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Utilization of Surplus in a With-Profits Life Insurance Company: Options and Considerations

Guide :

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Life Insurance Technical Case Study

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You are a Valuation Actuary in a large life insurance company. The Company has a **large with-profits book** and generating surplus from all **sources of surplus including from lapses / surrenders.**

Over the years the company has accumulated surplus and one of the Directors of the Board has raised a question on **how and when this surplus will be put to use.** You have been asked to **present various options that are available** for the consideration of the Board.

Discuss the **options** that you would present along with various **factors that you would consider** in arriving at these options.

Agenda

- With-Profits Business - Overview
- Surplus
- Sources of Surplus
- Distribution of Surplus
- Professional Guidance
- Factors leading to accumulation of Un-allocated Surplus
- Options & considerations for Utilization of Accumulated Surplus
- Conclusion

With-Profits Business - Overview

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With-profits or participating life insurance product is a type of product where the policyholders are entitled to share in the surplus (profits) of the life insurance company.

Regulatory reference:

- **IRDAI Actuarial, Finance and Investment Functions of Insurers Regulations, 2024 - Part I of Schedule-I**
  "Par policies" or "policies with participation in profits" means polices which are entitled to share in surplus (profits) during the policy term as per Section 49 of the Insurance Act, 1938.

- **IRDAI Insurance Products Regulations, 2024** states that only non-linked products can be offered under with-profits category.

With-Profits Business - Overview

With-profits policyholders have the **right to participate** in the **surplus (profits)** generated in the **participating fund**. The participation is through receiving bonuses under their policies.

Regulatory reference:

Insurance Act, 1938 – Section 49

- The bonus shall only be paid out of the surplus generated that is computed by actuarial valuation. The share of any such surplus allocated or reserved for the shareholders shall in no case exceed 10% of such surplus in case of participating policies and in other cases the whole thereof.

IRDAI Actuarial, Finance and Investment Functions of Insurers Regulations, 2024 -

- **Clause 1(1) of Part III (C) of Schedule-I -** A life insurer is required to maintain separate funds for participating and non-participating policyholders. Non-Compliance with the requirement shall mean that the life fund maintained by the insurer shall be for the benefit of the participating policy holders only.
- **Clause 5 of Chapter II** - Every insurer shall have a board approved Bonus distribution policy
- **Clause 2(2) of Part III (C) of Schedule-I -** One-ninth of the surplus is to be allocated to participating policyholder. Provided that an insurer shall however be required to obtain prior approval of the Authority in cases where the said allocation is not the one-ninth of the surplus.

Surplus

Surplus (profits) here refers to excess of value of assets over the value of policyholder liabilities. **Surplus arising** over a period can be defined as the change in the amount of the surplus in the inter-valuation period.

Surplus **arises** as a result of differences between what was expected to happen in accordance with the statutory valuation assumptions and what actually happened. Any change in the valuation assumptions themselves will also give rise to positive or negative surplus.

We can categorise the sources of surplus into **“Variance in experience”** and **“other applicable sources”.**

Sources of Surplus

- Variance in experience
  - Economic Variances
    - Investment returns
    - Inflation
    - Currency exchange movements
  - Non-economic/Insurance Variances
    - Mortality
    - Morbidity
    - Persistency
    - Expenses
- Change in underlying valuation assumptions
- Other applicable sources of surplus
  - Profits from non-participating business written in participating fund
  - Contribution from Shareholders
  - One-Off Favorable experience

Distribution of Surplus (1/2)

- The surplus from various sources as mentioned are distributed to:

Policyholders' Fund

Distribution of Surplus (2/2)

Board Approved Company Bonus Distribution Philosophy in accordance to the IRDAI (Actuarial, Finance & Investment Functions of Insurers) Regulations, 2024 provides the framework for the distribution of surplus within the company.

Things generally covered under this philosophy:

- The approach to setting reversionary and terminal bonuses;
- Guidelines on the extent to which reversionary bonuses may be changed from one year to another
- The proportion of asset share targeted for maturity claims payouts
- The treatment of “Funds for Future Appropriations (FFA)”

Professional Guidance

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- As mentioned under APS-1, should consider:
  - Policyholders' Reasonable Expectations
  - Sustainability of Bonus in future, including Terminal Bonus
  - Equitable and Fairness
  - Conduct of new business & investment strategy with due regards to financial resources
- GN6 stipulates to consider:
  - whether the surplus or deficit item forms part of the asset shares or is maintained within the fund
  - Grouping of policies

Factors leading to Accumulation of Un-allocated Surplus

The un-allocated part of the surplus accumulates over time and forms "Funds for Future Appropriation (FFA)". The un-allocated surplus might arise due to various factors.

- ❑ Company policies
  - E.g., Bonus Distribution Philosophy
- ❑ Deferring the distribution to meet financial aims:
  - E.g.,
    - Solvency Position
    - Optimistic New Business Outlook
- ❑ Closed Fund

Options & Considerations to utilize the Accumulated Surplus

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Assumptions

- The company has clear and established internal policies regarding bonus distribution, surplus management and investment strategies.
- The company complies with the Insurance Act 1938, IRDAI regulations, and relevant actuarial standards such as APS 1 and GN 6.
- The company writes both par and non-par business of base and rider policies.
- Company’s business is situated in India and all policies are written in INR only.
- The accumulated surplus means “Funds for Future Appropriations(FFA)”.
- The options recommended are in concurrence with the WPC committee.
- The options recommended are within the ambit of the File & Use Application.

Options to use the Accumulated Surplus

The following options are proposed to make use of the accumulated surplus:

A. Distribution of surplus in form of

1) Increased levels of regular bonuses
2) Special one-time bonus
3) Terminal Bonus

B. Retaining the surplus to

1) Enhance investment returns
2) Reduce volatility of bonuses
3) Reduce reinsurance cost
4) Augment financial position

The above options are not mutually exclusive and any combination of the options may also be chosen based on the composition of the accumulated surplus.

Options to use the Accumulated Surplus

Increasing the regular bonus (RB):

- Higher reversionary bonuses may improve persistency;
- Results in gradual increase of guarantees
- Releases part of the shareholders' share of surplus locked-in;
- Helps to meet the PRE

Considerations:

1) Suitability of source of accumulated surplus for RB:

- Accumulation due to company's bonus distribution philosophy, E.g.,
  - Gradually increasing RB with low initial levels;
  - Accumulated Surplus reflects the past under distribution and potential future increase;
- Fairly regular source, E.g.,
  - Undistributed portion of investment return from fixed interest securities or explicit bonus loadings in the policy;
  - Lapse and Surrender profit-if expected to follow regular pattern of emergence and is part of asset share;

Options to use the Accumulated Surplus

Considerations to increase RB (Cond…):

2) Policyholders' Reasonable Expectations (PRE): The level of increase and the rate of increase should be consistent with PRE.

3) Sustainability of the increase to be assessed in terms of :

- Bonus earning capacity of the policies ;
- Effect on reserves, capital requirements and solvency margin resulting from increase in vested bonus and expected future bonus increases;

4) Effect on solvency of the company:

- Increase in bonuses will rise the reserves & capital requirements thereby reducing the solvency margin;
- Increase in RB shall be restricted so that solvency ratio is at least at the regulatory minimum;

Options to use the Accumulated Surplus

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Considerations to increase RB (Cond…):

5) **Effect on free assets and business plan**:
   - Rise in capital requirements leads to reduction in the free assets over and above regulatory capital requirements;
   - This may reduce the capacity to accept the New Business in terms of nature (e.g. guaranteed business) and volumes;

6) **Smoothing policy of the company**: The decision whether the increased bonuses remain stable or subject to further gradual increase shall be consistent with the smoothing policy of the insurer.

7) **Future investment outlook:** E.g. if low interest rate scenario is expected, the company may tend to retain the surplus or restrict the increase in levels of bonus to cope with the increased reserving & capital requirements and decreased investment income.

Options to use the Accumulated Surplus

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Considerations to increase RB (Cond…):

8) **Competitive reasons**: Provided other important factors like sustainability, smoothing, effect on solvency are not compromised the company may Increase RB
   - to gain competitive advantage or if
   - existing bonus rates are not competitive and the accumulated surplus supports the raise in the rates

9) **Investment Freedom**: Increase in the RB increases guarantees hence the company may have to prefer more secured investments unless it has substantial free assets to absorb the losses from riskier investments.

10) **Equitability of the distribution between policyholders**: Bonus distribution should be consistent with the asset share of policies.

Options to use the Accumulated Surplus

Special bonus (SB):

- May be used to meet the guarantees on policies on their termination;
- Helps ensuring fairness of the allocation of surplus;
- If shareholders prefer immediate distribution of their share of locked-in surplus, this method is allows the same;
- As there is an immediate allocation of the surplus, the effects on capital requirements, solvency and release of shareholders' share would also be immediate.

Considerations:

1) **Suitability of source of accumulated surplus for SB :** Accumulation from Non-recurrent sources such as mentioned below may be considered for special bonuses

- Lapse/surrender profit of non-recurrent nature e.g. due to prevalence of Pandemic-The company may want to distribute the surplus without creating PRE on the bonus;
- Windfall gains due to changes in Regulations or Taxation;

Options to use the Accumulated Surplus

Considerations (SB) continued…:

- Closed Funds: If the company has any closed Par fund or acquired any Par liability closed to NB,
  - the accumulated surplus may result from past under distribution of surplus to be prudent on solvency of the fund
  - A series of special bonuses may be needed to minimize 'tontine' effect and to maintain the solvency
- Mergers/acquisitions: Valuation of liabilities of the acquired fund may result in surplus which may need immediate distribution to align the bonus structure of the merged fund;
- Accumulation of surplus in case of very long term policies: e.g. Undistributed surplus of a cohort of long term policies issued in a period are having significant outstanding term and company may feel that it is fair to distribute the surplus without any further delay;

2) **Effect on free assets and business plan**: As the guaranteed benefits increase, the reserves and capital requirements also increase-this reduces the free assets and hence capacity to accept the NB volumes and NB with guarantees and also capacity to opt for riskier investments.

Options to use the Accumulated Surplus

Considerations (SB) continued…:

3) **Effect on Solvency Ratio:** The solvency ratio after declaration of the bonus should be reasonably above the regulatory minimum level- e.g. as per the internal target solvency ratio.
4) **Investment outlook:** If the company is uncertain about the future interest rate scenario and expects this to affect the reserving and capital requirements adversely, it may defer the distribution to protect the solvency position.
5) **Policyholders' Reasonable Expectations (PRE):**Clear communication by the company regarding the non-recurring nature of the bonus is required so that no PRE are formed on such bonus.
6) **Equitability of distribution between policyholders and shareholders**-e.g. if the accumulation is mostly due to shareholders' contributions, company may tend to retain the surplus to augment the free assets than to distribute.
7) **Equitability of distribution within the policyholders**: Contribution by various products and cohorts of polices- e.g. issue year wise to be investigated and bonus allocation should be consistent with such contributions.

Options to use the Accumulated Surplus

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Terminal Bonus (TB):

- Helps ensuring equitability and fairness of the allocation of surplus meeting the PREs
- Releases shareholders' share of locked-in surplus

Considerations:

1) **Suitability of source of accumulated surplus for TB :**
    - Accumulation due to company's bonus distribution philosophy:
        - If the insurer's philosophy is to distribute major portion of the surplus as Terminal Bonus and the accumulated surplus reflects the effect of such deferment, TB can be opted to distribute the accumulation.

Options to use the Accumulated Surplus

Considerations (TB) continued…:

2) Accumulation may be used to increase the TB to

- ensure fairness of the distribution of the surplus, e.g.
  - to fund the shortfall of the statutory reserves over the asset share at the time of exit of a policy E.g., Capital gains on equity investments contributing to the accumulated surplus may be distributed as Terminal Bonus to the policies exiting;
  - to distribute the accumulated surplus from sources not forming part of the asset share: e.g. lapses/surrender surplus, rider surplus etc.

- meet the PRE defined in terms of Internal Rate of Return (IRR)

3) Effect on reserving, capital requirements and solvency:

- Reserving and capital requirements may increase if company reserves for rise in future TB to meet PRE;
- However, if not reserved, the ability of the company to meet future payments of unreserved terminal bonus needs to be assessed;
- Increase in capital requirements result in lowered solvency ratio
- The significance of the effect needs to be assessed before deciding on the level of TB to be declared

Options to use the Accumulated Surplus

Considerations (TB) continued…:

4) **Effect on financial and business plans:** If company reserves higher TB in future, the amount of free assets fall resulting lowered capacity to opt for the riskier investments and to write NB especially, with guarantees;
5) **PRE:** It shall be ensured that the PRE are not altered adversely to the company especially in case of distribution of the accumulated surplus not forming part of the asset share: e.g. lapses/surrender surplus, rider surplus etc.;
6) **Equitability of the distribution between policyholders and Shareholders** needs to be investigated-e.g. company may tend to retain the accumulation if
   - it is mostly due to shareholders' contributions like contribution to comply the regulatory limit on the Expenses of Management charged to the policyholders' account
   - it is from a source not intended to be part of the asset share e.g. rider surplus
7) **Equitability and fairness of distribution between the policyholders:**

- TB shall be supported by asset share unless there are guarantees on the policy or the company decides to pay over and above the asset share
- The levels of TB shall vary based on the type of exit E.g. -The level of TB payable on surrenders shall be lower than that payable on death

Options to use the Accumulated Surplus

Company needs to strike a balance between the above factors with primary considerations of PRE and solvency of the company

The considerations discussed are based on reversionary type of bonuses. However they are equally applicable for cash bonus system with following variations:

- *declared cash bonuses do not result in increase in reserve and capital requirements. However, solvency margin will be reduced due to fall in the assets*
- *Investment strategy may differ as the cash bonuses are immediately paid on declaration while for reversionary bonuses, cost of bonus needs to be invested to meet the guaranteed bonus in future*

Options to use the Accumulated Surplus

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The accumulated surplus can be kept as free assets and used to:

1) Enhance Investment Returns
   - By changing investment mix and strategy
     - E.g., increasing exposure to equity markets
   - The strategy could be different for assets backing the liabilities, targeted solvency capital and the free assets.

   - **Considerations**
     - Policyholders’ Reasonable Expectations
     - Bonus Distribution Philosophy
     - Level of Free Assets
     - IRDAI (Actuarial, Finance and Investment Functions of Insurers) Regulations, 2024) Schedule III- Clause 4 and Clause 8.

Options to use the Accumulated Surplus

2) Reduce Volatility of Bonuses

- Free Assets can be used to smooth bonus payouts
- Aids in improving persistency
- Instill confidence in existing as well as new generation of policyholders
- Provide competitive advantage in long run

- **Considerations**
  - Smoothing Policy
  - Policyholders' Reasonable Expectations
  - Competition
  - Treating Customers Fairly

Options to use the Accumulated Surplus

3) Reduce Reinsurance Cost

- Free Assets can be used to optimize reinsurance cost
- Reduction in Counterparty Risk
- Reduction in Administration Expenses

- **<u>Considerations</u>**
  - Reinsurance Treaty
  - Business Mix & Volumes
  - Cost Benefit Analysis
  - Level of Free Assets
  - Impact on Solvency Position
  - Policyholders' Reasonable Expectations

Options to use the Accumulated Surplus

4) Augment Financial Position

- Free Assets provides financial stability and strengthens company's solvency position
- May support in the capital requirements of the Non-Participating Fund
- Funds the payouts in case guaranteed benefits are more than asset share
- Enhance customer acquisition through improved policyholder protection
- Finance New Business Strain and Expense Overrun

- **Considerations**
  - Equity between policyholders and shareholders
  - Investment Strategy & PRE
  - Level of guarantees vis-à-vis Asset Share
  - Business Plan

Conclusion

- The options chosen needs to strike balance with, inter-alia:
  - Policyholders' Reasonable Expectations (PRE)
  - Fairness and Equity
  - Shareholders' return
  - Impact on the capital position of the company and implications thereof
  - Regulatory environment
  - Bonus philosophy of the company
  - Market and company practice
  - Competitive environment
  - Level of Accumulated Surplus

Thank you!

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