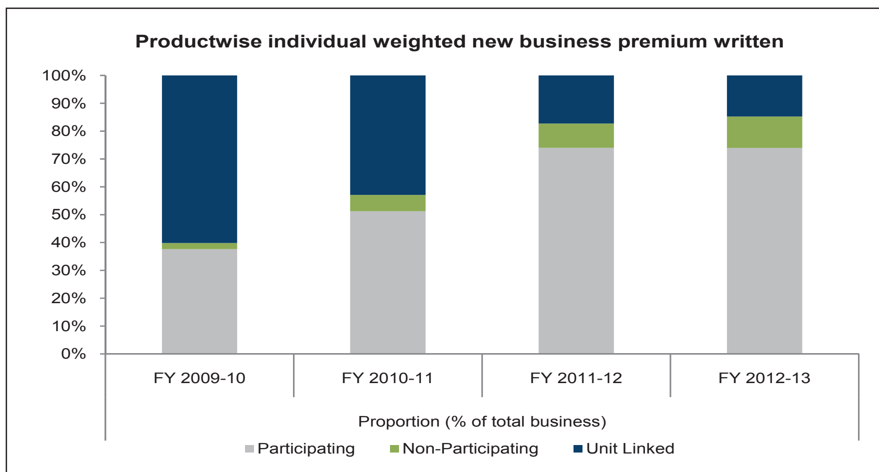
FEATURES

PARTICIPATING BUSINESS: ISSUES TO CONSIDER

Overview

A few years ago, many industry practitioners would have predicted a reducing role for participating products in life insurance markets across the Asia Pacific region, owing to falling interest rates, increasing customer sophistication and demand for unit-linked products. This was certainly true in India, where up until FY2009-10 a significant proportion of the new business for the industry (including that from the LIC) was from the sale of unit-linked products. The proportion of new business from unit-linked products in FY2009-10 was around 60%.



Source: IRDA monthly journals

However, contrary to these predictions, India has seen a resurgence of participating business, primarily due to the regulatory changes that have adversely impacted the sale of unit-linked products, and continuing high long term interest rates. The market share of participating business has increased substantially from 38% of weighted new business premium in FY2009-10 to 74% in FY2012-13. This growth has been precipitated by increased demand from both consumers and distributors. Consumer demand for participating business has increased since the 2008 global financial crisis as consumers are now seen to prefer products that offer more stable investment returns and some guarantees. Distributor demand for participating products has also increased considerably following the unit-linked product related regulations that have been introduced by the Insurance Regulatory and Development Authority ("IRDA") over the past few years that have led to participating products having more attractive levels of commission.

Since participating products have not been the area of focus in many companies in the past, less attention has been given to the establishment of an appropriate framework for managing participating business. However, given the increased volume of participating business now being written and the recent regulatory developments, companies will need to pay careful attention to all aspects of managing participating business in the future.

The Non-Linked Insurance Products Regulations 2013 released by the IRDA require life insurance companies to calculate asset shares (broadly, the accumulation of policy cash flows, expenses and claims) and to setup a "With Profits Committee" ("WPC") to oversee the management of participating business. In addition, the Institute of Actuaries of India ("IAI") has issued two guidance notes ("GN"), GN6 ("Management of participating life insurance business with reference to distribution of surplus") and GN22 ("Reserving for Guarantees in Life Assurance Business") that come into effect in March 2014.

The increased focus on participating business by the industry, the new regulations issued by the IRDA and the guidance notes issued by the IAI are all expected to result in companies paying greater attention to the many issues that need to be considered in the management of participating business in the near future.

POLICYHOLDERS' REASONABLE EXPECTATIONS (PRE)

The first step in developing a sound participating business strategy is for the company to share a common understanding of how the company interprets PRE. PRE may encompass many aspects of the operation of the participating business, such as bonus strategy, investment policy and equity between different groups and generations of policyholders. Building an understanding of PRE may involve consideration of how the frequency and content of various documents and

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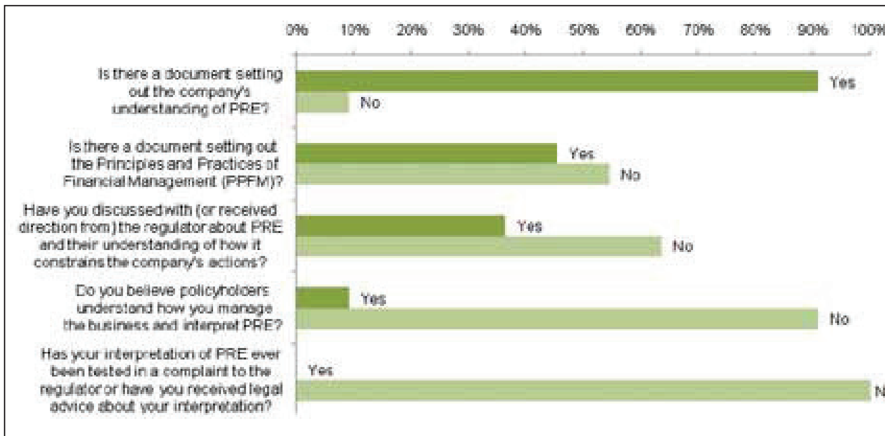

Source: Milliman's India Participating Business Survey

communication issued to policyholders and past actions taken by the company.

From a recent survey carried out by Milliman (published at http://in.milliman.com/insight/2013/India-Participating-Business-Survey/), while most companies believe they have a good understanding of how they interpret PRE, very few companies have formal documentation that sets this out. According to the survey results, a majority of life insurance companies in India have not had discussions with the IRDA, received directions from the IRDA, or tested a complaint or received legal advice on their interpretation of PRE.

Documentation of PRE may be simple or it could be as comprehensive as the Principles and Practices of Financial Management ("PPFM") document produced by UK insurance companies and disclosed to participating policyholders. While we don't expect companies in India to start publishing PPFM statements on their corporate websites, maintaining a well-articulated PRE document at least internally, would promote a better understanding of the company's philosophy regarding PRE, amongst all its stakeholders. The company can also use such a document to seek regulatory or legal feedback on their interpretation of PRE.

ASSET SHARES

The new non-linked product regulations require all life insurance companies to calculate asset shares at a policy level, which may be used for taking decisions regarding discretionary benefits. While some companies in India already calculate asset shares at a policy level, many companies are yet to adopt this practice.

Setting up asset share calculations at a policy level may pose significant challenges for life insurance companies, especially those that have been offering participating products for a long period of time and have not yet established the asset share calculations.

Apart from modelling and systems related challenges, there may be a number of other issues to consider such as:

- **Historical operating experience**
  - o Have the companies systematically stored the historical operating experience in all relevant areas?
  - o Is the experience granular enough to be able to determine the asset shares for participating products?
  - o Has the experience analysis been robust in each of the years?
- **Investment return reflected in asset shares**
  - o If companies do not separately identify the investments for the participating fund (e.g. in companies where the participating funds are small) from the other funds, how should investment income be allocated between participating and other businesses?
  - o Should the investment return used for asset shares be smoothed or unsmoothed?
  - o Is the actual investment return reflected derived consistently against the approach adopted in sales illustrations issued to the policyholders?
- **Level of expenses charged to asset shares**
  - o What is a fair level of historical expenses to be charged to the participating fund and to different cohorts of participating business?
  - o What proportion of expenses should be charged to the asset shares? It may be noted that the GN6 issued by the IAI requires the Appointed Actuary to be satisfied that if the total expenses allocated to the participating fund are higher than those charged to the asset shares, such an approach is sustainable and would not impact the company's ability to meet PRE by its effect on the surplus or working capital of the participating fund (the "inherited estate").
  - o How do you split these expenses amongst different cohorts of participating business?
  - o Are the expenses charged (particularly the acquisition expenses) consistent with those reflected in the sale illustrations issued to the policyholders?
- **Cost of guarantees reflected in asset shares**
  - o For what cohorts of business should the cost of guarantees be reflected in the asset shares?
  - o How do we calculate the cost of guarantee? If using stochastic techniques, how should the scenarios be calibrated?
  - o Is the allowance for cost of guarantees consistent with that reflected in the sales illustrations issued to policyholders?
- **Cost of capital reflected in asset shares**
  - o Should the inherited estate be used to cover the required solvency margin (RSM)? Or should all policyholders be charged for the cost of capital provided? Conversely, if a policy's contribution to the estate enables other policies (non-participating or participating) to

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cover their respective RSM, should there be a credit to the policy's asset share to reflect this?

- o At what level of RSM should the cost of capital be reflected in the asset shares in each of the past years? Should it be at the statutory minimum level (150%) or at the company's target level or at the actual level of solvency capital held?
- o How should this required capital be split amongst different cohorts for each participating product?
- o Is the allowance for cost of capital consistent with that reflected in the sales illustrations issued to the policyholders?

• **Treatment of miscellaneous sources of profits / losses**

- o How should the company deal with miscellaneous sources of profits / losses such as those arising due to surrenders, profits / losses from non-participating products or riders written in the participating fund? Should such profits / losses be allocated to the asset shares or reflected in the inherited estate?
- o Is the treatment of such miscellaneous sources of profit / losses consistent with that reflected in the sales illustrations issued to the policyholders?

• **Income tax**

- o Should income tax be charged to the asset shares when the company has not been paying taxes in the past? If not, when should the company start charging income tax to the asset shares? Should this be when the company starts making statutory profits or when it utilises all of its historical tax credits?

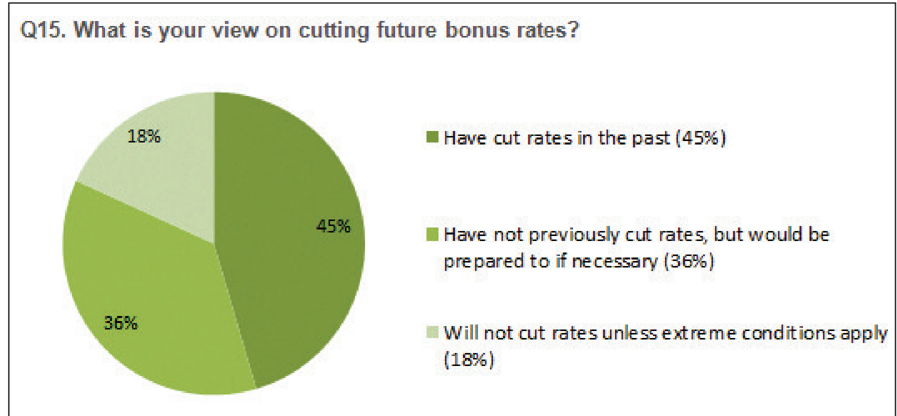
In order to develop a satisfactory approach to calculate the asset shares, companies may be required to invest a significant amount of time and to also carry out several iterations of the asset share calculations to assess their impact on bonuses and policyholder benefits. The Appointed Actuary is required to giving due importance to PRE and the need to maintain equity amongst different generations of participating policies, balancing this against the needs of shareholders as set by the Board of Directors.

A clear documentation of the company's philosophy for managing participating business in general and calculating the asset shares in particular would be essential.

SETTING BONUSES

Once the company has calculated its asset shares, this can be used for different purposes such as setting policyholder bonuses, setting the surrender value scale, determining the level of statutory reserves to be held etc.

The preferred methodology for distributing bonuses in India is a combination of reversionary bonuses and terminal bonuses. As per the Milliman survey, insurers do not seem to be inclined towards reducing the bonuses if investment returns decrease, possibly due to resistance from the distributors and due to PRE. A well-documented (and publicised) approach to managing bonuses, might facilitate more active management of bonuses by the companies.



Source: Milliman's India Participating Business Survey

The Milliman survey suggests that most insurers seem to have a good understanding of how discretion is to be applied given changes in market conditions (such as lower interest rates) and seem to have a clear idea of the triggers that would lead to a change in the bonus rates. While some companies already distribute bonuses based on target level of asset shares, largely, there does not seem to be a well-documented bonus management framework. It is important for companies to document such a framework, the key aspects of which may include:

• **Smoothing policy**

- o To what extent can reversionary bonuses be changed from one year to the next?
- o By how much will the company change bonuses in response to varying levels of changes in the economic environment or operating experience? At what level will the company abandon its smoothing policy completely?
- o How does the company ensure that all policyholder's are being treated fairly?
- o How is the surplus or deficit arising out of a smoothing operation treated?

• **Cross-subsidies**

- o What is an acceptable level of cross-subsidy between different cohorts of business? For example, how much of the excess investment returns earned by one cohort of business can be used to smooth bonuses for other cohorts of business?

• **Treatment of the inherited estate**

- o What are the company's upper and lower limits on the amount of inherited estate in the participating fund?
- o What is an acceptable level of inherited estate? It may be noted that although having such an estate is important for the smooth operation of a participating fund, a very high level of estate may also not be desirable, if it arises essentially

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due to 'under-distribution' of bonuses to past generations of policyholders.

- How should the inherited estate be distributed (if at all) to each cohort of policyholders?
- How much of the inherited estate should be retained to fund for future bonus pay-outs, RSM, new business strain and / or as working capital in the participating fund?

Finding an acceptable solution to these questions will require a clear understanding and documentation of the company's philosophy of managing participating business. Inputs on these aspects would be required from the Board of Directors.

INTERNAL GOVERNANCE

Given the significant discretion currently available to companies to distribute the profits in the participating fund, it is essential for companies to have a strong internal governance mechanism. The new non-linked product regulations require companies to take many steps towards improving the governance.

Appointed Actuaries are now required to demonstrate the following in the annual Actuarial Report and Abstracts:

- the appropriateness of the reinsurance arrangements adopted and demonstration that it is in the best interests of the participating fund;
- the appropriateness of and prudence in the approach adopted for debiting expenses to the participating fund, the cross sub-subsidies reflected between various cohorts of policyholders, and the appropriateness of the overall management and governance of the participating fund.

In addition, these regulations require the setting up of a 'With Profits Committee' ("WPC"), which would include one independent director of the Board, the CEO, the Appointed Actuary and an independent actuary. The WPC is required to approve the detailed working of the asset share calculations. A report of the WPC is required to be attached to the Appointed Actuary's annual Actuarial Report and Abstract.

Other key aspects of the management of the participating fund include setting the investment strategy based on a careful asset liability management ("ALM"). The IRDA already requires all insurance companies to setup an 'Investments Committee' and an 'Asset Liability Management Committee' to manage such aspects. While the regulations do not explicitly require the WPC to consider investment and ALM related aspects of managing a participating fund, companies may choose to expand the role of the WPC to include such aspects.

Such initiatives will go a long way in enhancing the transparency and governance standards in the management of the participating fund.

CONCLUSION

Participating business is complex! Companies need to ensure that there is an appropriate level of governance and documentation for an orderly growth of this business.

As participating business re-gains momentum in India, it is essential for companies to focus on the sound management of this business.

Managing participating business is likely to be a key role of the actuaries for the foreseeable future. It is important, therefore, for actuaries to develop a sound understanding of the various issues and challenges in managing participating business. ■■■

UP COMING EVENTS

THE ADVISORY GROUP ON LIFE INSURANCE HAS SCHEDULED 9TH SEMINAR ON

CURRENT ISSUES IN LIFE ASSURANCE

DATE: 29TH NOVEMBER, 2013 • VENUE: HOTEL ORCHID • TIMINGS: 08:30AM TO 05:15PM

SPEAKERS

Radhakrishnan Rawal – PWC
Nick Dumbreck – Milliman
Richard Holloway – Milliman
Sanket Kawatkar - Milliman
Satyan Jambunathan - ICICI Prudential
David Cook – Swiss Re
Tushar Chatterjee – Swiss Re

- Registration Fees : Rs. 5000
- Registration Starts from : 18th October & Ends on 25th November, 2013
- Register at : on IAI website, under Upcoming Event within India tag
- CPD Credit for IAI Members : 4 hrs (As per APS 9) in Life Insurance
- Point of Contact for any query : quintus@actuariesindia.org

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