Participating Business Governance Standards in Asia Pacific and India

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Agenda

- Governance standards for participating business in Asian markets
  - Governance in Singapore and Malaysia
  - Governance and the Independent Actuary
  - Case Study: Participating policyholders do understand
  - Case Study: Mergers of par funds
- Applicable standards in India
  - Overview
  - Internal management framework
  - With profits committee
  - Guidance notes

Disclaimer

The views and opinions expressed in this presentation are those of the authors and not of the employer they represent.

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Governance Standards Participating Business Singapore and Malaysia

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What is PRE and what shapes PRE?

- Policyholders Reasonable Expectations…
- Particularly important where **discretion** is involved
- Commonly Driven by:
  - Sales and Marketing literature
  - Policy illustrations
  - Past performance / previous actions of company
  - Competition – what other companies do
  - Market performance (e.g. equity indices)
  - Consistency with other policyholders
  - Internal documentation on bonus policy

Stakeholders and their considerations

Shareholders

- Profitability
- Returns
- Governance
- Brand image
- Capital sufficiency

Policyholders

- Return
- Guarantees
- Bonus expectations
- Treated fairly
- Company Strength

Regulators

- Companies treat policyholders fairly
- Solvency of company
- No mis-selling
- Expense apportionment is fair
- Documentation of bonus policy

Distributors

- Product mix
- Sales practices
- Sales training
- Commissions reasonable

The need for governance and bonus policy

Clearly defines processes and responsibilities

- Reduces operational risk
- Provides statute to base future decisions on
- Aids consistency between changes in management
- Clarifies boundaries

Improves transparency on how discretion is applied

- Demonstrates compliance with treating customers fairly (TCF)
- Helps to set PRE
- Makes business planning and projections easier

Example: Singapore MAS 320

Management of Participating Life Insurance Business

MAS has a requirement for companies to document bonus governance

- Applies to direct insurers registered to sell life insurance
- Provides insurance companies with a guide on how to appropriately operate in order to have a sustainable business that is responsible and ethical.
- Covers internal governance, disclosure and details to be included in product summary.
- Covers annual bonus update, past performance and future outlook, bonus allocation and an update on changes in future non-guaranteed bonuses.
- Internal Governance:
  - Bonus determination
  - Investment of participating fund assets
  - Risk management
  - Charges and Expenses
  - Circumstances under which to cease taking new business
  - Shareholders' Profits and Responsibilities
  - Disclosure requirements
- Product Summary:
  - Nature and objective of the plan
  - Benefits under the plan
  - Investment of Assets
  - Type of risks affecting the level of bonuses
  - Sharing of risks
  - Smoothing of bonuses
  - Fees and charges
  - Adjustments in Premium rates
  - Impact of early surrender
  - Update on performance
  - Conflict of interests
  - Related party transactions
  - Free look period

Issue date: 29 June 2007, last revised on 20 Feb 2009

Regulatory Constraints on the Operation of Participating Business

JPI 29/2004

- Sets out the duties of the Appointed Actuary in respect of any recommendation to revise bonuses downwards
- The default is for asset shares at the cohort level to drive bonuses
- However, it is acknowledged that PRE may be defined by illustrations at point of sale i.e. limited expectation to receive asset share if lower than the illustrated benefit

Board of Directors is Responsible for Setting Dividends

- But this is subject to the advice from the Appointed Actuary
- And the non-disagreement of BNM (All bonus recommendations need to be approved by BNM)

The Insurance Act 1996

- Section 41 requires the firm to ensure that the insurance company maintains assets of no less value than the liabilities of the insurance fund at all times

Appointed Actuary…:

- Consideration of the legal basis to cut bonuses
- Asset share study (or equivalent) investigation used to determine the level of any bonus revision, although regard also to be had to smoothing, past practices and policyholder communication including sales literature
- Surrender payments (by class of policy) should not be less than the asset share on average in any particular year

JPI 29/2004: Excerpt from MAA 2009 Accounts

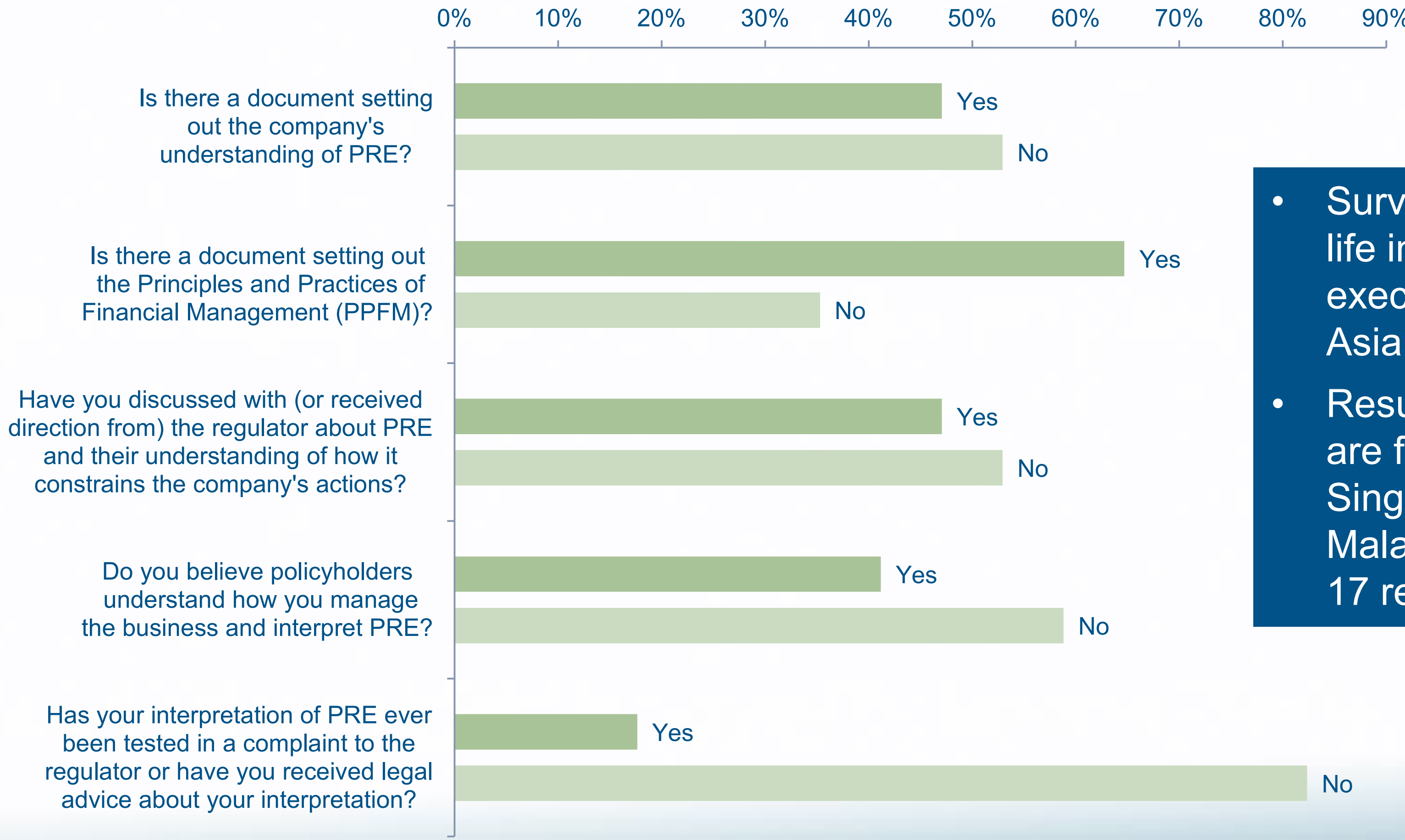
MAA Assurance
MALAYSIAN ASSURANCE ALLIANCE BERHAD

Compliance with Regulatory Requirements

The Company initially **recorded a shortfall in the value of assets over liabilities including long term policy liabilities, in its Life Participating ("Par") fund and Life Annuity fund at 31 December 2009**, due to the changes in the basis of valuation of insurance liabilities following the implementation of RBC, which requires explicit provisions to be set aside for future non-guaranteed liabilities which have yet to be declared and vested. The Company also **did not comply with the minimum CAR of 130%** at that date. The Company however has sufficient assets to cover the vested guaranteed liabilities in both the Life Par fund and Life Annuity fund as at 31 December 2009.

Subsequent to the balance sheet date on 11 March 2010, the Company obtained approval from the insurance regulatory authority for its capital resolution plan, including implementation of the following measures amongst others:
(i) **applying a bonus revision of MYR420 million to reduce the non-guaranteed future liabilities of the Life Par fund as at 31 December 2009;**
(ii) assigning surplus assets of MYR159 million from the Life Non-Par fund to the Par fund, and MYR89 million, consisting of MYR18 million from the Life Non-Par fund and MYR71 million from the Shareholders' fund, to the Life Annuity fund as at 31 December 2009; and
(iii) injecting proceeds from the proposed sale of the general insurance business in 2010 (as disclosed in Note 15 to the full set of financial statements) into the life insurance business.

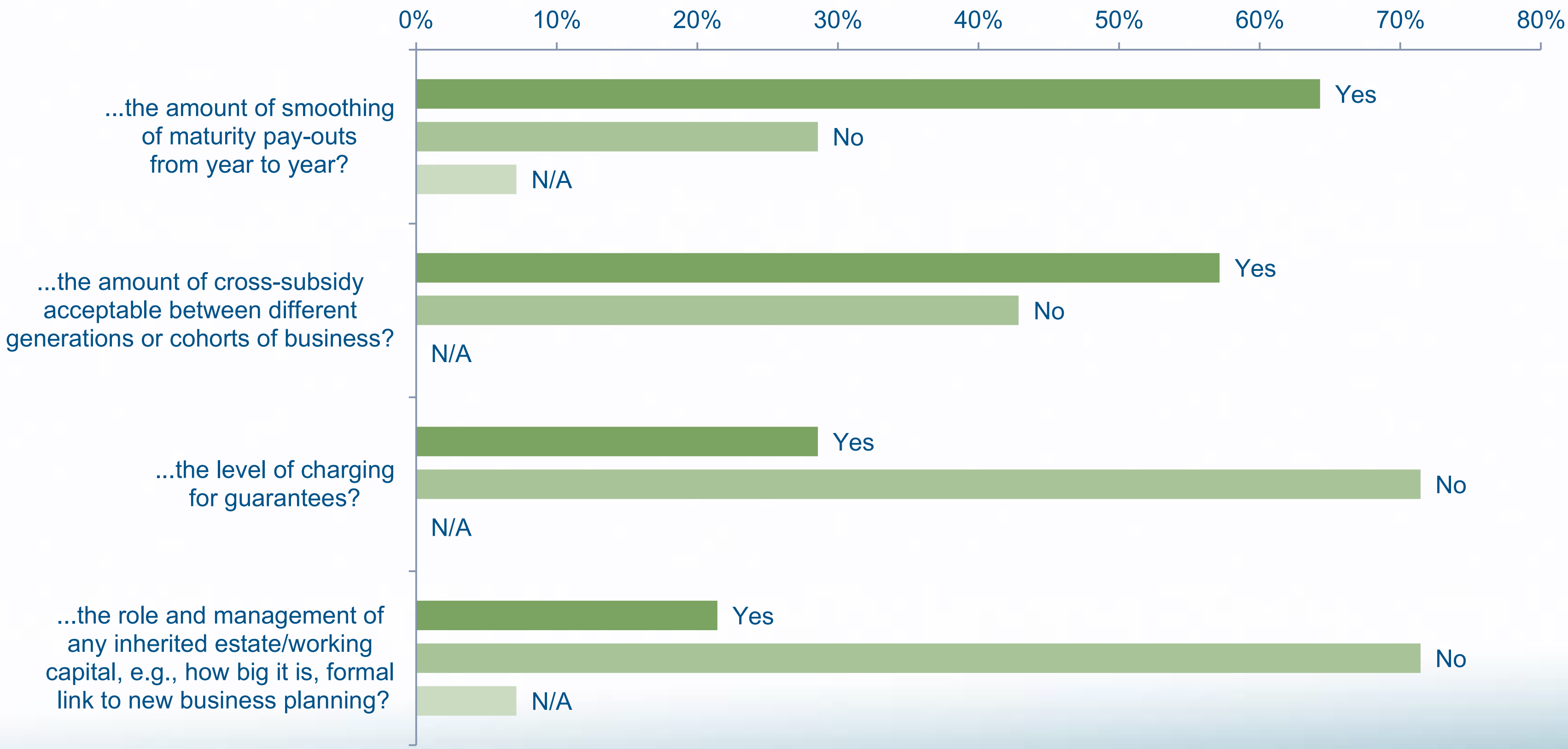
Governance in Singapore and Malaysia – survey results (1/3)



- Survey of senior life insurance executives across Asia in May 2013
- Results shown are from Singapore and Malaysia only – 17 respondents

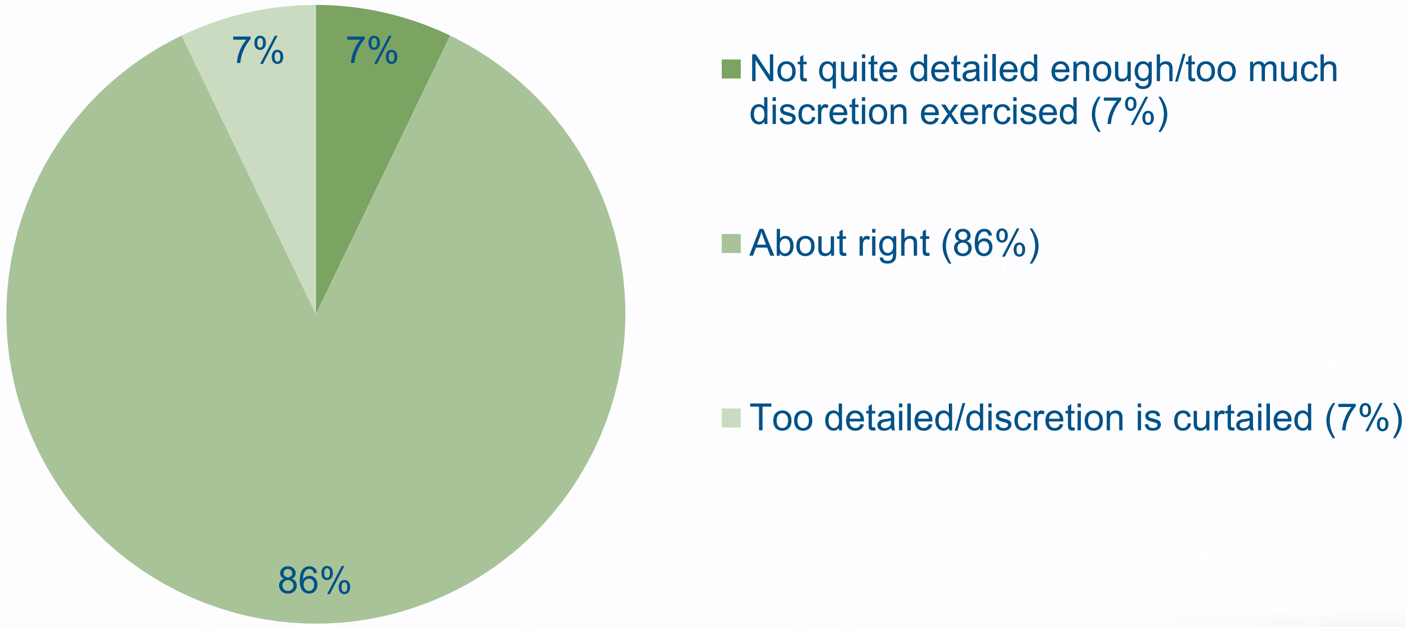
Governance in Singapore and Malaysia – survey results (2/3)

Does your company have clear policies/practices in relation to…



Governance in Singapore and Malaysia – survey results (3/3)

How sufficient do you think the internal governance for your par-fund is?



Example - Principles and Practices of Financial Management (UK)

Structure of the Long-Term Fund

- Ownership of the Society
- Basic structure
- Application of profits
- Use of shareholder funds
- Types of policy
- Legal and General Pensions Limited
- Structure diagram

Principles

- The amount payable under a With-Profit policy
- Investment policy
- Business risks
- Charges and expenses
- Management of the Inherited Estate
- Volumes of new business
- Equity between the With-Profits Sub Fund and shareholders

Practices

- The amount payable under a With-Profits policy
- Investment policy
- Business risks
- Charges and expenses
- Management of the Inherited Estate
- Management of capital
- Volumes of new business
- Equity between the With-Profits Sub Fund and shareholders
- Subordinated debt
- Contractual Minimum Addition (CMA)
- Contractual Annual Interest

Example PPFM: Phoenix With-Profits Fund (UK)

PHOENIX LIFE

353 pages and considerable details!

Investment Mix

- 70% growth assets and 30% in fixed interest
- Unless, term is less than 9 years, in which case the asset exposure to fixed interest is increased linearly to 65% (35% growth) for policies with one year outstanding
- Unless, the rate of return required to meet the guaranteed benefits is more than 5%, in which case the exposure to growth assets is reduced by up to 100% depending on the moneyness of the guarantee

Smoothing

- For traditional policies, when smoothing is applied, it is effected by changing final bonus rates. Normally, the change is such that maturity payments vary by no more than 15% over any 12 month period

Charges for Guarantees

- Charges for guarantees or smoothing may be made to policies. Current charges include:
  - 3% of each premium for traditional life policies
  - 2.1% of each premium for traditional pension policies
  - 0.5% per annum of the underlying value for unitised with-profits bonds issued between January 1999 and July 2000 inclusive

Annual Bonuses

- "…very low annual bonuses are being declared, because the value of excess assets is small. For these policies, the board do not expect to be able to increase bonus rates for a number of years…Only if the value of excess assets relative to the size of liabilities remaining in force has increased substantially would the board expect to make any increases"

Conclusions

- Policyholders have an expectation (PRE) which is built up from a number of factors
- Some regulators require the Board or management to document their interpretation of this
- Important not to make changes that go against expectations, otherwise it can lead to complaints

Case Study:

Participating policyholders do understand

Lessons from NTUC Income, Singapore

Introduction

This case study helps to appreciate how participating policyholders can be sensitive to the bonus expectations. Key features include:

- The impact of different bonus structures?
- What determines policyholders expectations regarding bonus amounts and bonus structures?
- The impact of the relevant regulations in Singapore regarding the management of bonuses?
- The role of the Board and the Actuary with respect to the management of bonuses?
- What do companies do to protect themselves against poor practices?

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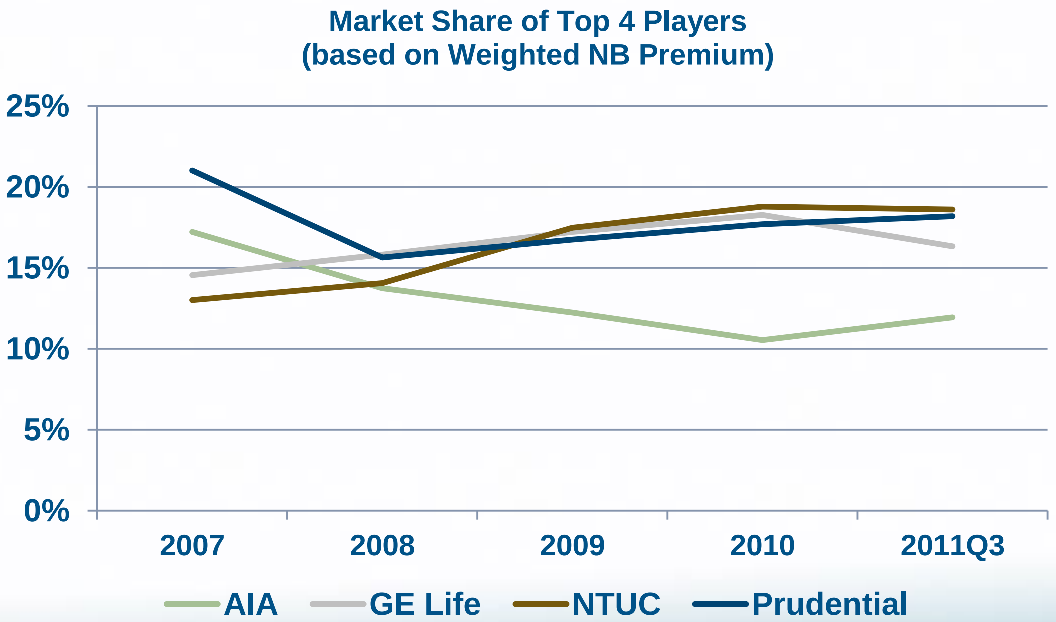
Singapore Regulation: Key Timeline of Events

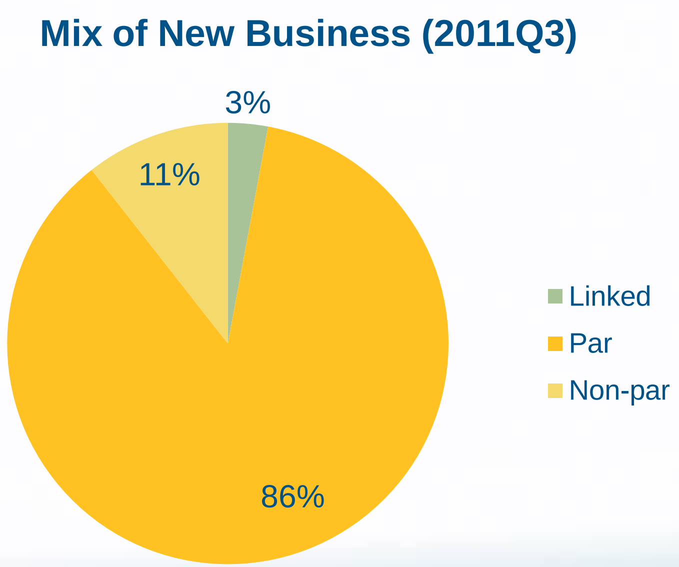
The regulation of participating business in Singapore has evolved in recent years. Following the introduction of Risk Based Capital in 2005 participating business and in particular the strength of the participating fund had greater scrutiny. MAS320 then introduced greater requirements for the governance of participating business, with the requirement for companies to formally document their bonus policies.

- **Until late 1990s**: Singapore Insurance Act (Cap. 142)
- **2005**: MAS introduces Risk Based Capital reporting regulations on 1 January 2005
- **2007**: MAS 320 on the "Management of Participating Life Insurance Business" was released in June 2007
- **2009**: A revised MAS 320 was released on 20 February 2009
- **2011**: MAS published a consultation paper on "Proposed Revision to the RBC Framework" in July 2011

NTUC Income – Background

- NTUC Income is a co-operative insurance society formed in 1970 with an initial capital of SGD1.2 million.
- It sells life, health, general insurance and investment-linked products and has achieved a rating of “AA-” by Standard & Poor's.
- Total premium income for 2011 Q3 amounted to SGD3.2 billion, compared to 2010 FY of SGD3.4 billion.
- NTUC Income has been one of the top four life insurers in the industry for many years and currently holds a market share of 19% based on 2011 Q3 weighted new business premiums.





Source: LIA Statistics

Increasing Focus on Capital Adequacy Ratios

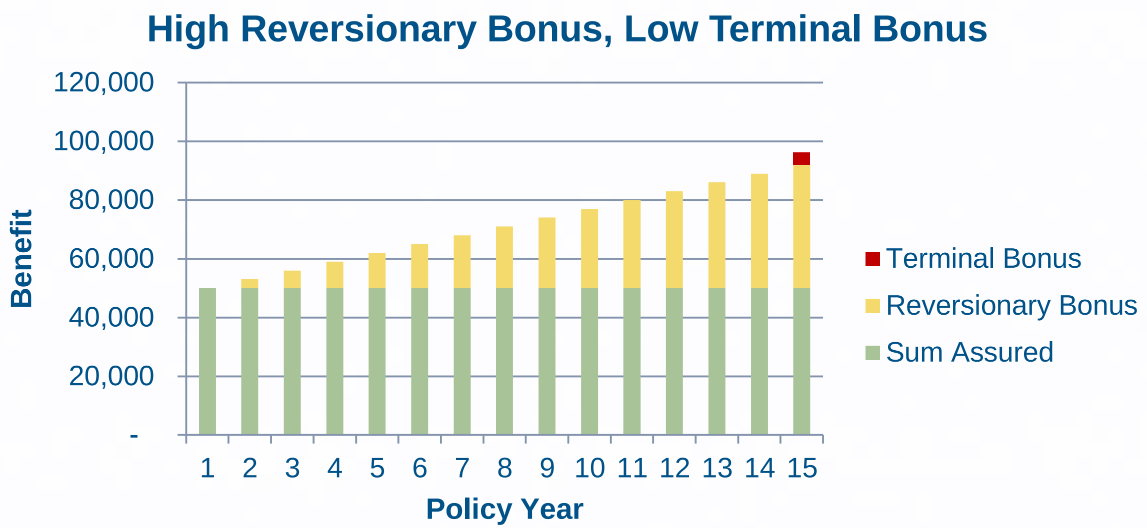
ntuc income

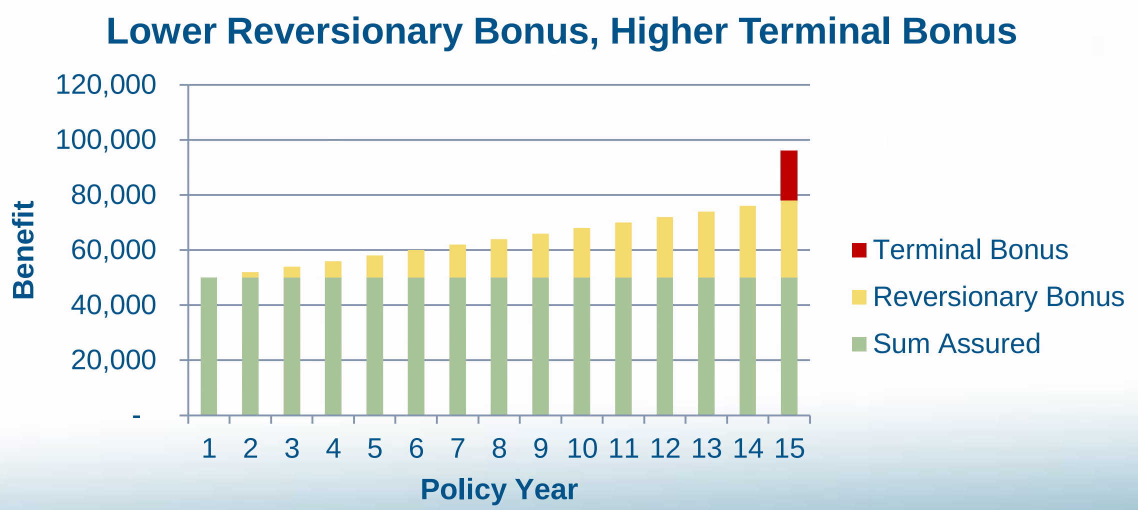
CAR	2007	2008	2009	2010
AIA	254%	228%	364%	345%
Aviva	368%	269%	299%	292%
AXA	196%	212%	145%	193%
Friends Provident	169%	177%	173%	896%
Great Eastern	248%	230%	229%	208%
HSBC Insurance	333%	348%	368%	267%
Manulife	556%	253%	391%	394%
NTUC Income	189%	191%	203%	234%
OAC	277%	211%	267%	251%
Pru Life	357%	211%	348%	239%
Prudential	339%	261%	280%	239%
Royal Skandia	-	199%	330%	50261%
Swiss Life	-	569%	383%	3162%
Tokio Marine	376%	304%	338%	354%
Transamerica	59%	598%	1085%	672%
Zurich	1716%	1217%	7396%	22021%

- Since the introduction of RBC NTUC Income has always had one of the weaker solvency positions, with one of the lower CARs in the market.
- For this reason, and in line with the MAS policy to divert more resource the weaker companies, NTUC Income has had a relatively higher level of scrutiny from the MAS.
- For this reason it is not surprising that NTUC Income has been looking for ways to enhance its financial strength.

Reversionary and Terminal Bonuses

- Reversionary bonuses are declared annually. Once declared that cannot be removed and hence become guaranteed.
- Terminal bonuses are typically paid on maturity or death, are not guaranteed and vary in amount depending on the historic performance of a policy.
- The payment of lower reversionary bonuses reduces the level of guarantees and typically improves the capital position of a company.





What Happened? (1)

ntuc income

- NTUC Income had become a significant writer of participating business.
- Its underlying philosophy was and is to provide good value to customers (many of whom are members of the co-operative). Its primary focus was the lower social economic groups in Singapore. Customer value is a stronger focus than profitability.
- The onset of Risk Based Capital regulation in 2005 placed greater focus across the industry on Capital Adequacy Ratios.
- The MAS has diverted a greater focus to those companies with the lower (or weaker) CAR's.
- The long standing CEO Tan Kin Lian left the organisation in 2008 to be replaced by Tan Swee Chieh. There was also a change in Appointed Actuary.
- In response to a weaker CAR, in April 2008 the management decided to change the structure of bonuses.
- The change in the structure of bonus declaration amounted to a reduction in reversionary bonuses and an increase in terminal bonuses.

April 2008: NTUC Income announced changes in bonus for policies signed on after 1993.
Annual bonus decrease from 2.3% to 1.3% of the sum assured
Special bonus would increase from 25% of accumulated bonus (for policies of more than 15 years) to 30% to120% (for policies ranging from 20 years to 2 years).

What Happened? (2)

2009: NTUC Income restructured the bonuses of all remaining life policies which affected 195,000 policyholders.

- Objections to restructuring came from Tan Kin Lian (the previous CEO) who held one of the affected policies!
- Specific objections were:
  - A higher annual (or reversionary) bonus is better for policyholders because it is paid immediately every year while the special (terminal) bonus is not guaranteed and can be withdrawn anytime
  - The Company was decreasing annual bonuses in a year with an unusually high investment yield of 10.7%
  - The Company did not specify certainly how special bonus would be increased.
  - Tan Kin Lian's high profile led to much further discussion in the press

"We believe that this unilateral change is to the detriment of the policyholders. It contravenes the 'reasonable expectation' of the policyholders." – Mr Tan Kin Lian, slamming the move to restructure bonus payouts on his blog

"In his blog posting, Tan says that he "will be asking a lawyer to organise policyholders who wish to submit a collective protest against the bonus cut. This will be sent to the board of directors and to the MAS." – theonlinecitizen.com

"Mr Tan reiterated that the best option would be to allow customers to choose between the old and new bonus structures, which is what some policyholders had also requested." – The Straits Times

The Outcome

- NTUC Income responded in a variety of ways.
- By communicating its justification as follows:
  - Higher weighting of terminal to regular bonus reduces the reserving impact of annual bonus. The Company can instead leave more money in the life fund which can better withstand investment market changes. This allows the Company to have better solvency, flexibility, and financial position.
  - To declare high annual bonuses, there was a need to reserve and make stable low-yield investments, when the money could have been put into higher-yielding investments.
  - The restructure would allow the Company to earn more and declare higher special bonuses.
  - With the overall idea of allowing the surrender value or death claim to be equal to what was given in the past, but allowing the Company to become more competitive and in line with industry standards.
- They engaged the services of the President of the Institute of Actuaries in UK to write a report to support the fact that the changes were made and in line with policyholders' reasonable expectations.
- The issue was discussed at NTUC Income's AGM, which the President of the Institute attended.
- Publicity on the matter has since ceased.

Conclusions

The following lessons can be taken from this case study:

- Participating policyholders are concerned about bonus structures and expectations
- Articulating bonus expectations (internally) is important
- Complaints can spread very quickly, so a need to manage change appropriately and to consider all the issues

Case Study: Merger of Manulife/ John Hancock in Singapore 2005

Background

- In 2004 Manulife and John Hancock effected a Global Merger
- Both had a presence in Singapore
- I was approached by Manulife (the 'leading' entity) to act as Independent Actuary (IA) and to discuss the requirements

Insurance Act – Section 48

- **48.**—(1) Before an application is made to the High Court for confirmation of a scheme under section 47
  - (*a*) a copy of the scheme shall be lodged with the Authority together with copies of the actuarial and other reports, if any, upon which the scheme is founded;
  - (b) not earlier than one month after the copy is so lodged, notice of the intention to make the application (containing such particulars as are prescribed) shall be published in the Gazette and in not less than 2 newspapers approved by the Authority; and
  - (*c*) for a period of 15 days after the publication of the notice a copy of the scheme shall be kept at each office in Singapore of every insurer concerned, and shall be opened to inspection by all members and policy owners of such an insurer who are affected by the scheme. [11/86]
- (2) ***The Authority may cause a report on the scheme to be made by an actuary independent of the parties to the scheme*** and, if it does so, shall cause a copy of the report to be sent to each of the insurers concerned. [11/86; 32/93]
- (3) Copies of the scheme and any such report as is mentioned in subsection (1) (*a*) or (2), ………………..shall, except in so far as the High Court upon application made in that behalf otherwise directs, be transmitted by the insurers concerned, at least 15 days before application is made for confirmation of the scheme, ***to every policy owner affected by the scheme.*** [11/86]

The role of an Independent Actuary

- Some countries have seen the need to formalize the role of an 'Independent Actuary' around any transfers of portfolios.
- Purpose is to safeguard the interests of policyholders.
  - Could be participating policyholders abut also covers other policies where company discretion is exercised e.g. unit-linked policy charges, plans with renewable premiums etc.
- Scope often discussed with relevant parties, including the regulator. Often discussion with Appointed Actuaries of both entities involved in the transfer (from/to).
- Regulation and professional guidance has developed in some countries to help define the role.

Scope for merger in Singapore

- Lawyers had prepared a draft scheme of transfer
- No precedent for a report by an IA; so a need to consult with MAS to determine requirements.
- MAS requested a report as per Section 48 of Act
- Looked at examples in UK, Hong Kong
- Agreed timeline of six months to fit into planned lodgment of Scheme with Court.
- Both companies had participating and unit linked business so a need to consider interests of both sets of policyholders

Practicalities

- Determining bonus philosophy and PRE
  - Interpretation
  - Past practice/precedence
  - Documentation
- Assessing financial strength before and after (and RBC/GPV was about to be introduced!)
- Interacting with both Appointed Actuaries
- Ensuring independence

The major gap was the formal documentation of the bonus policy that was adopted by both companies. This had to be developed through reading of historic documents and board minutes, as well as discussion with current and prior management.

Deliverables

- Draft IA report
- Final IA report
- Report available for inspection
- Report lodged with Court

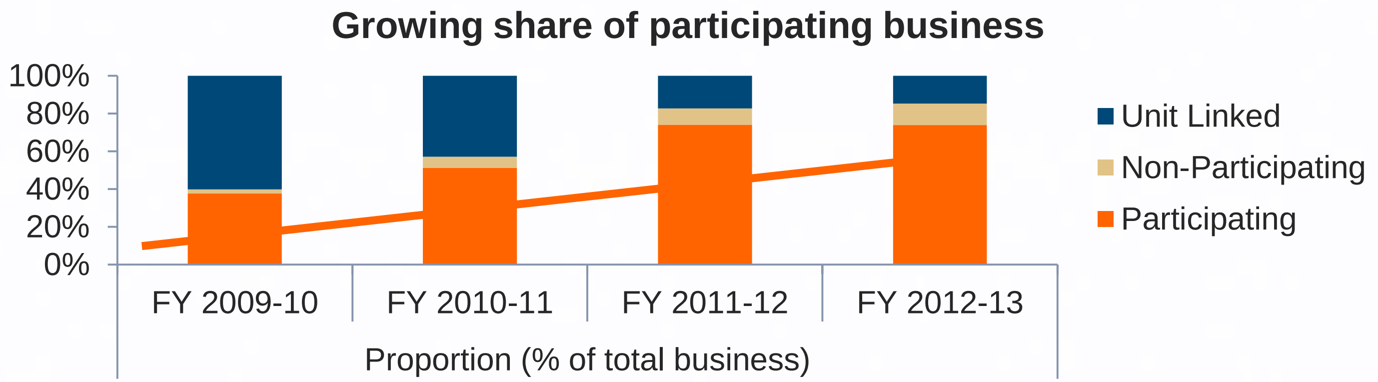
Applicable Standards in India

Overview

Increased focus on participating business

- Unit linked business declining following the ULIP regulations in Sept 2010
- “Index linked” non-participating products are withdrawn, effective 1 October 2013
- Expected increase in focus on participating business going forward

Source: IRDA’s monthly journal



Need to strengthen governance. Some initiatives include:

- Internal documentation / management framework
- GN6 (Management of Participating Business)
- IRDA regulations requiring a ‘With Profits Committee’ (WPC) to be set up
- GN 22 (Reserving for Guarantees)

Framework on management of par business (1)

Introduction

- Participating business is complex!
- Important to have a detailed documented framework for management
- Some companies have already developed internal documentation, many others are yet to have one
- Internal documentation can be similar to the PPFM document used by insurers in the UK, although need not be as detailed

- **Bonus structures - RB/TB/CB**
- **Smoothing policy**
- **PRE**
- **Investment policy**
- **Asset shares**
- **Management of estate**
- **Surrender values target benefit level**
- **Reserves**

Framework on management of par business (2)

Asset share considerations

Detailed guidance to actuaries through GN6

- Discussed at 8th CILA in November 2012
- Effective from 31 March 2014

Several things to consider in setting asset share framework:

- Grouping
- Historical operating experience available / analysed?
- Investment returns reflected (smoothed / unsmoothed)
- Level of expenses charged
- Cost of guarantees
- Cost of capital
- Miscellaneous sources of profits
- Income tax

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With Profits Committee (WPC)

Is focusing only on asset shares enough?

Scope

- The non-linked product regulations issued in March 2013 require the setting up of a With Profits Committee (“WPC”)
- The role of the WPC is stated to be to approve the asset shares and to produce a report to be appended to the AA’s Report submitted to IRDA
- Asset shares are required to be maintained at a policy level
- Surrender values offered should be consistent with the asset shares
- Two extremes possibilities for the role of the WPC:
  - Restricted to only approval of the asset shares – missed opportunity?
  - Overseeing the management of participating business

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.

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Proposed new GN to IA on WPC (1)

Background

- WPC should consist of AA, CEO, an Independent Director and an Independent Actuary (IA)
- Structuring is different from that in the UK. Important to clarify the roles / responsibilities of each member of the WPC
- Guidance to IA was felt necessary

Prudential With-Profits Committee – Terms of Reference

The WPC will be appointed by the PAC Board and will have at least three members, all independent and external. The establishment of a WPC and its membership are, as required by COBS 20.5.1(1)R and 20.5.3(4)(a), appropriate to the scale and complexity of Prudential's with-profits business.

PRUDENTIAL

WPC meetings are usually attended by PAC's Chief Executive and Chief Risk Officer, the Actuarial Function Holder and the With-Profits Actuary, though the Chairman may choose to hold meetings, or parts of meetings, restricted to committee members only. Other persons, whether employees or not of a Prudential Group company may attend at the Chairman's request. Prudential will ensure that the WPC has access to the Auditors, the FCA or other regulators as required.

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Proposed new GN to IA on WPC (2)

Selection criteria

- Independent
- Relevant experience
- No conflicts of interest

Terms of reference

- Important to review the ToR for WPC before accepting to work as IA
- Clear documentation of the ToR for IA

Exact ToR for IA not 'mandated'. But it may include:

- Attending the regular meetings of the WPC
- Reviewing / commenting on the recommended bonus rates in the light of emerging experience
- Reviewing the overall risk management framework adopted
- Contributing to / drafting the report of the WPC
- Reviewing that the Company / AA has complied with the IRDA Regulations / GN6
- Reviewing the checks applied on the working of the asset shares
- Making recommendations in enhancing the governance standards in managing participating business

Proposed new GN to IA on WPC (3)

Working with other members of WPC

- Difference of opinion – important to document
- Respecting the status of AA

Written report

- May not be required to have a separate report

Proposed new GN to IA on WPC (4)

Some issues to consider

- AA part of the WPC – potential for conflict?
- IA is the only "independent" actuarial voice on the WPC → so others may rely on IA to review the work performed by the AA. Structuring of the ToR is important?
- "Use test" – Will the insurers go by the letter and spirit of the regulations?

GN22 (Reserving for Guarantees) (1)

Overview

- Effective date: 31 March 2014
- Recommends suitable methods to reserve for embedded derivatives in all types of products (not just in participating products).
- Stochastic methodology recommended, but companies may opt for alternative methodology if such methods are actuarially sound.
- Deterministic methods may be suitable alternatives if:
  - the nature and size of the embedded derivative is such that stochastic methods is unlikely to increase the reserves materially. For example if the guarantee is internally dynamically hedged and the derivative gives rise to a payout only on failure of such a strategy.
  - Or no adequate stochastic model or credible calibration exist.
- If deterministic methods used, the AA should be able to justify it.
- Any judgment applied by the AA should be documented giving rationale and conclusion

GN22 (Reserving for Guarantees) (2)

Stochastic models

Asset models

- Stochastically model investment returns using ESGs for all material asset classes
- Freedom to select investment return projection model
- Attention to calibration of stochastic model (volatilities / correlations)
- Justify risk free returns and volatilities assumed for risk neutral methods
- Simulated asset returns should show appropriate level of variability – adequately reflecting the asset composition of the underlying portfolio
- The models and parameters should be appropriate for the business being modeled, internally consistent and based on recent market data
- Where possible, embedded derivate should be modeled using market values of market traded contracts. The model should re-produce these values.
- Volatility assumptions should be based on most recent market data. Alternatives (e.g. data from other markets adjusted to India; or historical data adjusted to be consistent with implied volatilities etc.) only if such data is unavailable or inappropriate.
- Number of scenarios selected should be enough to reduce sampling error to acceptable levels
- Particular attention should be given to the tail of the distribution
- The AA should be able to justify the model and its calibration

GN22 (Reserving for Guarantees) (3)

Other provisions

Liability models

- AA should take into consideration likely future policyholder behaviour and the extent to which this is correlated with the value of guarantees

Management actions

- In projecting cash-flows, management actions may be assumed only if they have the approval of the body that would have authority for sanctioning the action in practice.
- Examples – alteration of asset allocation; change in any charge on asset share; change in smoothing of cross subsidies etc.

Transaction costs

- If a dynamic trading strategy is assumed, the effect of transaction costs should be allowed for if material

Extreme observations

- Extremely high liabilities values shouldn’t be discarded or artificially reduced.
- If it is believed that the level / number of such reserves are not credible, the AA should revisit the calibration or choose a different stochastic model

Thank you!