04 February 2014

India Asset Share Survey

Asset shares: An important tool used in the management of participating business

"Asset shares" are widely used as an important tool in the management of participating business globally. As part of its "Non-linked Insurance Products" regulations, the Insurance Regulatory and Development Authority (IRDA) has made it mandatory for life insurance companies to calculate asset shares for participating business.

Recently, Milliman carried out a survey of the Appointed Actuaries of life insurance companies in India, to assess the industry's readiness for asset shares and to assess any emerging market practices in respect of the application of asset shares. Out of the existing 24 life insurance companies in India, we received responses from 14 companies, representing approximately 58% of the market.

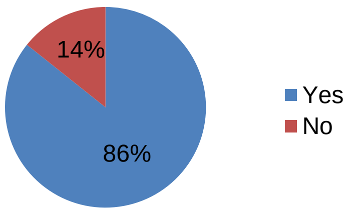
Our survey revealed that practices are still evolving, but that significant progress has been made. This is encouraging for the industry, given the key role that participating business is expected to play in the future.

We are pleased to present the results of our survey.

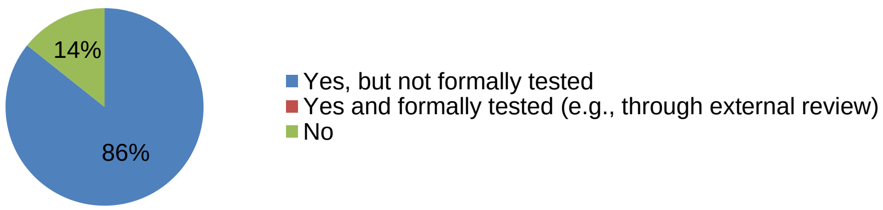
Results

General

Q1. Do you calculate asset shares for participating business?



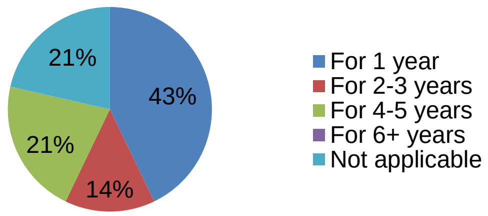
Q2. Are the asset shares calculated in line with the new Guidance Note 6 (GN6) issued by the Institute of Actuaries of India (IAI)?



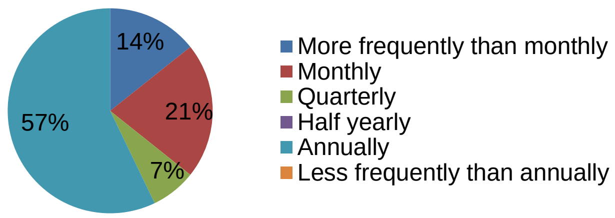
A large proportion of the respondents stated that they calculate asset shares in line with the GN6. However, none of the companies have had their asset share calculations formally tested through an external review.

This is likely to change in the near future as the IRDA now requires the establishment of a With Profits Committee (WPC), consisting of an Independent actuary and other members, with a scope which will include the approval of the detailed workings of asset share calculations.

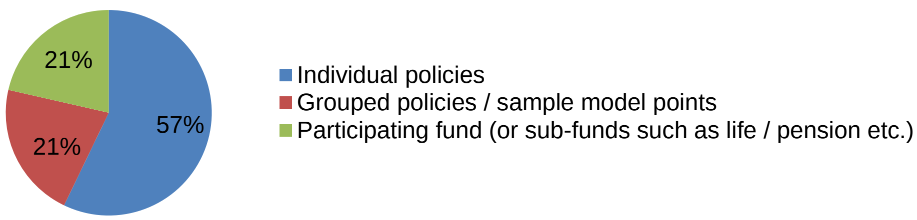
Q3. For how long have you been calculating asset shares?



Q4. How frequently do you calculate asset shares?



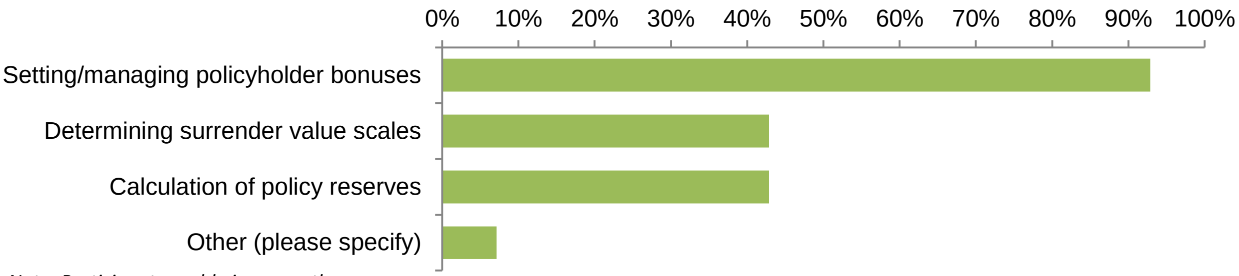
Q5. At what level are asset shares calculated?



It comes as no big surprise that a majority of the respondents have only recently started calculating asset shares considering that life insurers in India have only started focusing on participating business over the past three to four years.

A majority of respondents calculate asset shares on an annual basis at an individual policy level. Those companies (21% of the respondents) developing asset shares at a fund level, however, may be expected to change their models in the near future, considering the IRDA's requirements to calculate asset shares at policy level.

Q6. What purposes are the asset shares used for?



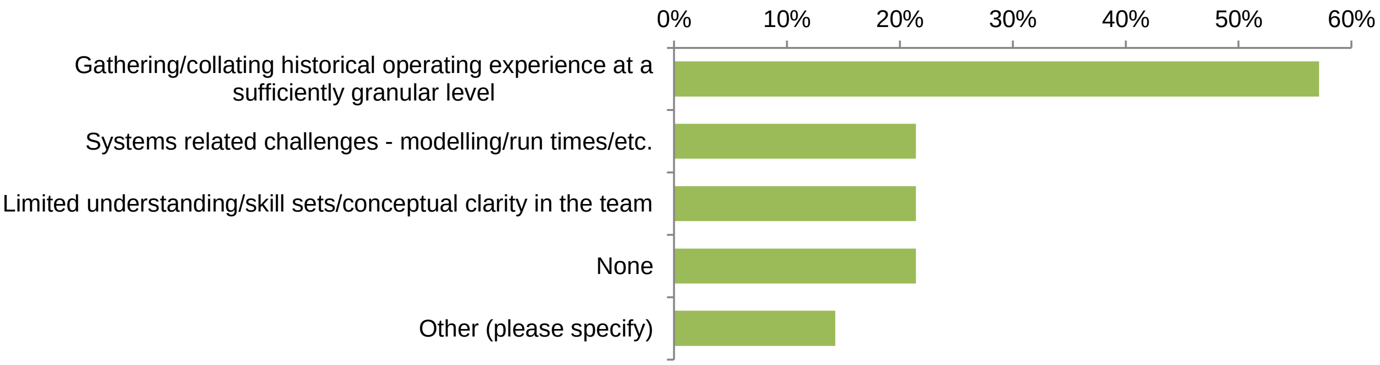
Note: Participants could give more than one answer

Responses under 'Other' are set out below:

- *"Get a broad idea for setting bonuses"*

Almost all the respondents use asset shares to set bonus levels. However, fewer companies currently use asset shares to determine the non-guaranteed surrender value scales. The new IRDA regulations require companies to provide special surrender values that are linked to asset shares. This is likely to require all companies in India to start using asset shares as a central tool for the setting of policyholder bonuses, surrender values, and for the determination of actuarial reserves.

Q7. What are the main challenges faced in calculating asset shares?



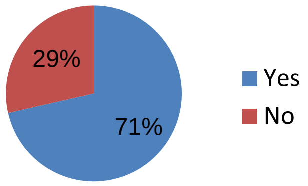
Note: Participants could give more than one answer

Responses under 'Other' are set out below:

- *"Treatment of transfers made from shareholders initially, components of asset share such as treatment of lapse profits and expense overruns in asset shares"*
- *"To manage the change, where asset shares were not used historically and the discontinuity it can cause and the effect it can have on PRE"*

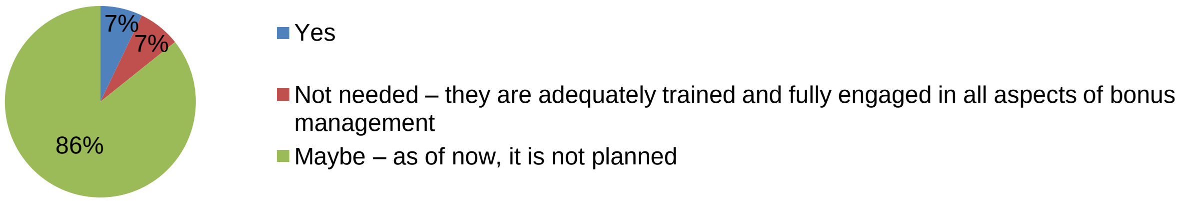
A majority of respondents indicated that collating historical operating experience at a sufficiently granular level was the main hurdle faced by them in calculating asset shares. This is likely due to companies either not having carried out an analysis of historical experience in sufficient detail or not having stored the granular data required to carry out such an analysis. Going forward, companies are expected to address this challenge by regularly carrying out detailed analysis and storing the necessary data in a granular manner.

Q8. Is there detailed documentation specifying all aspects (e.g., methods, assumptions and approximations/groupings) of the calculation of asset shares and usage of the same?



We would expect all companies to start maintaining robust documentation (somewhat similar to the PPFM document prevalent in the U.K.) on the management of the participating fund in general and on the aspects concerning the development of asset shares in particular. Indeed, such documentation is a requirement as per GN6 issued by the IAI.

Q9. Do you plan to provide detailed training to your non-actuarial senior management and Board in the role of asset shares for participating business?



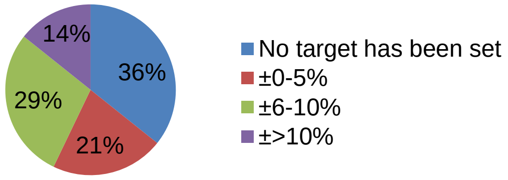
An overwhelming majority of the respondents have stated that their non-actuarial senior management and the Board members are not trained on the role of asset shares in the management of participating business.

This is a risk, considering that key decisions pertaining to the bonus declarations are taken by the Board, which may not be fully familiar with the role of asset shares in the management of the participating business. We advise Appointed Actuaries to ensure that the Board, or at least the newly formed WPC, is fully familiar with the asset share concept and its implication on decisions pertaining to the participating business.

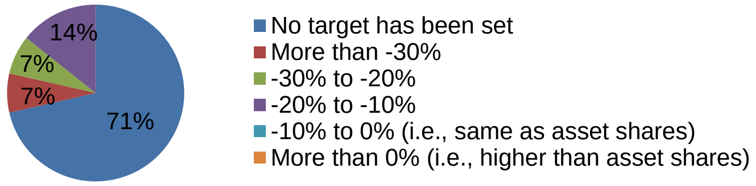
Bonuses and policyholder benefits

Target payout ratios

Q10. To what level of asset shares are the maturity amounts targeted in the normal course of events for any given cohort of business?



Q11. To what level of asset shares are the total surrender value amounts targeted in the normal course of events for any given cohort of business?



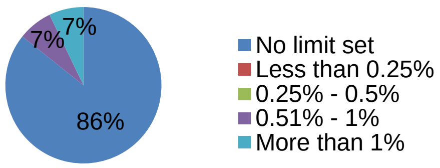
A large proportion of the respondents have said that there is no target set on the maximum amount that maturity or surrender benefits can deviate from the asset shares.

This indicates that a significant level of discretion exists in the hands of the Board of Directors pertaining to the level of future bonuses and overall benefits to the policyholders.

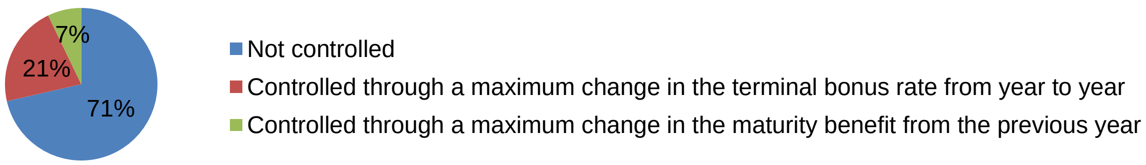
Going forward, we believe it will be important for companies to set such limits to help guide Boards of Directors in the determination of bonuses and to help better articulate 'Policyholders' Reasonable Expectations (PRE)', a term which is used in the regulations but not defined.

Smoothing

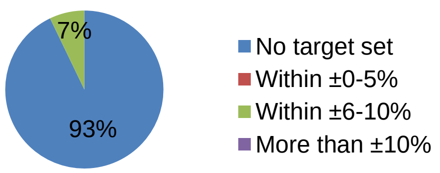
Q12. What is the maximum permissible change in the declared reversionary bonus rate from the previous year for any given cohort of business in the normal course of events?



Q13. How (if at all) are the changes in level of maturity benefit payouts controlled from year to year for any given cohort of business?



Q14. For a given cohort of business, what is the target level of maturity benefits in the current year (t) as compared to the maturity benefits in the previous year (t-1) in the normal course of events?

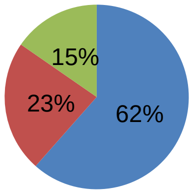


Again, a significant majority of the respondents have stated that there are no set limits on the maximum deviation in bonus rates or maturity values from year to year. This reflects the significant discretion on smoothing of benefits that currently exists in the hands of the Boards of Directors.

As with target payout ratios for maturities and surrenders, we would expect companies to adopt such limits and specify the rules on smoothing to guide bonus declarations and better articulate PRE.

Asset share calculation and management of estate

Q15. How are investment returns credited to the asset share?



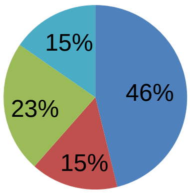
- Unsmoothed, actual returns (with unrealised gains / losses) earned
- Smoothed, actual returns (with unrealised gains / losses) earned
- Other (please specify)

Responses under "Other" are set out below:

- *"Unsmoothed returns without unrealised gains / losses"*
- *"Investment returns based on book value + realised gains"*

There appears to be a range of methods used for crediting investment returns to asset shares. The favored method appears to be to use unsmoothed, actual returns, allowing for unrealized gains and losses.

Q16. At what level are the acquisition expenses charged to the asset shares?

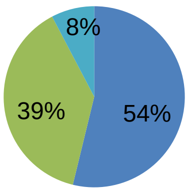


- Pricing expense loadings
- Expense loadings used in arriving at the point of sales illustrations (if different than pricing)
- Actual expenses (including acquisition expense overruns)
- Actual expenses (excluding acquisition expense overruns)
- Other (please specify)

Responses under "Other" are set out below:

- *"Actual expenses subjected to maximum of 120% of pricing expense loading"*
- *"Lower of pricing and actual"*

Q17. At what level are the maintenance expenses charged to the asset shares?

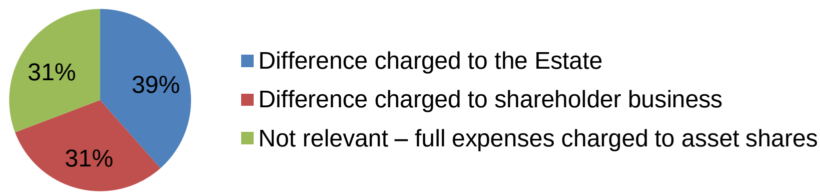


- Pricing expense loadings
- Expense loadings used in arriving at the point of sales illustrations (if different than pricing)
- Actual expenses (including maintenance expense overruns)
- Actual expenses (excluding acquisition expense overruns)
- Other (please specify)

Responses under "Other" are set out below:

- *"Lower of pricing and actual"*

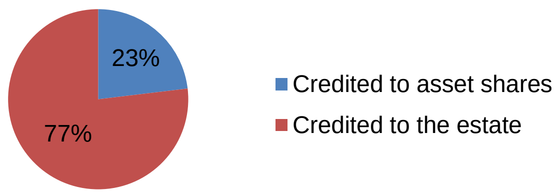
Q18. If expenses (acquisition or maintenance) charged to the asset shares differ from the actual expenses incurred, where is the shortfall or excess charged?



A majority of the respondents either use pricing assumptions or the expense loadings used to derive the point of sale illustrations, if they are different from the pricing assumptions, as the expenses charged to the asset shares. Those companies charging expense loadings (instead of actual expenses) to the asset share are almost evenly divided over charging the difference to either shareholders or to the inherited estate.

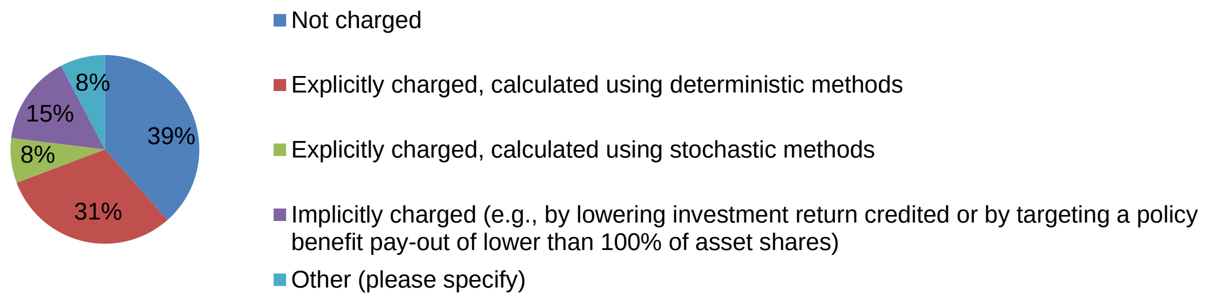
Q19. How are the profits/losses from lapsed or surrender policies reflected in the asset shares?

20. How are the profits/losses from miscellaneous sources (e.g., riders) reflected in the asset shares?



A majority of the respondents have stated that any surrender profits/losses or miscellaneous profits/losses are reflected in the estate and not credited to asset shares.

Q21. How is the cost of guarantees charged to the asset shares determined?



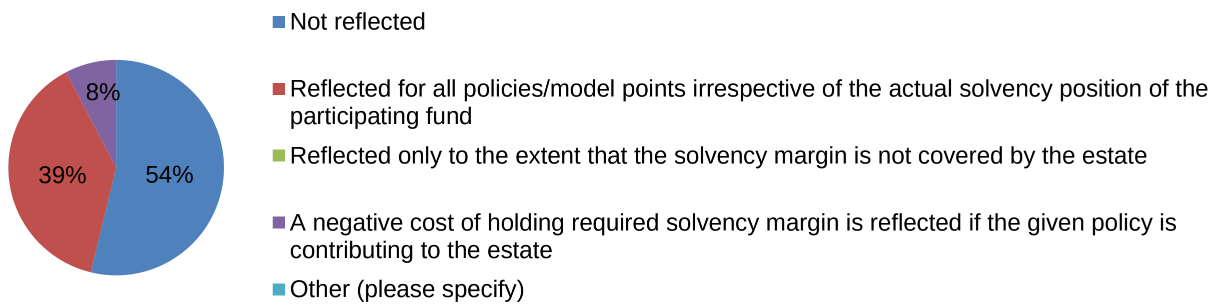
Note: Although 'other' was selected, no description was provided

There is a wide variation in the approaches used in charging the cost of guarantees (COG) to the asset share.

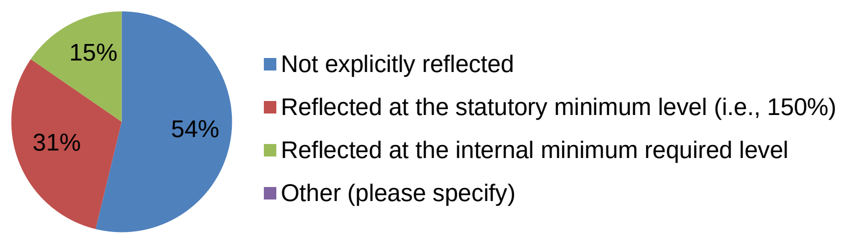
However, a large number of respondents either don't charge COG to the asset share or use a deterministic method to calculate the COG charged.

Going forward, as the focus on participating business increases, we expect more consideration to be given to the COG assessed using stochastic techniques as suggested by Guidance Note 22 (GN22) issued by the IAI.

Q22. How is the cost of holding the required solvency margin reflected in the asset shares?



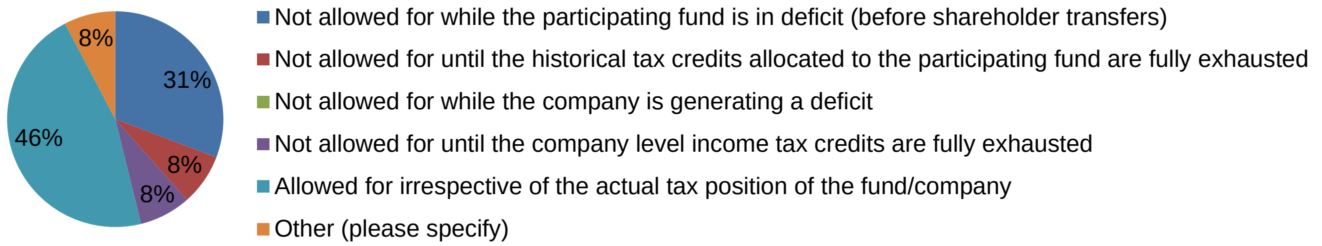
Q23. At what level is the cost of holding the required solvency margin reflected in the asset shares?



A majority of the respondents have stated that the cost of holding solvency capital is not reflected in the asset share calculations. Interestingly, one respondent stated that a negative cost of holding solvency capital is considered if the policy is contributing to the estate.

A majority of those who levy a charge on the asset shares for the cost of holding solvency capital do so at the regulatory minimum level. Only two of the respondents stated that they charge the cost of holding solvency capital at the internal minimum level.

Q24. How is income tax allowed for in the asset share calculations?

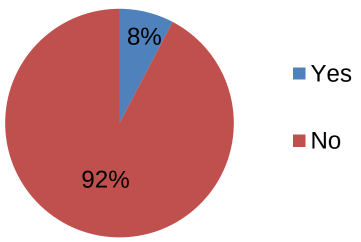


Responses under "Other" are set out below:

- *"Currently not allowed for, as the tax treatment currently is that par surplus is not taxed"*

As with the COG, there are a number of ways in which income tax is reflected in the asset share calculations. The most common approach is to allow for the full income tax, irrespective of the actual tax position of the company.

Q25. Is there a target level of estate specified?



Responses in respect of those who said 'yes':

- *"5% of reversionary bonus"*

Almost all the respondents have stated that no target level of estate is specified. Although this seems to be a common practice, we expect that companies will need to think about their participating funds in a more holistic manner given the importance of participating business. As PRE becomes better defined and the sources of profits to be credited to the estate or losses to be charged to the estate are identified, modelling and planning for the evolution of the estate will take on a greater importance, even if precise limits for the estate are not identified.

Conclusions

The industry has started calculating asset shares but faces a number of challenges: Most life insurance companies have only recently started implementing asset shares to manage participating business. It is important for companies to quickly develop expertise, collate historical experience and develop the models to calculate asset shares.

At a more strategic level, it is also important for the senior management/Board of Directors of life insurance companies to understand the role of asset shares and how they will be used to manage participating business. Issues such as building the link between asset shares and PRE and the wider management of the estate will become increasingly important as the books of participating business grow and policies mature.

A variety of approaches possible, but documentation will be key: It is clear from the survey that there are a variety of practices adopted in the calculation of asset shares and their application to determining payouts. While a range of practices is not unexpected, the documentation could be improved. The approaches adopted may also be required to be amended to meet the requirements specified in the GN6.

Please visit the Milliman Insight page given on the link below to see more articles/surveys related to participating business: http://in.milliman.com/insight/.

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