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Role of With-Profits Committee

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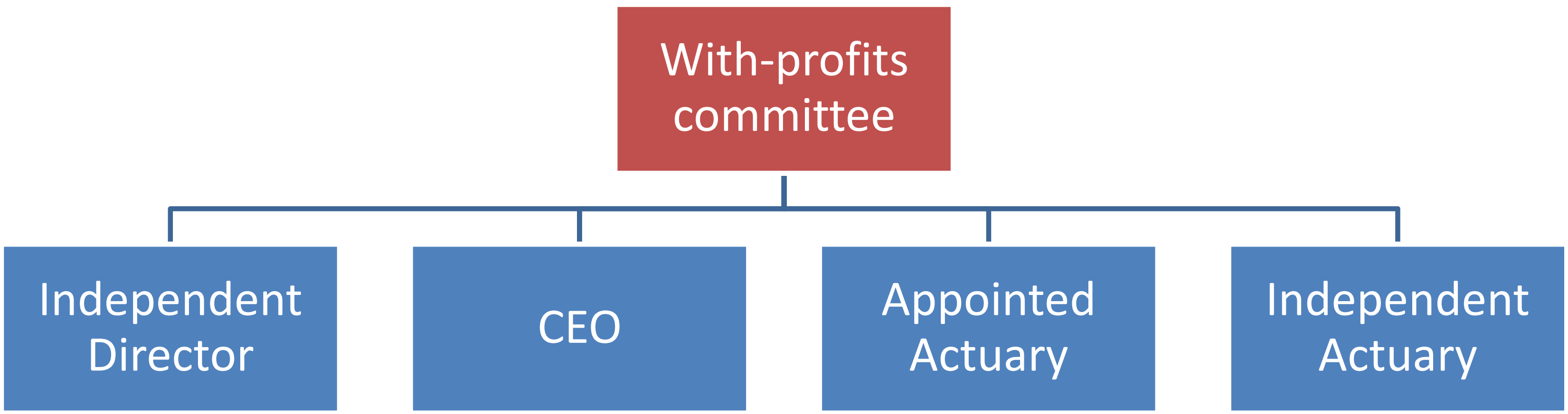
Indian Actuarial Profession
Serving the Cause of Public Interest

Agenda

- Introduction
- Regulations
- Challenges
- Alternative scope
- Questions?

Introduction to WPC

- "Non-linked Insurance Products" Regulation, 2013 require the setting up of a With Profits Committee (WPC)



- WPC also in UK – but structure and role differs from India

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Role of WPC in India

- Role of the WPC:
  - Approve the detailed working of the asset share
  - Report of WPC shall be appended to the Actuarial Report and Abstract (ARA)

- Asset share calculations are integral in ensuring fairness to policyholders
- Asset shares are used as a guide in determining benefit payouts – which includes declaration of bonus rates
- 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.

Insurance Regulatory and Development Authority (Non-Linked Insurance Products) Regulations, 2013

c. The detailed working of the asset share, the expenses allowed for, the investment income earned on the fund etc which are represented in the asset share shall be approved by a with profits committee.

d. With Profits Committee: The With Profits Committee shall be constituted with one independent director of the Board, the CEO, the Appointed Actuary and an independent actuary.

e. The report of with profits committee shall be appended to the Actuarial Report and Abstract.

Key regulations concerning par funds

- Management of par funds is more complex than non-par, UL funds
- Several regulations, guidance notes need to be considered in the management of par funds.

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

….regulations (contd)

Regulation	Summary of content
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"*

….regulations (contd)

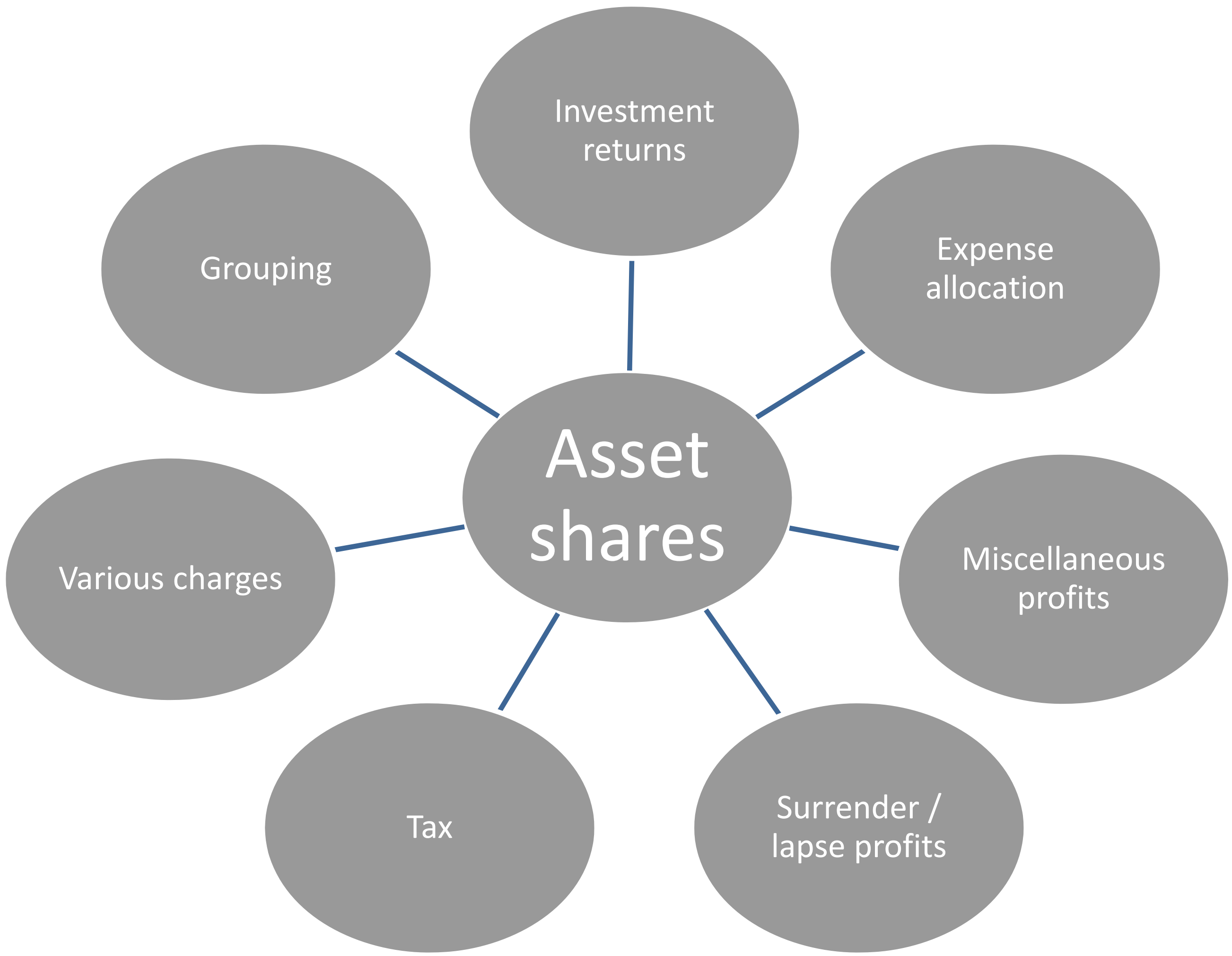
Regulation	Summary of content
IRDA (Non-Linked Insurance Products) Regulations, 2013	Specifies rules on product structures, timing of bonus, surrender values and **management of with-profits business** including the setting up of WPC. • *Asset shares calculation – at policy level; fair allocation of expenses and crediting of interest rate* • *Responsibility of asset share calculations - Appointed Actuary* • *The **detailed working of the asset share -** approved by a **with profits committee***
GN6 (Management of participating life insurance business with reference to distribution of surplus)	Provides guidance on the following: • Grouping of policies • Uses of asset shares • **Calculation of components of asset shares** • Determination of **assumption** for calculation of asset share • **Management of par funds** with focus on smoothing, level distribution relative to reserves, surrender values, PRE, riders and non-par business written in the par fund, expense allocations • Reinsurance • Investment • **Cost of guarantees** • Segregation and merging of funds

Asset share calculations

- Asset share calculations is the most important issue.
  - **Appointed Actuary:** Responsibility of determining asset share
  - **WPC:** Approves detailed working of asset share
- All members of WPC do not have complete access to all relevant information
- GN6 issued by IAI details a "**Recommended Practice**"
  - Leaves scope for judgment and differing methodologies
- Conflicting opinions between members of WPC possible?
- Other practical issues in finalising methodology and assumptions

GN6 definition: *"An **asset share** for a policy grouping at a given point in time is the accumulation of the **premiums received** plus **investment income earned** from the inception of the policies, less **deductions** due to benefit payments, commission, expenses, tax, a reasonable cost of capital and of guarantees, contribution from **miscellaneous surplus** (if considered appropriate) and **transfers to shareholders**"*

Asset share calculations – practical issues….



Asset share calculations – practical issues….

Component	Issue
Grouping	• Are the policy groupings homogenous enough? • Extent of cross subsidy between various groups? • Asset share should be calculated for each policy
Investment returns	• Choice of methodology – market consistent vs. amortised costs? • What if historical data is not available? • Vary by nature of policy groups? • Vary for asset shares and estate? • Smoothing methodology?
Expense allocation	• Is the allocation of expenses to with-profits funds fair? • Consistent with rest of the business? • Treatment of indirect expenses? (e.g. rents) • What if historical data is not available or not reliable? • Actual allocated expenses vs. benefit illustrations made to policy holders • Expense overruns
Surrender / lapse profits	• Should policyholders share profits / losses on surrenders, lapses? • Inclusion in asset shares: implicit (via. Investment returns?) or explicit?

….(contd) asset share calculations – practical issues

Component	Issue
Miscellaneous sources of profit / losses	• Should these accrue to asset shares or estate? Examples include: ▪ Reinsurance ▪ Non-participating business written in the WP fund
Tax	• Extent to which participating policyholders should benefit from deferred tax asset?
Cost of guarantees charge	• Is it in line with PRE? • How has the charge been determined? – potential issues due to lack of use of stochastic models in the Indian market
Other charges	• Should any other charges be levied and what should they be? • Examples include – capital charge, smoothing charge

Most importantly : Are asset share calculation consistent with **Policyholders' Reasonable Expectations**; and are all **policyholders being treated fairly**?

Benefit illustrations create expectations on calculation of asset shares, with regard to expense deductions, allocation of other profits and losses. Are asset share calculations in line with communications made with the policyholders?

Resolving conflicts

- Members of WPC may have conflicting opinions
  - E.g. consider a possible scenario where CEO & AA; and Independent Director and Independent Actuary have conflicting opinions?
  - What should the Independent Actuary do in such a situation?

- Independent Actuary is the only independent “actuarial” voice on the WPC

- Members will need to arrive at suitable solutions, which ensure fairness to all policyholders

- Should significant disagreements between WPC members; or between WPC and the Board be reported to the regulator?

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Internal documentation

- Indian insurers have set up internal documentation on asset share methodologies and management of with-profits funds.
- WPC has access to methodology related to asset share calculations
- Documentation not as detailed as PPFMs (by UK firms)
  - E.g. Treatment of estate in possible run-off scenario not included?
- PPFM-like documentation not a regulatory requirement
  - Potential future development?
  - WPC may need to approve certain sections of such documents?
- WPC: could encourage the production of more detailed documentation?
- Cost vs. benefits – of increasing documentation
  - Role of WPCs
  - Funds may be small / new

Should WPC play a larger role?

- Limited to review of asset shares – is this enough?
- Larger role in management of the funds?
- Does WPC have enough powers?
- Should we aim to move closer to the WP fund management model in a more developed market, like UK?

Participating business is complex. As the business in India grows, it becomes increasingly important to adopt strong management framework where ***policyholders' interests*** are protected and ***conflicts between various stakeholders*** are taken care of.

With-profits funds in UK market, for example, have suffered due to management frameworks not being strong enough.

What happened in the UK?

1980s

- High interest rates
- Tax relief on premiums
- Aggressive sales
- Competitive payouts

In between

- Tax relief removed in 1984
- Falling interest rates
- High guarantees , low yielding assets
- Stock market falls in 2000s
- Decline in reputation

Now

- WP have fallen out of favour
- Guarantees continue to bite
- Several funds closed to new business

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More on UK – what happened to Equitable Life?

- Equitable Life, world's **oldest mutual assurance society**, was forced to close to new business in 2000. The decision affected many policyholders and the reputation of the insurance market.
- Lord Penrose was asked to investigate what brought this **£30bn** fund to a position where it had to close to new business; put it up for sale; apply significant MVAs and reduce apparent value of its in-force policies by just under £5bn?
- Completed in 2004, the "***Penrose Report***" concludes Equitable Life's problems were primarily a result of ***senior management failings***

Main issues

- Treatment of terminal bonus – "differential terminal bonus"
- Liability valuation and financial adjustments
- Policyholders' reasonable expectations
- Clarity of the regulatory objective

Conclusions of Lord Penrose

- A consistent smoothing policy would reduce the possibility of allocating returns on policies at an unsustainable level that gradually eroded reserves
- Equitable Life had not provided for accrued terminal bonus and had used a weak, or "dubious" basis for valuing liabilities
- Guaranteed annuity rates were not thought to represent an additional cost to Equitable Life and these were not reserved for, though the regulator belatedly required them to do so
- Regulatory solvency tests made no allowance for non-contractual financial benefits, e.g. terminal bonuses, and so had limited regard to policyholder reasonable expectations

What kind of conflicts arise?

With profits policholders Vs.

Other with-profit policyholders

Policyholders within a fund may have certain interests which take priority over those of other members of the fund, such as those with guarantees and those without

Managemement

Management may have a preference for courses of action which preserve jobs, or may be reluctant to accept that strategies that they have previously advocated are not working.

Bonuses may be linked primarily to shareholder profits

Non par policyholders in the same fund

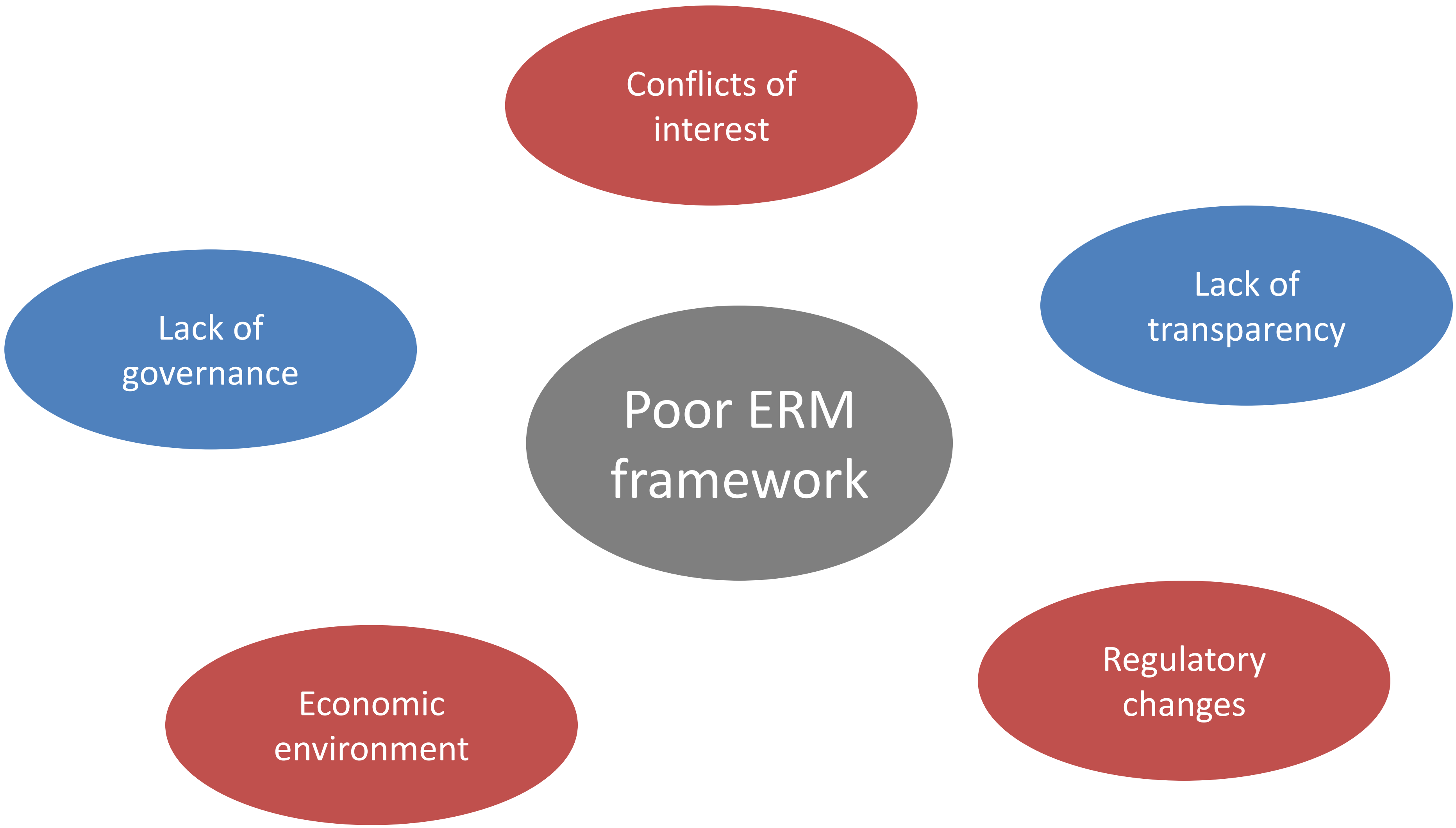
Capital requirements for non-profit policies may affect the surplus available for distribution to with-profits policyholders

-this may be of particular concern in a closed fund

Shareholders

If a shareholder-owned service company makes a mistake which results in overpayments to some WP policyholders, where should the cost be borne?

In a nutshell….



How are WP funds managed in UK?

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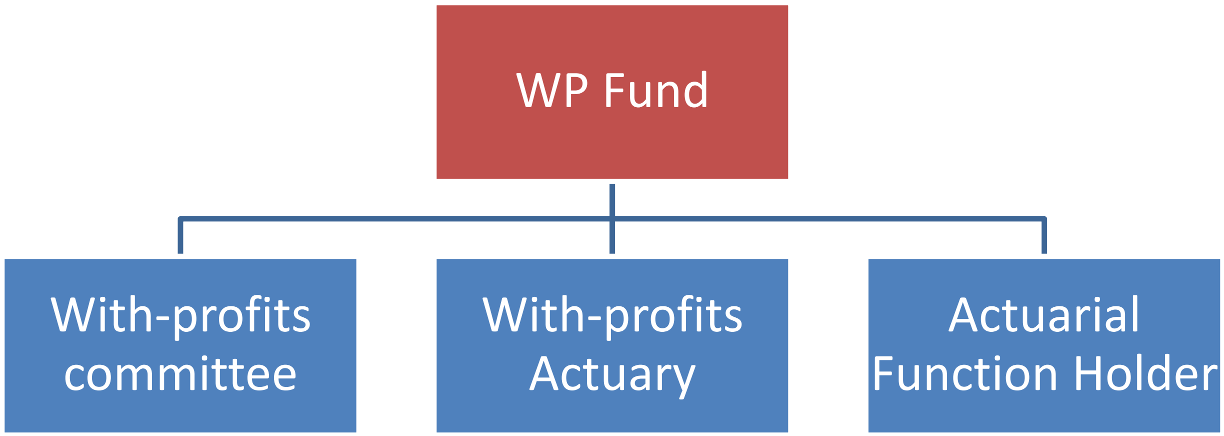

- There has been increased focus on management of WP funds in the UK
- Set up of **WPC** is now recommended for all firms unless the firm can demonstrate that it is either too small for it to be proportionate or too simple in operation for it to be necessary
- WPC must have an "**independent**" majority
- Management of WP funds in UK is **more complex**; but also **more robust**

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Role of WPC in UK

- The **role of WPC** is to provide focused **advice and challenge to management** on the running of the with-profits fund, including the **conflicts of interest arising**, with specific reference to with-profits policyholders:
  - Compliance with PPFM
  - Conflicts of interest
  - Bonus rates and MVRs
  - Distribution / retention of surplus
  - Significant changes to the risk/investment profile of the with-profits fund
  - Impact of planned or implemented management actions
  - Future new business strategy
  - Firm's customer communications
  - Drafting and adherence to distribution, management and run-off plans and court schemes as appropriate;
  - Operational costs
  - **Any other issues the with-profits policyholders may reasonably expect WPC to scrutinise**

In India, comparatively, main responsibility of the with-profits fund lies with the Appointed Actuary and the role of WPC limited to review of Asset Shares

India market outlook

- Economic environment - high interest, high inflation, rising equity markets - similar to UK a few decades ago?
- UL out of favour ----> Increased focus on par products
- Products priced using rates well below the risk free rates (10 year G Sec)
- Compared to UK, par funds in India less complex – in structure and products sold.

BUT……….

- **The future outlook is never certain.**
- **Economic, regulatory, political & reputational risks could affect the strength of par funds.**
- **Will interests of policyholders be protected if conditions were to become unfavourable?**
- **“Independent” opinions (like in WPC) in the management of par funds are necessary given the nature of the business**

Alternative scope in India?

- Greater clarity in roles / responsibilities of WPC members
- Clear documentation of Terms of Reference for **Independent Actuary**
  - Attendance at regular meetings of WPC
  - Reviewing bonus rates
  - Reviewing overall management framework
  - Reviewing that AA has complied with GN6 and IRDA regulations
  - Reviewing checks applied on asset shares
  - Making recommendations in enhancing the governance standards in managing participating business
- Larger role for WPC in the above
- Documentation of difference in opinion – mention in report

Management of par funds in India may be simpler compared to UK; but there is merit in forming a more robust management framework; where WPC can play an important role

Questions?