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Traditional Life Insurance Products - High early duration lapses, Increasing complaints of lower surrender values, assessing fairness of GSV factors in the context of PRE

Life Insurance - Technical Topic

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Presenters

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Case study

You are an Actuary working with the Actuarial department of a Life Insurance Company. Your Customer Experience Officer wrote to you about increased number of complaints he has been receiving on the lower surrender value under traditional products, especially during early durations of the policy. When he approached policy servicing department regarding the same, they replied that the surrender benefits were in line with the product specifications and the policy document issued to the policyholder. Hence he approached you with a suggestion to review the surrender values.

In this situation,

1. Do you think the Guaranteed Surrender Value (GSV) factors prescribed under product regulations are fair to the surrendering policyholders during the early duration of the policy?

2. Please analyse your conclusion in the light of high lapsation of life insurance policies during early duration and the Policyholders reasonable expectations created through Benefit illustrations and other documents provided to policyholders.

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Governing regulations and guidance

Pricing considerations

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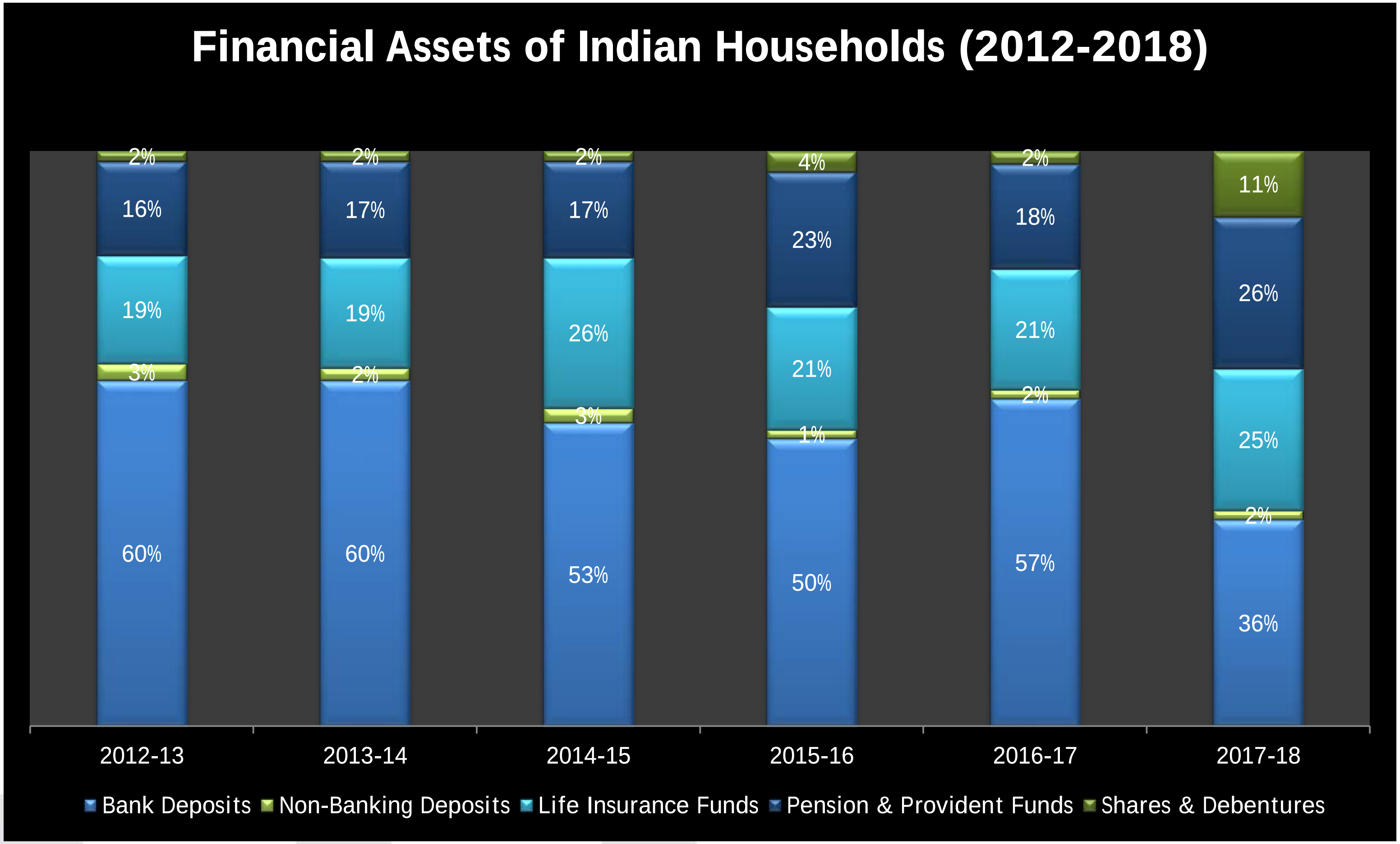
Market share between financial instruments



*Life insurance fund includes central or state governments employees' insurance funds and postal insurance funds.
*Shares and Debentures include investment in shares and debentures of credit/non-credit societies, public sector bonds and mutual funds (other than specified undertaking of the UTI)

Source: https://www.relakhs.com/rbi-data-indian-households-savings-2018/

Persistency trends

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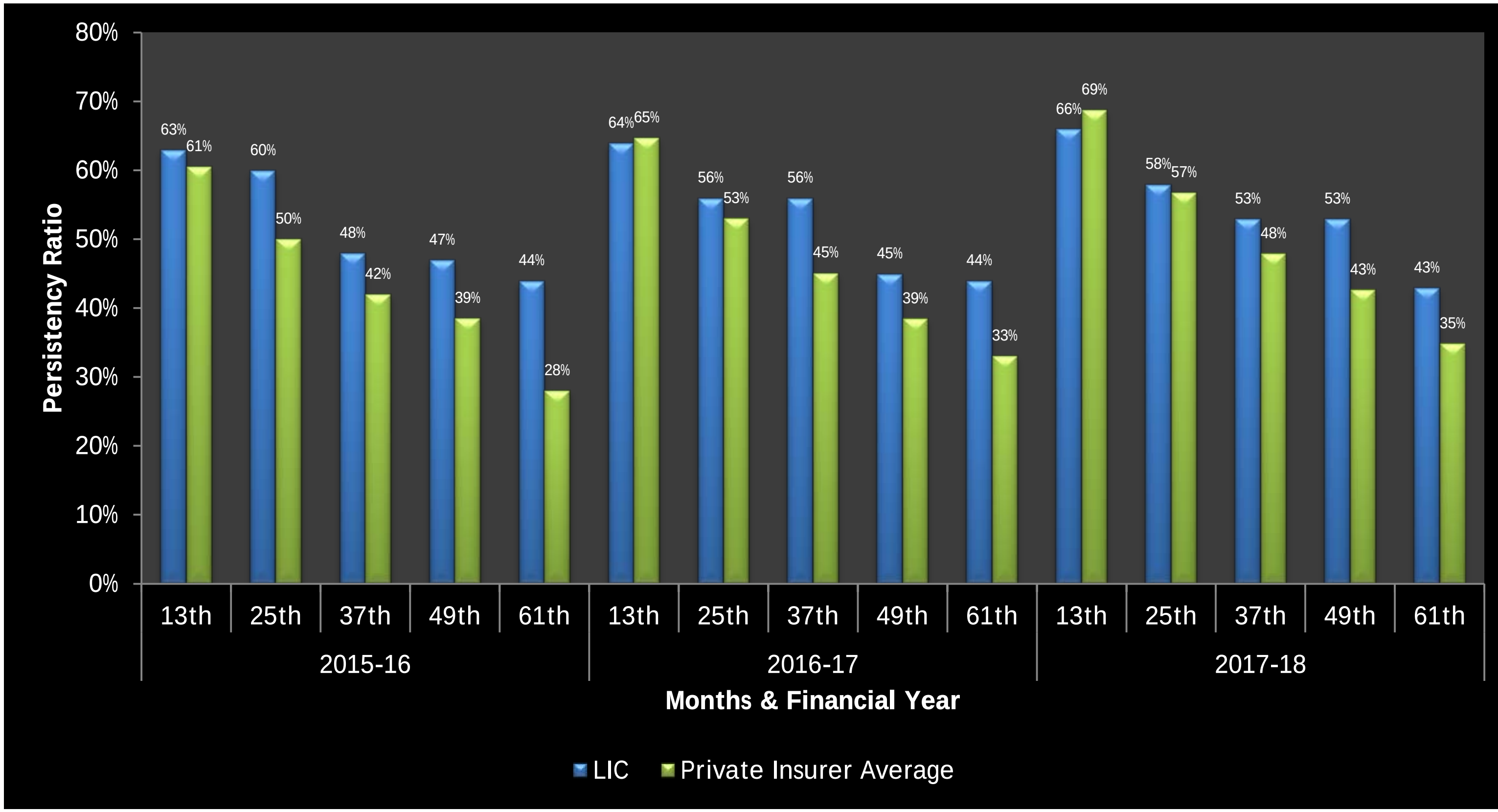
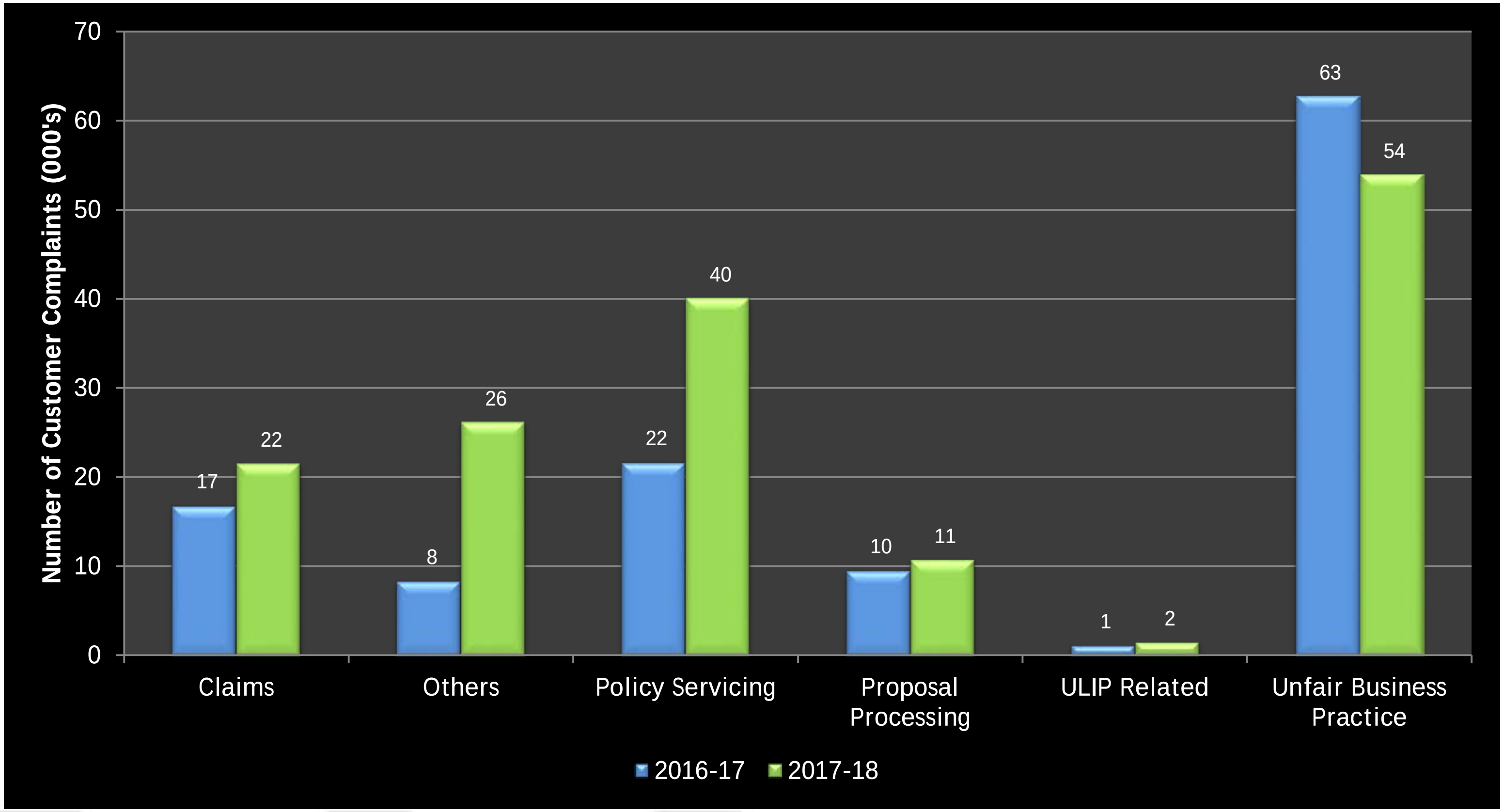


Note: Based on linked and non-linked number of policies
Source: IRDAI Handbook on Indian insurance statistics 2017-18

Complaint statistics



Source: IRDAI Annual Report 2017-18

Context

Reasons for surrender at early durations

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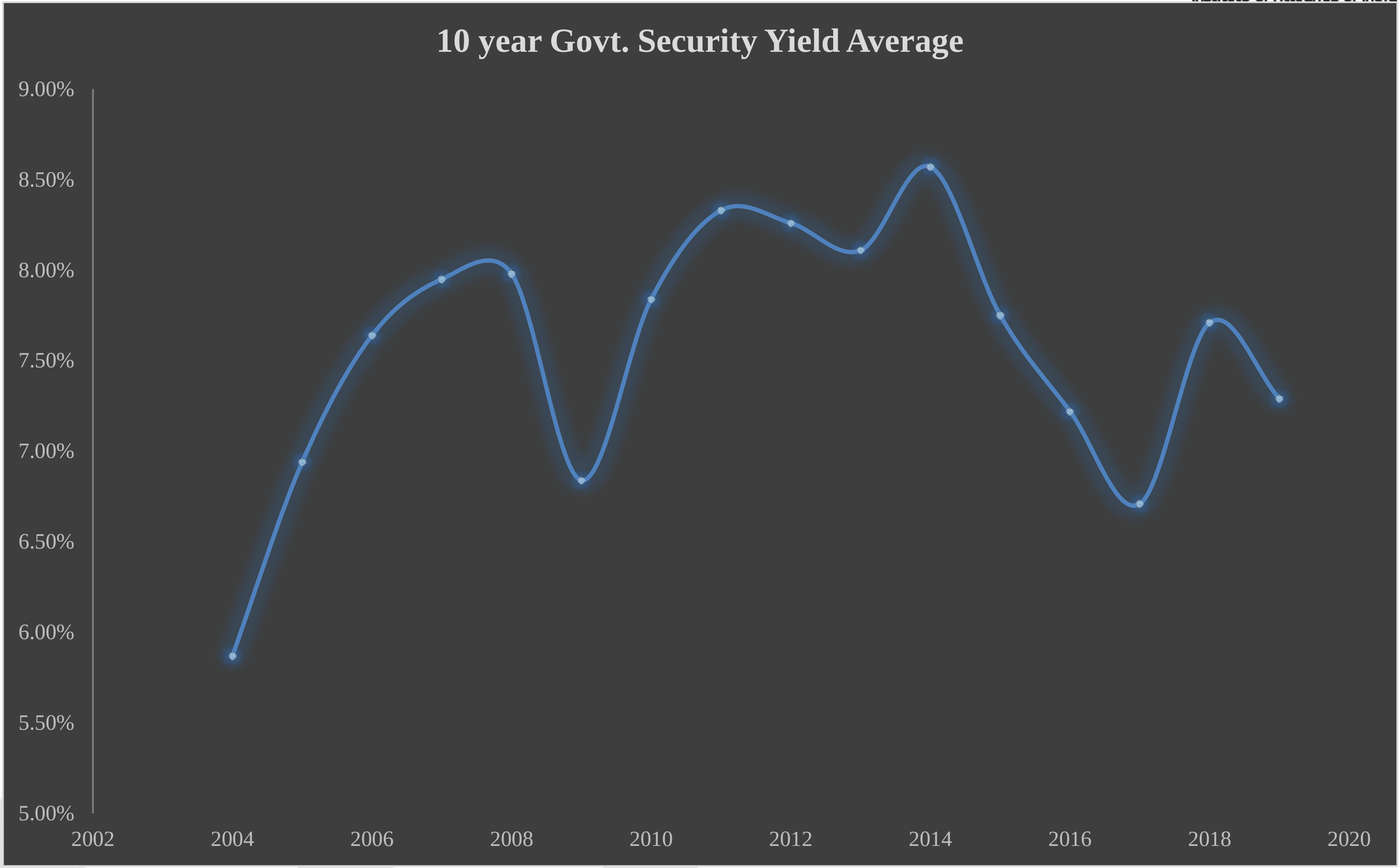
- Mis-selling: Fraud/Forced sales
- Financial illiteracy of customers
- Ineffective policyholder communication at sales stage
- Business churning at the time of renewals due to higher incentive to sell new policies as compared to renewing existing policies
- Poor customer service after issuance
- Change in policyholder needs
  - Increased income
  - Change in risk profile
- Economic situation – volatile interest rate environment and other attractive investment options
- Affordability
  - Unemployment
  - Changes in policyholder income

Historical interest rates



Source: Bloomberg

Reasons for policyholder complaints on low surrender value

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- Comparison of the surrender value against the total premiums paid

- Comparisons with charges/penalties on discontinuing other investment instruments
  - *Unit-linked products: Fund value is payable with relatively low surrender charges*
  - *Mutual funds: Fund value is payable with relatively low exit penalty*
  - *Bank deposits: Net positive return is certain with minimum or no charges*

- Unrealistic policyholders' reasonable expectations (PRE) set at the time of issuance
  - *Mis-selling - promise of higher returns on surrenders*
  - *Not highlighting the loss of capital in case of discontinuance*
  - *Complex benefit illustrations*
  - *Complicated policy wordings*

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APS

- Actuarial Practice Standard (APS) 5 – Appointed Actuary and principles of life insurance policy illustrations - on disclosures of benefit illustrations

GN

- Guidance note (GN) 6 – Management of participating life insurance business with reference to distribution of surplus, which provides guidance on asset share calculation methodology

Regulation

- IRDAI Non-Linked Insurance Products Regulation, 2013 on minimum guaranteed surrender value (GSV) and on special surrender value (SSV)

IRDAI Non-Linked Insurance Products Regulation, 2013 (1)

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PPT[1]	GSV[2] eligibility	Minimum guaranteed SV
<10	Premium paid for at least 2 consecutive years	GSV + surrender value of any subsisting bonus or guaranteed additions, as applicable, already accrued to the policy
>=10	Premium paid for atleast 3 consecutive years	GSV + surrender value of any subsisting bonus or guaranteed additions, as applicable, already accrued to the policy

1. PPT – premium paying term
2. GSV – Guaranteed surrender value

Policy year	GSV factor: Regular premium products (Policy term< 7 years)	GSV factor: Regular premium products (Policy Term>= 7 years)	GSV factor: Single premium products
1	0%	0%	70%
2	30%	30%	70%
3	30%	30%	70%
4	50%	50%	90%
5	90%	50%	90% / File and Use
6	90%	50%	90% / File and Use
7	N/A	50%	90% / File and Use
>=8	N/A	File and Use	90% / File and Use

IRDAI Non-Linked Insurance Products Regulation, 2013 (2)

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- The guaranteed surrender value will be equal to the GSV factor above multiplied with the total premiums paid less any survival benefits already paid.
- The surrender value will be higher of GSV and SSV
- The special surrender value shall represent:
    - o the asset share, in case of the <u>par</u> policies, where the asset share shall be determined in accordance with GN/APS issued by IAI (i.e. GN6)
    - o The experience of the insurer, in case of <u>non-par</u> policies. It shall be determined as per the proxy asset share in accordance with the with GN/APS issued by IAI

APS 5 – Appointed Actuary and principles of life insurance policy illustrations

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Role of Appointed Actuary

- Appointed Actuary must take all reasonable steps to ensure that new policyholders are not misled with regard to their expectations, e.g. in connection with illustrations at the point of sales.
- The Appointed Actuary should satisfy himself/herself that the illustration, which is prepared by the Insurer as required under the Standards of Conduct and Sound Practices (SCSP), does not create unreasonable expectations and that such illustrations are not prepared in any other way

Lapses, surrenders and non- forfeiture provisions

- The SCSP provides that a Company may show illustrative surrender values. If the illustration shows surrender values, it should clearly distinguish between guaranteed and non- guaranteed surrender values.
- In the case of the latter, the policyholder should be told how long the current non-guaranteed surrender values would be applicable and should be encouraged to check with the company the available non-guaranteed surrender values thereafter.

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Setting surrender value scales

Balancing the requirement of customer IRR at the time of surrender versus generating value for the shareholder and the distributor

- *Customer IRR increases with duration, maximizing on maturity*
- *Value to the distributor is highest on initial premium collection and slowly declines due to lower renewal commission rates*
- *Value to the shareholder is low in the initial years, increases steeply and then falls in later years*

In case GSV is believed to be insufficient, insurers can provide higher SSV. SSV should represent:

- asset share in case of par policies
- proxy asset share in case of non-par policies
    - *Therefore, should reflect insurer's experience*
    - *Current industry practice is varied - represents the expectation of future experience*

Other pricing considerations (1)

- Complex nature of life insurance products - high acquisition expenses and commissions needed to incentivise the distributor
- IRDAI Payment of commission or remuneration or reward to insurance agents and insurance intermediaries Regulations, 2016
  - *Single premium products: 2% of single premium*
  - *Regular premium products: As per the table below*

Category of life insurance product	Maximum commission payable to insurance intermediary on regular premium products	
	FY premium	Renewal premium
Individual pure risk	40%	10%
Individual other than pure risk, in respect of policies with PPT of:		
5 years	15%	7.50%
6 years	18%	7.50%
7 years	21%	7.50%
8 years	24%	7.50%
9 years	27%	7.50%
10 years	30%	7.50%
11 years	33%	7.50%
12 years or more	35%	7.50%

Other pricing considerations (2)

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- IRDAI Expenses of management of Insurers transacting life insurance business Regulations, 2016, allow expenses between 60% to 90% of first year premium for non-single premium traditional savings products
- On the other hand, the premium is level.
- An average life company incurs nearly 80% of the first year premium as initial expenses and commissions. The company can charge for this by pricing it into the product and recover through an explicit penalty in case of surrendering policies.
- Protection of shareholders' expected value generation in case of surrendering policies
  - *higher mortality loadings in the initial years due to anti-selection*
  - *ALM mismatch due to surrenders - early realisation of illiquid long duration assets*
  - *Low future profits due to discontinuing policies*
  - *Allocating fixed costs over smaller number of policies*

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Fairness of surrender value

Policyholders' perspective

Insurer's perspective

Other considerations

Policyholders' perspective

- Level of customer understanding for traditional products
- Customer mindset – Needs return of the principal amount at least, if not any interest component
- Customer may not want to bear the cost of high initial expenses in the insurance business model, which are passed on in the form of low surrender value at the time of discontinuance

- Policyholders may desire for traditional plans to have transparent charge structure, similar to ULIP
- Sales literature and related documents are often complex and unclear, furthering the discontentment
- Policyholders require flexibility to liquidate their 'investment' with minimum penalties
- High number of frauds of selling dubious policies leading to lack of trust in the insurance industry

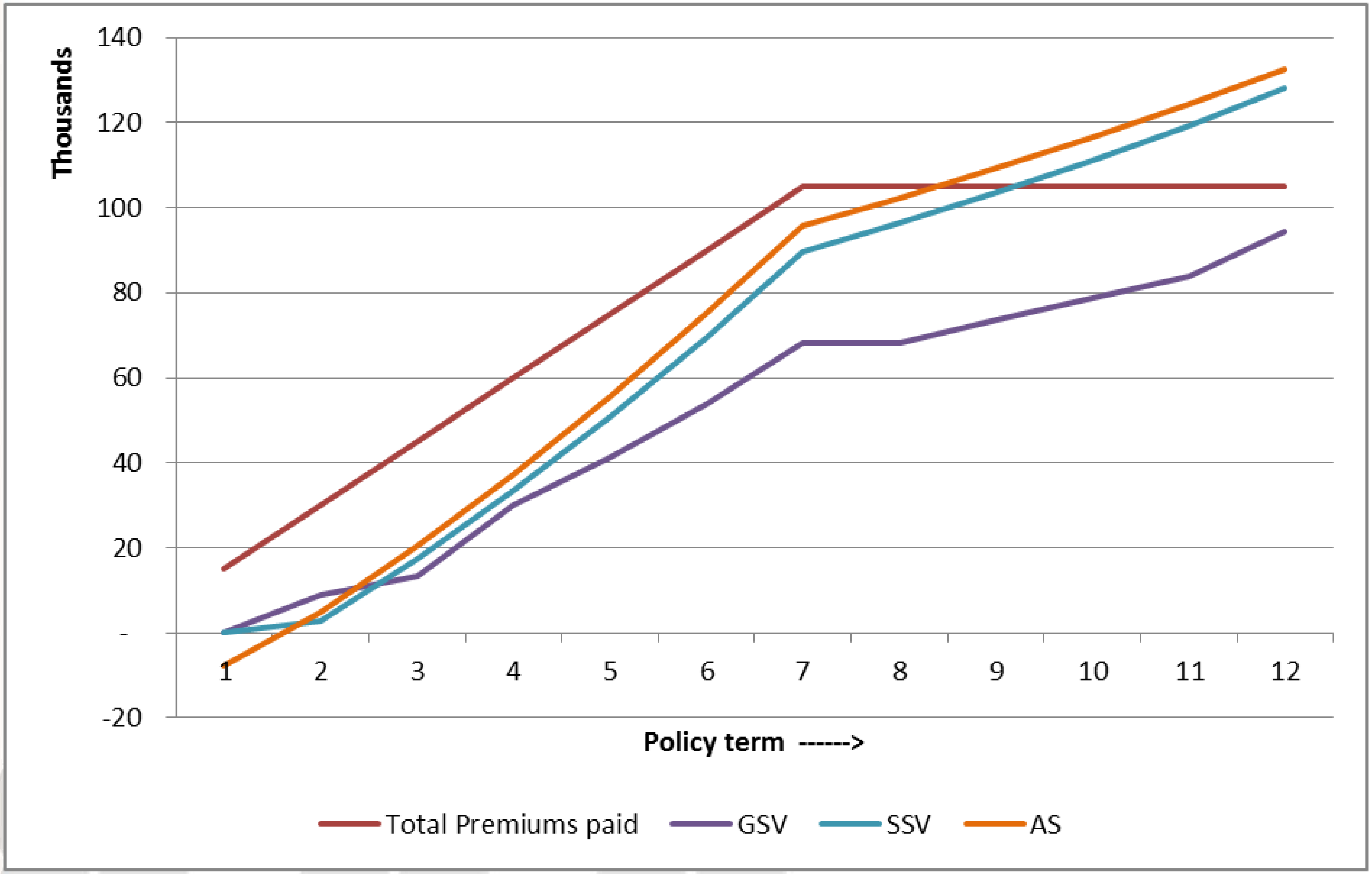
Insurer's perspective (1)

- Buying an insurance product implies entering into a long term contract. Surrendering early violates the terms of the contract
- Insurance liabilities are invested in long term assets, liquidating early may lead to losses and require changes in investment strategy
- Push based sales results in high acquisition expenses. Regulator also recognizes this – higher commission for long term products and higher EOM allowable
- Benefit Illustrations mention the exit value at different durations of policy term
- SSV shows realistic position of the value of policy, if not calculated prudently

Insurer’s perspective (2)

- Insurance is unique in terms of providing protection and guaranteed returns, for long term and even on future investments.
- Participating policies are also eligible for a major share in emerging profits.
- Life insurance provides risk cover. This is not appreciated by customer if he/she survives the period of cover.
- Customer’s perspective of comparing with other financial products – not a fair comparison overall
- Under pure protection products, surrender value is not expected to be payable for a regular premium paying policy. However, this is not true from a technical actuarial standpoint as a surrender value can be created to the extent of additional premium paid in the initial years due to a level premium structure.

Surrender value trend



Non-par endowment: 7 pay 12 policy, age 35, premium = INR 15,000

Other considerations

- Is lower surrender value the only the source of discontent?
- To tackle the issue of mis-selling, regulations provide the option of free look cancellation, where the refund premium is calculated after deducting:
  - *Pro-rated risk premium for the period of cover*
  - *Medical examination expenses incurred by the insurance company*
  - *Stamp duty charges*
- Free look period may be increased
- Also customer has option to report to ombudsman for cancellation from inception
- Risk of lapse and re-entry
- If insurers increase surrender value scales, then they may need to incorporate the cost of higher surrender benefits in the premium rates, making insurance products more expensive and harder to sell

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Increasing surrender values - Pros

- Increased attractiveness of insurance products
- Reduced capital losses for policyholders
- Reduce insurance industry trust deficit

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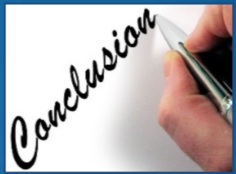
Draft IRDAI Non-Linked Product Regulations, 2018

Policies shall acquire guaranteed surrender value if premiums have been paid for at least two consecutive years.

Guaranteed surrender value factors have been increased between the second year and third year of the policy, both inclusive.



Ways of increasing surrender value

- Cost efficiencies
- Trail based commission structures
- Leaner distribution models
- Less stringent investment policy
- Reducing anti-selection in initial years
- Drive persistency improvement by ethical training of agents and encouragement to ensure higher persistency

Issues plaguing insurance

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Trust deficit in the insurance industry

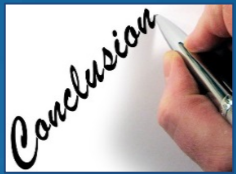
Lack of need based selling

Insurance awareness gap

Alternative solutions(1)

- Customer segmentation and need-based analysis
  - *Improved understanding of customer needs*
  - *More appropriate resource allocation*
  - *Identification of market opportunities*

- Insurance awareness initiatives and policyholder education
  - *Drive an industry level campaign of promoting insurance as a savings-cum-protection vehicle and not solely as an investment or tax saving tool*
  - *Heighten individual's responsibility towards potential risk*
  - *Enhance understanding of insurance mechanisms*
  - *Enable the development of consumer's knowledge*



Alternative solutions(2)

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- Innovative product features
  - *Premium holiday*
  - *Policy loans*
  - *Reduction in premium payment periods*
  - *Flexibility in policy alterations*

- Secondary market for insurance policies
  - *Well developed secondary markets in USA, UK & Germany*

- Digital transformation
  - *End-to-end advice and purchase*
  - *Continuous engagement programs*
  - *Digital and transparent claims process*

Questions?