used for the allocation and apportionment of the expenses
- Review the appropriateness of the methodology for calculation of the reserves
- Review the system, controls and process

Thank You