5th GCA
Deficit in Policyholder’s Fund

19th and 20th February 2003

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Deficit in Policyholder's Fund

- Focus on
  - Statutory Reporting
  - Policyholder Protection
  - Bonus Regulation
  - Solvency
  - Some Taxation Issues
  - NOT Realistic Reporting of profits

Deficit in Policyholder's Fund

- Background
- Requirement of The 1938 Act and IRDA Regulations
- Methods of Dealing with Deficit
- Consequences for Indian Insurers and Actuaries
- Practice of Other Countries and View of Other Actuarial Bodies

Background

Background

- Indian Insurance Industry opened again for private participation in year 2000
- Participating business is marketed by new companies
  - Need for new life funds
  - New Life funds tend not to have retained profits or profits generated by existing business to mitigate cost of capital of new business
  - Expense overruns are high
  - Hence deficits occur

Background

- However, deficits can still occur due to
  - Mis-pricing
  - Mismanagement
  - Inappropriate Asset Liability Management (ALM)
  - Therefore, deficits not unique to Indian environment

Background

- Definition of Deficit - should be defined
  - Best estimate liability level or solvency?
    - What if life fund has no deficit at the best estimate level of liability?
  - What level of MAD and PAD?
  - What is the basis of asset valuation - marked to market or book?
  - Should deficit be eliminated only at balance sheet date?
  - Deficits calculated for each fund or aggregate of all funds?

Requirement of The 1938 Act and IRDA Regulations

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- The IRDA Act 1999 amended the Insurance Act 1938
  - insurers are required to keep separate accounts for policyholders and shareholders
  - PREPARATION OF FINANCIAL STATEMENTS AND AUDITOR'S REPORT OF INSURANCE COMPANIES) REGULATIONS, 2002 requires the accounts to be shown separately.

Methods of Dealing with Deficit

Methods of Dealing with Deficit

- Allow the deficit to continue
- Transfer from shareholders fund to cover the deficit
- Earmark assets to cover the deficit
- Shareholder loaned funds to the policyholder
- Reinsurance with reinsurers
- Reinsurance between funds?

Methods of Dealing with Deficit

- Allow the deficit to continue
  - As long as total company meets its solvency requirement
  - Other creditors (of the shareholders) should be made clearly subordinated to policyholders
  - ALM can be managed through the use of a “shadow portfolio”

Methods of Dealing with Deficit

- Transfer from shareholders fund to cover the deficit
  - Straight forward but
    - 90/10 gate applies on the way out
    - capital injected into fund is NOT tax deductible

Methods of Dealing with Deficit

- Earmark assets to cover the deficit
  - Assets must be of good quality
  - Other creditors (of the shareholders) should be made clearly subordinated to policyholders

Methods of Dealing with Deficit

- Shareholder loaned funds to the policyholder
  - Through subordinated (sub) debt or other means
  - Legislation does seem to allow policyholder fund surplus to be used to service “Debentures”
  - Should interest on the loan be allowed and at what level?
  - Must avoid double counting of loan asset in both policyholder and shareholder funds

Methods of Dealing with Deficit

- Reinsurance with reinsurers and/or Reinsurance between funds?
  - IRDA Reinsurance Regulations do not allow for reinsurance at original terms
  - Is reinsurance between funds allowed?
  - Reinsurance without true risk transfer should really be recognized as a loan?
    - Is a loan under US GAAP
    - The impact would then be on solvency margin only - as one liability is replaced by another one

Consequences for Indian Insurers and Actuaries

Consequences for Indian Insurers and Actuaries

- If deficit not covered by funds injection
  - Is the policyholder's interest really protected?
  - How to gauge Policyholder Reasonable Expectation?
    - Is subordinated debt truly subordinated?
    - Should deficit financing other than capital injection be disclosed to the policyholder?

Consequences for Indian Insurers and Actuaries

- Capital
  - once capital in fund, 90/10 gate applies on the way out
- Taxation
  - although we are focusing on statutory and solvency reporting, tax is an issue
  - taxation should be consistent with statutory treatment
  - capital injected into fund is NOT tax deductible

Consequences for Indian Insurers and Actuaries

- Insurance Act 1938
  - Only allows dividends/bonuses to be declared out of surplus
  - Indian insurers are limited therefore to two choices
    - Inject capital
    - Loan from shareholder’s fund (if allowed by the IRDA)

Practice of Other Countries and View of Other Actuarial Bodies

Practice of Other Countries and View of Other Actuarial Bodies

- Australia
  - Statutory funds are kept
  - Assets in each fund must be able to cover liabilities (and Capad) independently
  - Shareholder must transfer or retain (their share of) profits in the fund
  - But
    - shareholders can account for their interest in the fund
    - shareholders can transfer their interest out when not needed

Practice of Other Countries and View of Other Actuarial Bodies

- Australia
  - Advantage
    - safety of policyholder's interest
    - recognizing shareholders can transfer their interest out when not needed

Practice of Other Countries and View of Other Actuarial Bodies

- Singapore and Malaysia
  - No deficit allowed in fund
  - Shareholder must transfer to cover deficit
  - Shareholder can only recover the capital through the bonus declaration method (and share 90/10 with the policyholders)

Practice of Other Countries and View of Other Actuarial Bodies

- Japan
  - Most Large companies are mutual companies
    - selling par and non-par business
  - No Life fund concept, solvency at the company level
  - Many companies have run into solvency problems and
    - haven been taken over
    - rescued by “group companies” through subordinated debt which counts a capital
    - taken over by industry protection fund and subsequently sold

Practice of Other Countries and View of Other Actuarial Bodies

- Korea
  - No Life fund concept, solvency at the company level
  - Par business have a separate income statement and balance sheet
    - no segregation of assets, separate bank accounts,..
    - Allocation of expenses and investment income defined by regulations
    - deficits of par business is allowed to be carried forward
    - dividends can be declared even with deficits in par business
  - Companies have been in trouble and being supported by subordinated debt of parent/group companies

Practice of Other Countries and View of Other Actuarial Bodies

- UK
  - Falling equity prices have resulted in support from shareholders in the policyholder’s fund
  - Use of subordinated debt is common
  - Use of reinsurance is also common
  - UK actuarial profession is in active discussion regarding PRE, disclosure and solvency issues

Practice of Other Countries and View of Other Actuarial Bodies

- USA
  - National Association of Insurance Commissioners (NAIC), the de facto regulator do not require assets and liabilities of life fund be separate from shareholder's fund
  - Solvency is looked at from a total company perspective
  - Demutualized companies set up a "par fund" to ensure that policyholders are protected
  - Par fund must be solvent

Acknowledgements

- Actuarial Society of India
- Mr S P Subhedar
  - Article in “the Actuary India” - 1 January 2003
- Fellow Appointed Actuaries
  - Peter Akers, FASI
  - Nick Dexter, FASI
  - Andrew Wakeling, FASI
- IRDA

Thank You