29th India Fellowship Seminar

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Participating Funds - Most appropriate management & governance framework to ensure fairness to policyholders and the global practice.

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Agenda

- Overview
- Framework for Management of With Profits business
- Governance Framework of With Profits business
- Global Practice in General

Overview (1)

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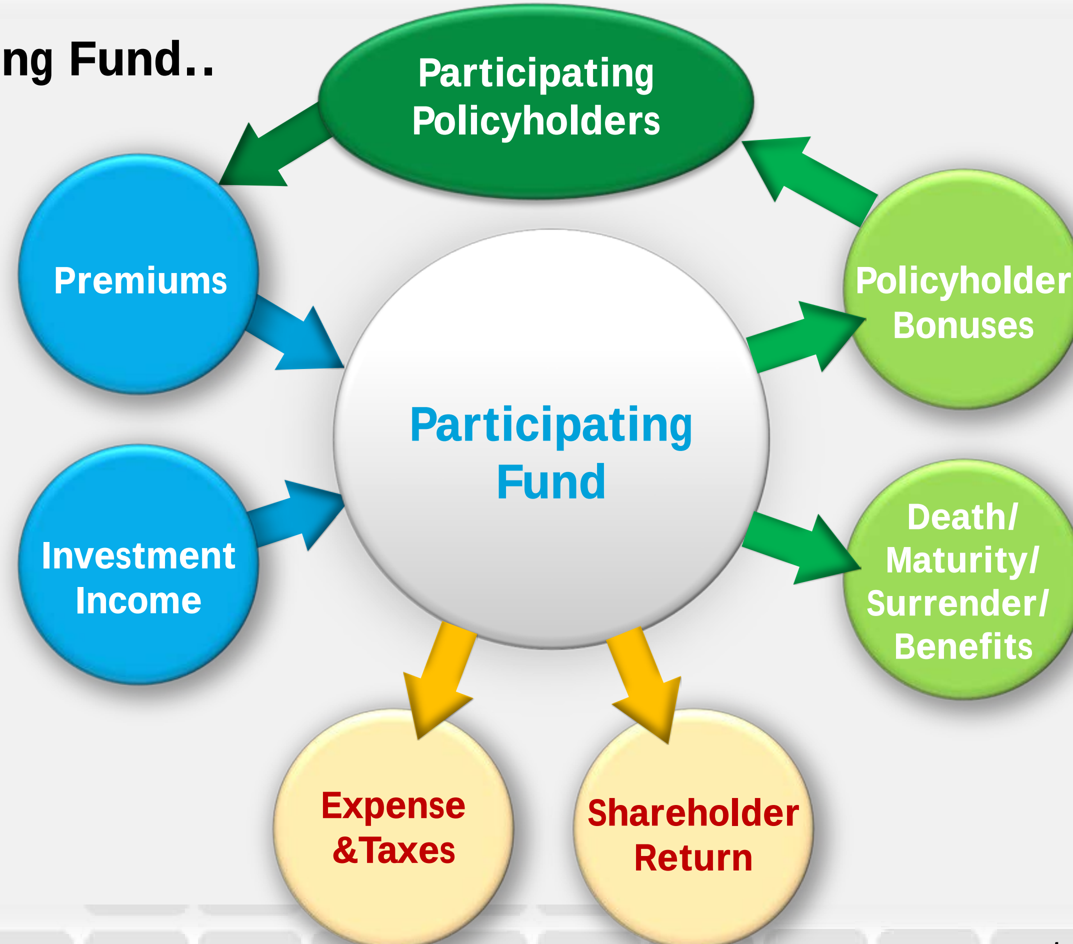
Participating Products pay the policyholders bonuses, which are generated from the profits of the Fund.

Participating Fund..



Overview (2)

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History..

Since nationalisation of Insurance sector in **1956**, LIC had been operating as a monopoly and sold wide range of products, mostly par over last 6 decades

Opening up of the Insurance sector to private players in **2000**

Up until **2003-04**, around 80% of NB sold through par products

In **2004-05**, market share of par business dropped significantly with introduction of ULIPs and surging stock markets

By **2010**, more than 80% of NB by private players through ULIPs. LIC too started promoting ULIPs aggressively

Source: Milliman Research Report, 2016 Edition

Overview (3)

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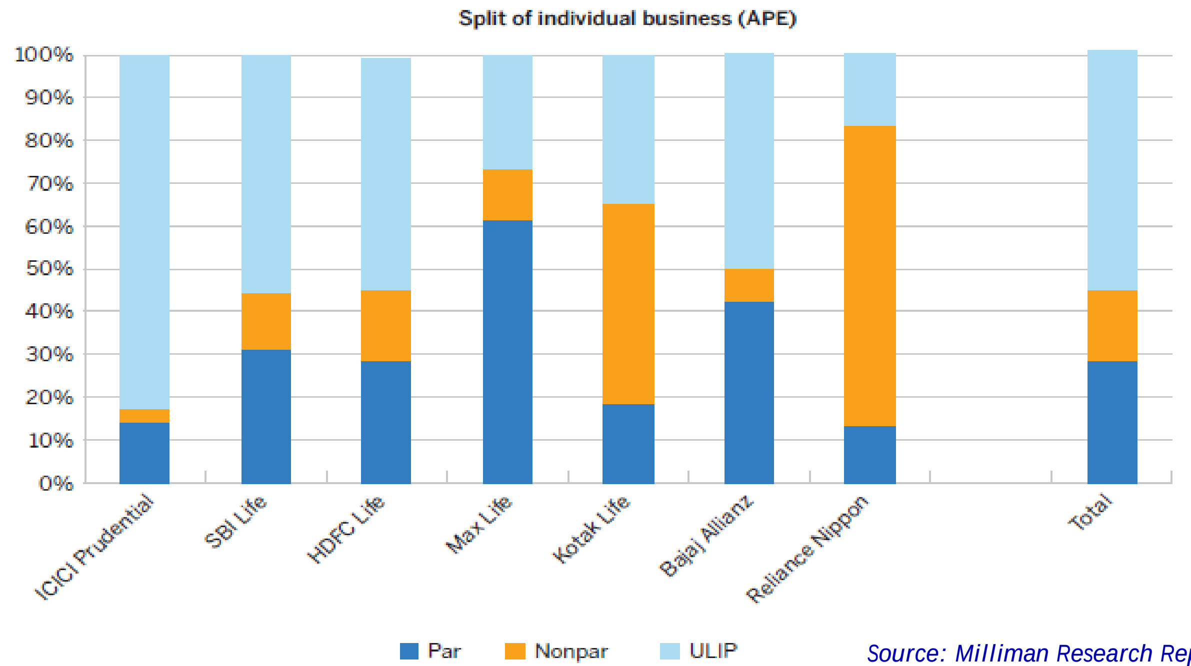
Participating Business is here to stay..

- Unit linked business plummets post Regulatory policy action to address issues in ULIP design in Sept 2010, coupled with bad press around ULIPs
- “Index linked” non-participating products withdrawn, effective 1st Oct 2013
- Proportion of par business at industry level is dominated by LIC.

Proportion of NB Par for Private players (representing +70% of NB APE, FY 2016)



Source: Milliman Research Report, 2016 Edition

Framework for Management of With Profits business (1)

To Start with..

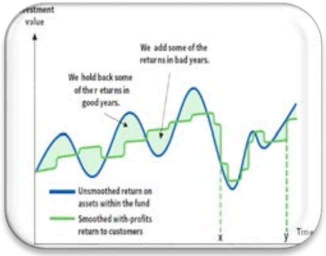
- Participating business is **complex!** Too many moving wheels..
- Important to have a detailed documented framework for management and public
- Companies moving to internal documentation
- Internal documentation similar to **PPFM** document used by insurers in the UK.

Asset Share Calculation

Bonus Structure

Expense and Charges

Investment Policy



Smoothing Policy

PRE

Business Risks

Management of Estate / FFA

Asset Share Calculation

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General Scenario

- Currently, the asset share is to be determined in accordance with GN6 issued by IAI
- GN6 requires documentation of the approach to the various sources of surplus
- The actuary must consider whether each source of surplus forms part of asset share or must be part of the estate
- No strict guidelines on what the exact method should be.
- However, the Non Linked Regulations, 2013, require the WPC to approve the detailed working of asset share calculations.

Asset Share Calculation

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Factors to consider

There are various factors to consider in how the asset share is calculated:

- **Grouping**
  - What level to group the policies at while allocating experience
  - Balance between cross subsidy and pooling
- **Investment return**
  - Methodology of calculating fund performance
  - Historical data available?
  - Smoothing methodology
- **Expense**
  - Allocation – Consistency and fairness
  - Historical data available?
  - Overruns
  - Comparison against Benefit Illustrations
  - Consideration of EOM regulations

Asset Share Calculation

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Factors to consider

- **Miscellaneous items**
  - Lapse/surrender profits – whether to be included
  - Lapse/surrender profits – how to allocate to policy groupings
  - Non Par business written in Par fund
- **Tax**
  - Whether to charge tax if company is in loss
  - Extent of credit to be taken from Deferred Tax Asset
- **Other charges**
  - Cost of guarantees
  - Cost of smoothing and capital
- **Other considerations**
  - Consistency with benefit illustrations
  - Consistency with regulations

Bonus Structure

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Freedom in adopting different bonus structures

Forms

- Reversionary Bonus
- Cash bonuses
- Reduction in premiums
- Terminal Bonus

- No restrictions on the type of bonus that may be declared
- Additions to benefits are most common, with a few products with cash bonuses
- Most companies tend to ensure regular bonuses are in line with PRE generated by disclosures and aim to provide the surplus at maturity as terminal bonus
- While asset share calculation methodology is scope of the WPC, the actual bonus rates declared themselves are not.

Expenses and Charges

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Fairness in allocation of expenses

- Charging expenses to asset share may be based on:
  - Actual expense
  - Pricing expense
  - Expense in Benefit Illustrations
  - Best Estimate expense
- With the EOM regulations, 2016, limits have been set to the expenses that may be charged to the policyholder. Any excess will be borne by the shareholder.
- The should reduce parking of overruns in the With Profits fund, and should lead to increasing IRRs for customers.
- The EOM regulations specify limits as a percentage of the premiums – the limits varying based on premium term and duration of insurer's life insurance business.
- It requires the CFO and the AA to arrive at the basis for expense allocation, have it documented and subject to annual review by the Board.

Investment Policy

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Multiple factors to consider

- The Investment policy must consider:
  - Return and risk
  - Policyholder's reasonable expectations
  - Current size of fund
  - Implicit guarantees in fund
  - Duration of assets and liabilities

- The IRDAI Investment Regulations, 2016, specifies:
  - The list of permissible securities
  - The exposure caps and floors for different securities

- Current industry practice involves very less exposure to equity (average <10%), in the With Profits fund, much lesser than the permissible limits

Smoothing Policy

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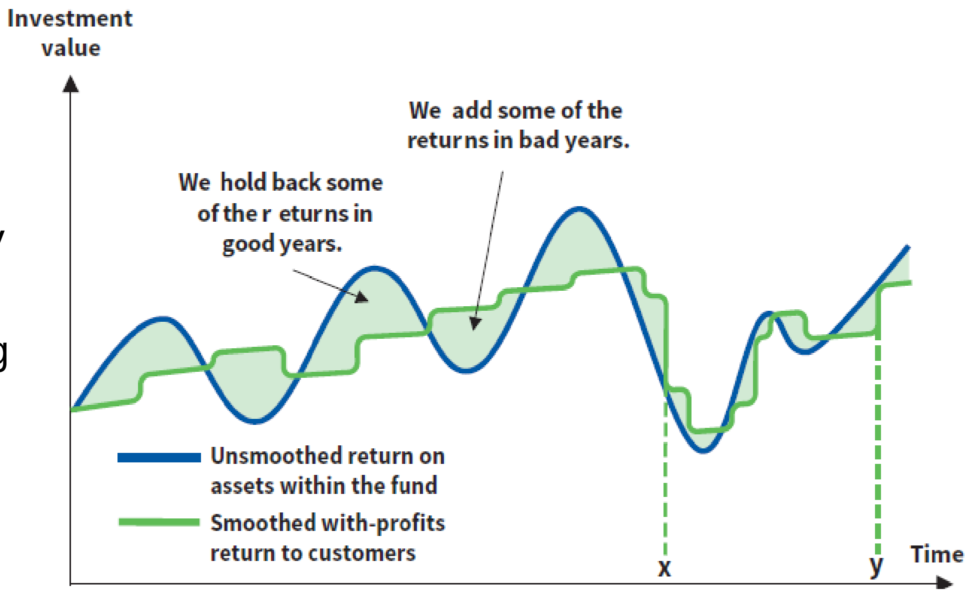
Ensure smooth progression of benefits from year to year..

- Smoothing of bonuses essential to reduce impact of fluctuations in experience
- Smoothing policy may typically specify a delta range in YoY movement of bonuses such that the projected Maturity payout to Asset Share ratio is say 90% to 110%.
- Application may be different for different types of policies, generation of policies, or even different types of policy payouts.

Important factors to consider..

- PRE
- Level of reduction in volatility of payouts
- Impact on risk of insolvency of Par Fund
- Adherence to TCF belonging to different cohorts
- Neutralize the cost of smoothing over time



Policyholders' Reasonable Expectations

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PRE is a SUBJECTIVE subject

Circumstances giving rise to PRE

- *Declaration of Bonuses*
- *Special Surrender Value*
- *MVR on UWP*

Stakeholder in PRE

- *Current Policyholders*
- *Existing Policyholders*
- *Ombudsman / Courts*
- *Agents, other intermediaries*
- *Press*

PRE

Sources of PRE

- *Sales Illustrations*
- *Policy Literature*
- *Macroeconomic Environment*
- *History & Past Practice of Co.*
- *Advertisements & Press Release*
- *Practices adopted by LI Industry*

Measuring and Monitoring PRE

- *Fair treatment of policyholders vis-à-vis shareholders*
- *Fair treatment of different groups and generations of policyholders*

Business Risks

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Identify.. Evaluate.. Treat.. Monitor..

Business risks

- Acquiring of new business
- Management of participating business
- Operation of Options and Guarantees
- Demographic Experience
- Economic Experience
- Change in Regulatory/ Economic environment
- Product Design Features
- Selling/Marketing Practices

Control within the Risk Management Framework of the Company

Management of Estate/ FFA

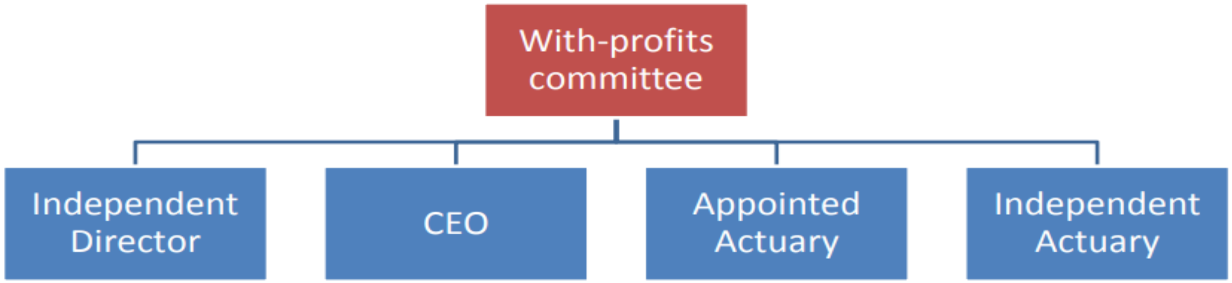
Manage and use which it may be put to..

Solvency Capital	• *Meet Par Fund Solvency Capital requirement* • *Cushion against unexpected adverse events*
Flexibility	• *Investment Flexibility* • *Smoothing*
Fund NB	• *Fund initial strain caused by new business*
Guarantees	• *Bears the risk associated with provision of guarantees*
Investment	• *Investment Strategy of Par Fund* • *Asset mix of FFA may be different from assets backing policyholder benefits*

Framework for Management of With Profits business

With Profits Committee (WPC)

- The Non-Linked Product Regulations, 2013 require the setting up of a With Profits Committee ("WPC")
- The primary role of the WPC is to approve the asset shares and append a report to the AA's Report submitted to IRDAI



- WPC also in UK – but structure and role differs from India
- Role of WPC key in ensuring fair calculation of asset shares for all policies
- BUT, WPC does not review eventual payouts (bonus rates) or advise on the management of the fund
- Members of WPC may have conflicting opinions
- Independent Actuary is the only independent "actuarial" voice on the WPC

Governance Framework of With Profits business (1)

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Need for Governance Framework

- Clearly defines processes, roles and responsibilities
- Instils confidence and improves transparency
- Paves the way for TCF
- Helps to set PRE

Governance Framework of With Profits business (2)

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Governance Framework... Indian Context

IRDA (Non-Linked Insurance Products) Regulations, 2013

- The Appointed Actuary should demonstrate in ARA:
  - Appropriate allocation of expenses to the with profit fund
  - Overall sound financial management and governance of the with profit fund
- With Profits Committee (WPC)
  - Constitutes of one independent Director of the Board, the CEO, AA and IA.
  - The report of the WPC required to be appended to the ARA
- Asset Share
  - Determination of asset share in accordance to GN 6 issued by IAI
  - The methodology for determining asset share to be approved by WPC

Professional Guidance (GN6): Management of participating life insurance business

- Recommend use of asset shares for determination of the bonus rates
- Recommends approach to calculate the asset shares
- Appropriate allocation of expenses to the with-profit fund
- Treatment of non-participating business written in the participating fund
- Recommends documentation of the company's approach to setting bonuses

Governance Framework of With Profits business (3)

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Governance Framework… Indian Context

Regulation	Summary of content
The Insurance Act, 1938 (sec 49)	Places restrictions on the distribution of surplus as bonuses to policyholders and as dividends to shareholders
IRDA (Investment) Regulations, 2000	Investment **guidelines** for with-profits funds
IRDA (Distribution of Surplus) Regulations, 2002	Requires life insurers to maintain **separate funds** for non-par and par business. Places restrictions on the **distribution of surplus to shareholders**
IRDA (Assets, Liabilities and Solvency Margin of Insurers) Regulations	*"The gross premium method of valuation shall discount the following future policy cash flows at an appropriate rate of interest:* *(a) Premiums payable……….benefits payable……:* *……..* *(iii) bonuses that have already been vested as at the valuation date,* *(iv) bonuses as a result of the valuation at the valuation date, and* *(v) future bonuses (one year after valuation date) including terminal bonuses (consistent with the valuation rate of interest…….* *………………………* *(d) allocation of profit to shareholders, if any, ………………..* *.* *Provided that allowance must be made for tax, if any"*

Governance Framework of With Profits business (4)

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All in all..

- Section 49 of Insurance Act, 1938 (Declaration of Bonuses)
- IRDAI (Appointed Actuary) Regulations, 2000
- IRDAI (Appointed Actuary) Regulations, 2013
- IRDAI (Non-linked Insurance Products) Regulations, 2013
- IRDAI Protection of Policyholders Interest, Regulations, 2002 and subsequent amendments
- IRDAI Distribution of Surplus 2002
- IRDAI circulars dated 23rd March 2004 & 30th March 2012 regarding declaration of bonus
- APS1: A practice standard on Appointed Actuary & Life Insurance business by The Institute of Actuaries of India
- GN6: A recommended practices on with-profit management by The Institute to Actuaries of India
- Section 44 and 45 of IRDAI (Non- Linked Insurance Products) Regulations, 2013

Global Practice in General

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Trend in Global Participating business

- The potential to higher investment gains and the concept of profit sharing are two biggest attraction points for participating products
- On an average around 10-15% of the total business is contributed by with profit products
- Inadequate transparency and disclosures are one of the major reasons for low public confidence in some of the geographies.
- Move towards independent representatives of policyholders and minimum guaranteed returns have been taken by many countries
- Fair and equitable distribution of dividend is the prime objective overall
- With the advent of IFRS 17 , there will be a greater need to effectively manage the funds as the current and future profitability from the insurance contracts will be very much visible to various stakeholders

Global Practice in General

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Salient Features in some geographies

HONG KONG

- Companies disclose fulfilment ratios i.e. ratio of actual bonus to illustrated bonus at the point of sales
- Re-illustrate future benefits taking into account any dividend changes
- Shift from higher guarantee and higher annual bonus to lower guarantee & higher terminal bonus

CHINA

- Surplus distribution – 70:30 between Policyholder & Shareholder respectively
- Common bonus distribution mechanism -Annual cash dividend.

UK

- Customer centric with profit report highlighting the future payouts and other details
- Surplus distribution – 90:10 between Policyholder & Shareholder respectively.
- Firms have larger proportion of around 50% in equity & real estate.

CANADA

- Bonus generally paid as annual dividend , terminal bonus is not common
- Contribution method used : Interest , mortality & expense surplus is generally shared
- Generally 100% surplus is distributed

AUSTRALIA

- Surplus distribution – 90:10 between Policyholder & Shareholder respectively
- Asset Share – Mortality & expense surplus , no share of surrender profit

JAPAN

- Traditional Par – share mortality , interest & expense profit
- Semi-par – share only investment gains

Case Study : With Profits in Singapore

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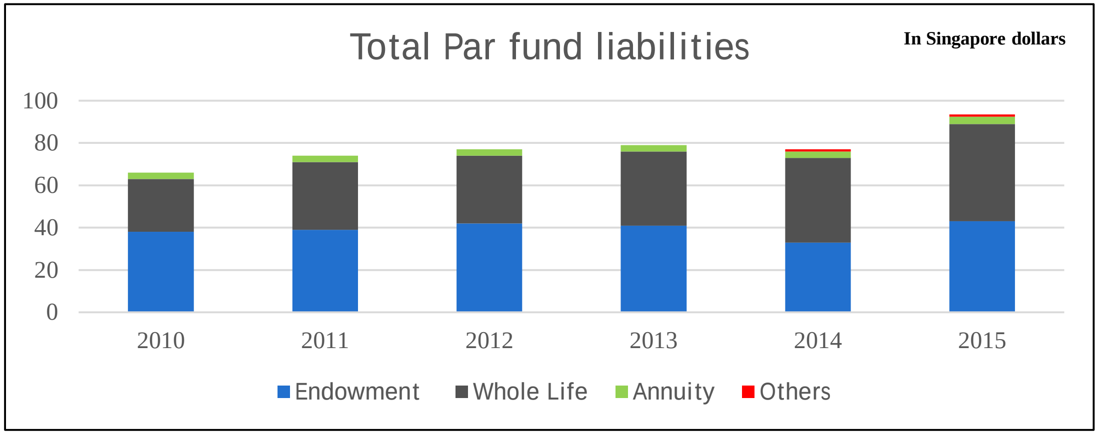
A look at Singapore Insurance Market

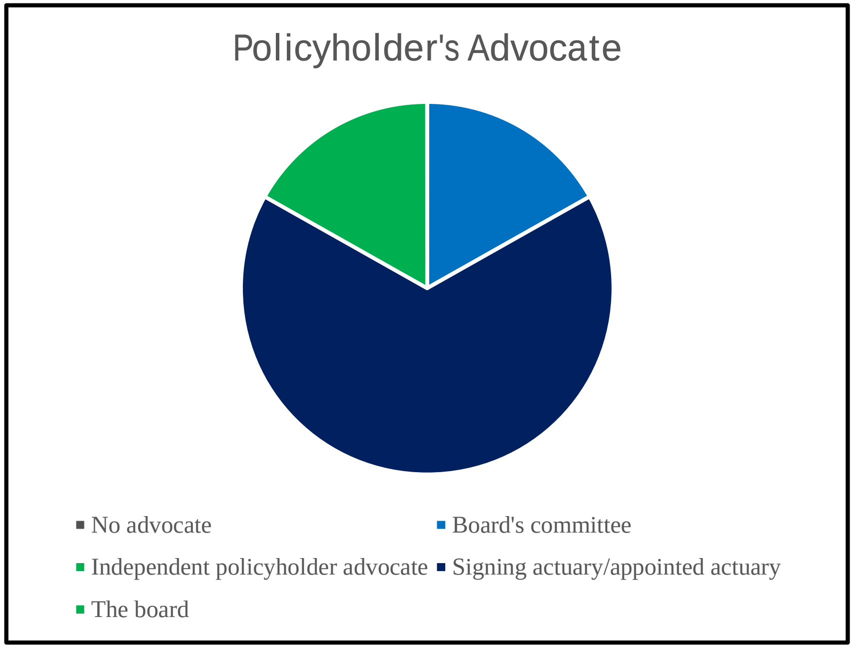
- REGULATOR : The Monetary Authority of Singapore (MAS)
- ASSETS : Around 30% equity and 70% bonds. Have the highest equity exposure among Asian countries
- Regular and Single Premium Endowment and Whole life products dominate, with a small amount of par annuities
- Bonus rates are set with reference to asset shares and are generally adjusted if expected cost of future bonus doesn't fall within limits.



Case Study : With Profits in Singapore

A look at Singapore Insurance Market

- Segregation of a Separate Par Fund
- Surplus distributed in 90:10 between Policyholder and Shareholder
- No regulatory requirement for specific committees to oversee par funds



- Illustrations require benefits to be shown at two interest rates : 4.75% pa and 3.25% pa
- In the last few years , move towards higher terminal bonus with lower focus on reversionary/cash bonus

Case Study : With Profits in Singapore

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A look at Singapore Insurance Market

- Requirement to hold board-approved internal governance policies on par fund management
- The internal policy should highlight investment strategy, charges & expenses, risk management and disclosure requirements
- Availability of updated benefit illustration upon customer's request highlighting maturity value and maturity yield for any bonus declarations
- Shortfall in par fund to meet guaranteed benefits or solvency requirements to be funded by shareholder
- Projection of Asset Share is recommended for deciding upon bonus rates but it isn't mandatory. Less prevalence of terminal bonus rates

What India can adopt from the Global Market

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Things to Consider

- Increase in equity proportion for par fund : India have among one of the lowest equity backing , affecting the returns
- A customer centric with-profit report highlighting the benefits & companies policy on the par products in a simpler language
- A standardized approach to calculate asset share
- Adoption of risk-based capital approach to allow the companies to better manage their required capital

Conclusion

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Current status of governance and framework

- The asset shares are vetted by the WPC, however bonus rates do not form part of WPC formally.
- Asset share calculation method specified in GN6, however classified as “Recommended Practice”.
- EOM regulations ensure expenses are managed within limits, and policyholders are not penalized for inefficiency in operations.
- Distribution of Surplus regulations ensure 90:10 distribution of profits and separate funds for With-profits business.
- Caps on the investment in risky/unrecognized assets.
- Under-distribution of surplus only helps build estate, which cannot be transferred to shareholders. Helps solvency and writing more par business, though.
- Cases of negative IRRs in the industry

Conclusion

Things to ponder on…

- Consistency: Consistent approaches to asset share calculation and bonus distribution across industry?
- Transparency and disclosure:
  - Improving customer understanding of products? Better disclosures. Bonus philosophy and methodology
  - Showing NRY in Illustration akin to unit linked. Sharing projection of asset shares in illustration
  - Showing performance of fund and asset share year on year in actual viz-a-viz what was demonstrated during point of sale
- Customer Returns: Should customer IRR be a key focus?
- Taxation of surplus: Should tax on surplus be removed? – Consistency with Non-Par and ULIPs
- Surrender Values : Re-look at surrender values, given the lapse/surrender profits?
- Loan to Fund Shareholder Loan to support the fund in initial years?
- Investments: Non guaranteed Investments in real returns assets – More exposure in Equity and property ?

Thank You..