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President

7th November., 2011

Submission to IRDA

Re: Regulatory Treatment of Participating Business

This note provides the comments from the Advisory Group on Life Insurance of the Institute of Actuaries of India and does not constitute views of the Council of the Institute.

Scope

In this note we consider certain elements of the regulation of participating funds and recommend changes that, we believe, would facilitate growth without endangering policyholder security.
The specific points we consider are:

1. the liability held in respect of future transfers of (up to) one ninth the cost of bonus to the shareholders' fund;
2. the provision of capital support to participating business, in a manner that would allow fungibility of that capital once it is no longer required by the participating business;
3. the treatment of riders on participating policies;
4. the treatment of capital injections into a participating fund, as permitted under Insurance Act, 1938;and
5. the treatment of the RSM arising from participating business, and the extent to which the loss absorbency of liabilities may be utilised to cover such capital requirements.

We note that the Institute of Actuaries India is currently preparing a guidance note on the valuation of embedded derivatives. This would be expected to have an effect on the valuation of participating liabilities. This issue is not addressed in this note.

In the note, we refer to the following regulations and statute:

1. IRDA (Assets, Liabilities and Solvency Margin of Insurers) Regulations, 2000
2. Insurance Act, 1938
3. IRDA Circular No 041/IRDA/ACTL/MAR-2006: A Note on Method of Determination and Provision of Reserves for Lapsed Policies under Linked Business
4. IRDA Circular F&A/CIR/011/MAR-04: Re. Preparation of financial statements of life insurers et seq.
5. IRDA Circular F&A/CIR/014/May-09: Re. Declaration of Bonus under Section 49 of the Insurance Act, 1938
6. IRDA (Protection of Policyholders' Interests) Regulation, 2002
7. IRDA Circular /ACTL/Dept/KS on 6 November, 2001: Re: Treatment of Riders

Future Shareholder Transfers

1. The regulations ([1], above) require the mathematical reserve to provide for future policy cashflows. In the case of participating policies in particular, Schedule II-A, Section 3 states:

    The gross premium method of valuation shall discount the following future policy cash flows at an appropriate rate of interest …

    (d) allocation of profit to shareholders, if any, where there is a specified relationship between profits attributable to shareholders and the bonus rates declared for policyholders:

    Provided that allowance must be made for tax, if any.

2. In the current regulatory and tax framework, in practice, this works out to grossing up the assumed bonus rate for the future, for shareholders' share of profits, at 10 %, (other than LIC where the shareholders' share is 5 %) and again grossing up the total surplus for tax at 12.50%, plus applicable surcharge, cess, etc. The liability in respect of future bonus calculated as above is part of the mathematical reserve. Also, solvency margin is calculated on this part of the mathematical reserve (at the prescribed 4%) together with the requirement that companies should maintain a minimum of 150% of the required solvency margin.

3. We recognise that from the perspective of the financial position of the participating fund, it is reasonable to provide for the future transfers of emerging surplus to shareholders. It is accepted that based on 90:10 framework for sharing of surplus between policyholders and shareholders and the tax liability on the total emerging surplus, the calculation of liability in respect future bonus to policyholders will also take into account the other two consequential obligations i.e. shareholders' share of surplus and tax on total surplus.

4. However, we suggest that there is no justification for treating the shareholders' share of future surplus as a liability to policyholders. We propose, instead, that it be treated as a separate reserve which would sit in the participating fund. This would mean that, as with current practice, assets would have to be found to meet this reserve. The changes would be:
    i) As it would not be part of policyholder liability, there would be no solvency margin requirement on this reserve.
    ii) This reserve would be available to meet the solvency margin requirement. We may consider whether this reserve should be allowed to meet the solvency margin only of the participating fund, or of the whole company.

        Currently, in spite of constraints on actual fungibility, for the purpose of the demonstration of solvency, the participating fund's estate may be used to meet the company's solvency margin, not solely that of participating fund's business. Now, future shareholder transfers, unlike the estate, are actually expected to become fungible. So the argument for allowing this reserve to be used to meet solvency requirements at company level appears at least as strong as any for allowing the estate to be so used.

Quite apart from regulatory constraints, we should also consider what is conceptually legitimate in this regard. It appears legitimate to report the future shareholder transfers as a liability of the par fund. However, it should then, correspondingly, be viewed as a realistic shareholder asset. Given constraints on the fungibility of this asset because of the timing of its emergence, it would be inadvisable to allow it to be used to back long term liabilities outside the participating fund. However, it may be used to back capital requirements outside the participating fund. Since by rights it would a shareholder asset, it appears that it may legitimately be used to meet the company's solvency margin. This outcome would be achieved by the above proposal.

It is emphasised that this reserve would not be part of the shareholder fund.

5. The proposed treatment of future shareholder transfers is comparable to the treatment allowed by the IRDA of the fund for future appropriations (FFA) in respect of unit linked business. This arises from the surrender penalty of lapsed unit linked policies. In accordance with the IRDA Circular ([3], above), the value of this penalty, net of expected revivals, is held within the policyholder funds until expiry of the lapsed policies' revival period. On expiry, the surplus arising from the surrender penalty may be taken into the revenue account, and only then appropriated to the profit and loss account. Until then, however, IRDA has allowed the linked FFA to be counted as available assets towards the solvency margin requirements.

6. As with all other liability items, the proposed reserve towards shareholders' share of surplus will be subject to movements up and down taking into account the annual release of surplus and the revised calculation of this reserve on every valuation date.

7. It is also to be kept in mind that the corresponding assets are still part of policyholder funds which are to be invested as per the investment regulations applicable to participating business and the investment return is also part of the participating business fund.

8. As the reserve amounts are unbundled items, it would be easy to identify them to make changes in the NLB, IA, KT Forms etc. and in the Financial Statements.

9. The proposals, if accepted would provide substantial relief in terms of capital requirements for par business, without impairing the security of policyholder interests or bonus prospects.

Capital Support

10. The injection of capital into a participating fund is not attractive to shareholders, given that they can only get a return on this capital as and when bonuses are allotted to participating policyholders via the 90:10 (or 95:5 for the LIC) gate. That is, shareholders will get one ninth (or one nineteenth) of the cost of bonus as and when it is paid to policyholders. However, capital injections may be necessary in order to generate a surplus, which could be used to fund a bonus declaration.

11. A more appropriate approach is proposed to recognise the source of funds used to support the participating business. The proposed approach introduces the concept of a 'surplus account' which sits alongside the participating fund, but which remains the property of the shareholders. Shareholders would inject capital into the proposed surplus account to provide capital support where appropriate. The surplus account is intrinsically integrated to and tied to the participating fund, but belongs to shareholders. The shareholders' access to the fund would be fettered to prevent the removal of funds from the surplus account should they be required to provide adequate financial security for the participating fund. The surplus account could be drawn down to the extent that the capital in the surplus account were not needed to support the participating fund.

12. The proposal is similar to that introduced by the Monetary Authority of Singapore when they reviewed the Singapore Insurance Act and relevant regulations in 2005.

13. As an example, if the participating fund is in deficit by say 10 crores (i.e. liabilities exceeding assets), shareholders would inject 10 crores into the surplus account. This money would then be invested and would belong to the surplus account until such time that the participating fund moves into a surplus position when the capital in the surplus account can be returned to shareholders. In the meantime, it may be used to support the solvency of the fund, in particular, to meet the cost of bonus declarations.

14. Under Section 49 of the Insurance Act, a shareholder may need to inject capital into a participating fund should it fall into deficit to facilitate the declaration of bonus to policyholders as set out in IRDA Circulars F&A/CIR/011/MAR-04 et seq. The injection of such surplus is not attractive to shareholders as discussed above.

15. Alternative methods to provide capital support have been used in other territories including the use of contingent loans or other support arrangements. For example, following a reattribution exercise or other corporate re-organisation, a shareholder may be required to provide capital as either a contingent loan or as a ring-fenced account. The capital support is drawn down when a pre-defined measure of solvency is breached and only repaid when the financial support is no longer needed. Such arrangements share the attraction of the proposed surplus account in that they allow capital support to be provided only when needed, but suffer from the difficulty in establishing an appropriate rate of interest to be levied against such support. Adding investment returns earned from the assets held in the shareholder

account to the surplus account ensures a fair commercial return is achieved for shareholders providing such support, but without imposing a penalty or other charge on the participating fund itself. In Singapore, capital is returned to shareholders at face amount, with policyholders benefiting from any investment income earned on the surplus account. This is equivalent to imposing a zero rate of interest on a contingent loan.

16. Notwithstanding the availability of a shareholder surplus account to provide capital support as referred to above, it may be necessary to prescribe a minimum requirement in respect of the assets held within a participating fund. Such an approach has been adopted in the UK, where the participating fund's solvency is required to be maintained on a 'realistic basis' and in Singapore, where the participating fund's assets must cover at least a 'minimum condition liability.' **We recognise that such arrangements would require the construction of minimum requirement for the participating fund. The Institute would be happy to help develop such a construct in India.**

Riders on Participating Policies

17. As per Circular ([7], above), the treatment of the rider has to be consistent with that of the base plan. The whole policy, base policy along with the rider, is deemed a participating contract if the rider is attached to a participating base contract.

18. Riders are expected to generate surplus. We note that bonus series for a particular product will not typically differ by whether a rider is attached to the base policy or not. As a result, the benefit of the surplus generated is shared among all participating policies. This may amount to a systematic cross subsidy under certain situations, from policies with riders to those without. If the rider were written in the non-par fund, this cross subsidy would be avoided.

19. We also note that riders written in the non-participating fund would be more profitable to shareholders, since their profits would not be shared with participating policyholders. This would render them more attractive to shareholders and possibly have a beneficial effect on pricing, which should stimulate the development of protection business.

20. We note that IRDA recognises policies to be participating or non-participating, and that riders are not recognised as separate policies. Hence, if the base policy is participating, the rider is deemed to be so. However, we suggest that this view may be reviewed in the light of the above.

Capital Injections into a Participating Fund

21. We have already considered the alternative solutions for capital support and here only deal with issues related to capital injections into a participating fund.

22. Section 49 of the Act ([2], above) provides that no insurer shall declare bonus to the policyholders except out of a surplus shown in the valuation balance sheet. It also provides that shareholder injections may be used to generate surplus for funding the cost of bonus, so long as the injection is 'brought in as revenue through revenue account applicable.' However, IRDA Circulars ([4] & [5], above) limit the ability to inject capital into a participating fund to the first ten years of operation of a company.

23. Insurance companies may have started a participating fund some time after the start of their operations, or may be generating reasonable new business strain in their participating fund long after the start of their operations, or may require capital to smooth bonus rates in line with PRE. In such a scenario, the existing estate may not be sufficient and so shareholders may be required to provide capital to the participating fund even after the ten year limit mandated by IRDA.

24. We note that shareholders are naturally averse to injecting capital into a participating fund, since the return on investment may be made only from distributions through the 90:10 (or 95:5) gate. However, for the reasons given above, though injections may not be desirable from the shareholders' perspective, they may be necessary in order to grow the business or to meet PRE. Given the economic disincentive, regulatory obstacles may be considered supererogatory.

25. One reason for injecting capital into the participating fund could be to artificially inflate bonuses. Though this is a plausible risk, there are checks and balances already in place which should ensure that this does not happen.

26. Increase in bonuses, by injecting shareholder capital, would prima facie lead to inflating PRE. The Appointed Actuary in the Section 4.3 of 'Appointed Actuary's Annual Report' and Section 8.1.1 of 'Actuarial Report and Abstract' has to justify the sustainability of the bonuses declared and also ensure that the PRE is not inflated. We believe this is a strong enough check and there is no need to restrict capital injections into the fund.

    We further note that when the injection is allowed, as per IRDA Circular ([5], Item C6):

    > *The transfer of funds to the Policyholders' A/c shall be supported by a special resolution of the shareholders at the general meeting of the insurer. Further, the Insurer shall appropriately increase the paid-up equity capital, within a period of six months from the date of transfer of funds, or such longer period as may be approved by the Authority, with a view to aligning the paid-up equity capital, such as to make up the deficiency (including the cost of bonus) in the life fund as aforesaid, and is backed up and represented by Policyholders' assets/investments.*

    We request the Authority to relax this constraint. The overall capitalisation of a company may be very strong, and injections to the participating fund well

within its financial capabilities. Raising further capital should not be mandated in such circumstances. Whether further capital is required would depend on the overall financial condition of a company, not on one such transaction.

RSM Arising from Participating Business

27. **Our recommendation is that the IRDA considers treating 50% of the value of future policyholder bonuses as being available to meet solvency requirements. In recognition that future bonus rates are loss absorbent, it is reasonable to argue that some part of the reserve for future bonus should be treated as solvency capital.**

28. As commented above in the context of the provision for future shareholders' transfers, such an approach is practiced in Singapore, where 50% of future bonuses and 50% of any MAD's built into the valuation liability are available to meet solvency requirements. The relevant Malaysian regulations also permit a proportion of the undistributed surplus to be used to cover capital requirements.

29. In Europe, Solvency II and the current UK regime also explicitly allow for the loss absorbency of future bonus in considering the risk capital requirements.

With Regards,

Liyaquat Khan