Nov 25, 2012

Views of the Institute of Actuaries of India on Proposed IRDA's (Life Insurance-Reinsurance) Regulations, 2012

Background

It is not apparent from the proposed regulations as to what issues promoted changes to the existing regulations. However, it was felt the possible concerns that might have led to the proposed changes are as follows:

- Unjustifiably low level of retention resulting in lack of risk assessment capacity building at the insurance companies – This is a genuine concern if it is really wide-spread. There may be products or risks where a quota-share and/or low level of retention is justifiable from risk management point of view. There is already disincentive through cap on capital credit for use of reinsurance. Such an issue would be best addressed by examining why such a high level of reinsurance that the company concerned thought appropriate and guide them on why such an arrangement might not be appropriate. So, exception management is perhaps a better way to deal with the issue than bringing out an umbrella change to the existing regulations.

- Fronting by one or more insurers – The use of word 'fronting' for low level of retention does not seem wholly appropriate. 'Fronting' has a negative connotation and typically means situations where one entity, normally not able to or allowed to operate in a particular jurisdiction, is fully controlling another entity which is able to and allowed to operate in the said jurisdiction. In essence, the 'Fronting' is designed to circumvent any of the existing regulations. Should that be the case, then the appropriate response would then be non-compliance handling. There are instances of very low retention within the country on the general insurance for large risks. So, it is important to have regard to the reinsurance regulations in general insurance in terms of terminology, treatment of large risks, and retention within the country for reasons of consistency.

- No direct monitoring/control over the foreign reinsurers by IRDA with the current legislative/regulatory framework. The reinsurers present in the market are global in nature and regulated by authorities in various jurisdictions. Possible and more appropriate solutions to this issue would be

- to work through the International Association of Insurance Supervisors (IAIS) to develop comfort on the reinsurers and their practices
- to seek additional information on the reinsurance arrangements from the insurance companies (something that the IRDA has already been doing)
- to make legislative changes to enable the reinsurers set up local branch offices (our understanding is that this is something the Government of India is already working on)

General Comments

- Reinsurance is a well established risk management tool across the globe for many years. The proposed prescription on the level of reinsurance is not wholly appropriate, and arguably limiting extensively the use of reinsurance by the risk managers of the insurance companies. We suggest that reinsurance may be seen as part of an insurer's capital and risk management framework. It is also a commercial decision and insurers should be free to decide on retention limits that, inter alia, optimize the commercial benefits. If reinsurance is cost effective, all other things being equal, customers will benefit from lower premiums.

- Reinsurance is an integral part of the insurance industry globally. Particularly, in developing industries such as ours, the role of reinsurers in terms of products, risk management and knowledge/best practice sharing cannot be undermined. So, regulations should facilitate development and growth of the reinsurance industry as much as that of the direct insurance companies.

- Financial strength of the reinsurers is of prime importance and this is already covered by the existing regulations. Also, the existing regulations on the extent of capital relief for use of reinsurance ensure that there is sufficient capital within the insurance company in order to reduce over-reliance on reinsurance and the resulting counter-party risk.

- If, in the view of an actuary pricing a product, reinsurer's estimate of future experience reflected in the reinsurance premium rates indicates an opportunity for arbitrage (the reinsurer's view being more aggressive than that of the actuary), there is no reason why the actuary should not maximize reinsurance, other things being equal. This helps keeping the price to the end-customer low and provides more comfort for the insurers to venture into newer territories in terms of products, distribution etc. The existing reinsurance regulation provides this flexibility.

- Under-reinsurance is likely to be more detrimental than over-reinsurance from risk management point of view, other things being equal.

We would therefore recommend a principle based regulatory regime with any prescription applying at the company level (similar to the existing framework linking to capital/solvency credit for reinsurance) and leaving the product/risk level arrangements to the judgment of the risk managers of the company.

Specific comments

- **Point (i) of regulation 3(a) proposes maximizing retention within the country as one of the objectives of reinsurance.**

  The reinsurance market is a global market and diversification of risk is essential to its functioning. It is therefore improbable that any single domestic market, if it retained its risks, could offer good value.

  Unlike original terms reinsurance, the existing risk premium YRT reinsurance structure does not lead to significant funds getting built and so any notion of maximizing retention within the country would help improve domestic infrastructure investments is not accurate.

  The maximization retention within the country may conflict with objective (iii) of regulation 3(a) of securing the best possible protection for the reinsurance cost incurred. Furthermore, there may be insufficient capacity and/or expertise to reinsure risks in the domestic market.

- **Regulation 3(b) proposes reinsurance programmes to be filed every year**

  Reinsurance programme evolve over time and any significant changes lead to administrative complications; the yearly filing appears too frequent and might not add much value; Also, given that reinsurance arrangement is looked at product level through the product approval process, the frequency of this filing should be low, say, once every 3 or 5 years.

  Justification of a particular reinsurance programme will tend to be quite subjective and may lead to inconsistencies from one case to another; alternatively, the IRDA may ask confirmation as to whether the arrangement has the approval of the Board of the company.

- **Regulation 3(d) prescribes that the insurer shall determine the credit risk and concentration risk of the reinsurance arrangements and explain the measures taken to mitigate such risks in the reinsurance programme.**

The more objective way to achieve this is to apply restrictions on ceding of business to reinsurers based on their credit rating.

- ***Regulation 5 stipulates benchmark retention limits by age of insurer and line of business (type of product).***

Companies attempt to balance growth, risks & capital at the portfolio level and so cross subsidies may be inevitable to achieve the optimal results. The product level ratio monitoring takes away this flexibility. It will also lead to administrative burden without adding much value. Further, since reinsurance premiums will increase with age while the office premiums remain level, the ratio will vary from year to year. So, product level ratio approach is not wholly appropriate. It is therefore recommended that the ratio be applied at a portfolio level. The 2% and 30% limits may not be adequate for all types of products even within a particular line of business. We suggest that these limits could be applied in aggregate.

Linking the retention limits to the age of the company, especially for pure protection contracts, may result in protection products with significant or innovative covers not being made available. For example, the retention limits specified for health products will require insurers to practically retain the entire risk. Given the lack of suitable experience, it will be difficult for insurers to offer health products without reinsurance support. Alternatively, higher premiums may need to be charged to customers to account for higher cost of capital.

Prescription of monetary limits for retention is rare globally. It requires heavy maintenance as risk dynamics change over time and also takes away the flexibility outlined above. It is a welcome feature that there is some flexibility in the sense that the insurers may be able to justify lower retention on certain types of risks. However, this is a matter of high subjectivity and would likely lead to issues of consistency from one exception to another. These limits indicate there should be no quota share arrangement. Risk premium quota share arrangement can be appropriate on risks where there is greater uncertainty around the incidence than the cost of claim (e.g. health insurance).

These limits on the level of reinsurance may lead to significant additional capital requirements for some insurers if it means significant shift from the current levels. With the current business slow down, this could prove to be very challenging for the insurers. It is therefore important that any changes are phased in gradually. The additional cost of capital required would also flow through to the policyholders in the form of higher premium.

Depending upon how these limits impact the revenue stream, there may be issues of scale for the reinsurers to have meaningful local operations/support services. This will negatively impact the developing insurance industry in many ways not limited to, access to reinsurance services like product development, underwriting, claims and risk management frameworks, optimal use of capital, and leveraging of international experience and expertise.

- **Importance of reinsurance in the development of Annuity business**

  The proposed regulations make no explicit reference to the reinsurance of annuity business. We understand that IRDA is keen to develop immediate annuity business in India and is concerned about longevity risk exposure of LIC. Reinsurance may have a central role in meeting both objectives. In view of poor quality of annuitant mortality experience data and almost no information on longevity improvement a new annuity writing company in Indian market may like to reinsure a large chunk of such business. If a company wishes to introduce impaired life annuity/ underwritten annuity, reinsurance will play a major role. It is therefore important to create a stable regulatory environment, legislative framework and meaningful business to encourage the global reinsurers to invest in local research and training.

Recommended next steps

Detailed examination of the specific issues/concerns the proposed regulations attempt to address and appropriateness of the solutions to each of those issues with specific reference to the following:

- Existing levels of retention by the insurance companies to assess if indeed there was a wide-spread issue of unjustifiably low retention levels and what types of risks that they are associated with, while linking the same to the current regulatory framework with a view to assess the linkage between the intent and results stemming from the same
- A Cost Benefit Analysis on individual components of the Regulation and its overall impact on business (policyholders and shareholders measured against the stated objectives) is essential before such changes are made.
- How the proposed changes compare to that of International best practices, particularly the principles outlined by IAIS (refer to Annexure 1)
- Extent of and areas in which the policyholder protection/benefits are enhanced or eroded by these changes
- Impact on capital requirement and risk management of the proposed limits on the current and expected future portfolio of the insurers
- Examining the impact on the reinsurers in terms of what these changes would mean to the current scale and operations model of the reinsurance business in India

Annexure1: IAIS Principles

It is important to note the International Association of Insurance Supervisor's (IAIS) has issued a document titled Insurance Core Principles, Standards, Guidance and Assessment Methodology dated 1st October 2011. Amongst other things the document details the aspects relating to Reinsurance in section 13. Some key aspects are detailed below:

- Reinsurance by cedants should be looked at as part of an overall risk assessment of the cedant and not merely with reference to a single type of risk and whether that risk has increased or decreased.
- Responsibility for developing and agreeing upon the strategy should rest with the Board and Senior Management of the cedant, who should also be responsible for establishing appropriate monitoring mechanisms to ensure that the strategy is being delivered and complied with by the company's management.
- Reinsurance provides flexibility for insurers in the size and types of risk and the volume of business they can reasonably underwrite. It can allow the insurer to enter into new business, expand or withdraw from a class or line of business and/or geographical area within a short period.
- Properly structured reinsurance programmes will assist insurers by limiting wide fluctuations in underwriting results. As a consequence, the limited risk spread will allow the insurers to reduce the required amount of their own funds at risk and hence improve the insurer's solvency margin.