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President

16th April, 2012

Submission to IRDA

Response to IRDA letter on Product Design (IRDA/ACTL/NAV/55(6)/02/2012) dated 16th February, 2012 to Life insurance Council

INTRODUCTION:

This submission provides comments from the undersigned based on the feedback from Advisory Group on Life Insurance of the Institute of Actuaries of India and other stakeholders in the subject matter taken off-line through personal discussions. This approach was adopted so as to get to the bottom of the issues to the extent possible and convey to IRDA. Therefore, this submission does not constitute views of the Council of the Institute.

Though the above letter from IRDA was addressed exclusively to the Life Insurance Council, on request the same was subsequently allowed to be commented upon by the undersigned.

We appreciate IRDA's intent in respect of the protection of the interest of the policyholders and whole heartedly support its efforts in that direction. We emphasize that the raison-de-etre of insurance regulatory regime is protection of the interest of the policyholders irrespective of the fact as to who other stakeholders are: The Insurers (whether in the public or private sector), Intermediaries, Consultants or the Government. The development on sound basis and growth of life insurance industry is imperative to provide products that meet the needs of the mass of humanity that India consists of. However, such development can not be at the cost of the first and basic objective ie protection of the interest of the policyholders. The growth of the life insurance industry objective falls in the lap of number of agencies, primarily the government, the business houses if the opportunity of business makes sense to them and the civil society through organized societies centered around principles of mutuality and solidarity, created for objectives other than taking insurance cover.

The Life Insurance is a mechanism to provide solutions so that enough financial resources are available to an individual when the same is needed while such an individual travels through the passages of life. Details apart, there is no substitute to life insurance and thus the life insurance products are bread & butter for a financially healthy and self-respectful society. The structural design of these products and steering these in a manner that policyholders' financial requirements are met first

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while returns to other stakeholders are generated. There is thus a conflict of interest inherent in the system between the policyholder, who pays for buying the products and other stakeholders, who derive monitory compensation for services performed, through the passages of the life insurance products. The institutional mechanism to ensure this is through the system of Appointed Actuary, an individual appropriately qualified, professionally regulated and performing tasks within the realm of the Insurer, a watchdog for the policyholder, reporting to the Insurance regulator the later being charged with the responsibility of protecting the interest of the policyholders by the Law.

As against the above canvass, the product design and steering it in a manner that it meets the policyholder needs first and allows cash flows to satisfy business requirement of the insurer (who provides the capital) and service providers such as intermediaries and consultants is prime task of the insurance Regulator thr' the regulatory regime of the Appointed Actuary.

PRINCIPLES OF PRODUCT DESIGN:

For all the above to be achieved, the product and processes should at the minimum meet the following;

1) Product suitability: The appropriate product is to be sold so as to meet the specific financial needs of the client. The intermediary should keep the interest of the policyholder in mind and sell those products which meet the needs of the customer. This leads to i) need for strong market conduct enforced on the intermediary and ii) intermediary remuneration neutral to product design/features (as products are expected to be designed to meet specific needs and intermediary should not be financially motivated to push one product as against another) and iii) strong regulatory/punitive regime on the Insurer so as to eliminate the possibility of "profiteering" and "money laundering".

2) Product Flexibility: The product should have the necessary flexibility and choice of features to meet the client's current and changing future needs.

3) Product innovation: As the societies are always in a state of flux and evolution, the principles around which products are designed by the insurer and approved by the regulator should facilitate innovation to better match the client's changing needs.
4) Product Complexity: If structured around sound principles, the products may appear complex, however the same would be relevant. The combination of client needs that such products are intended to cover can not be complex. The

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Regulatory regime has to have mechanism to ensure that such complexity is not driven by Insurer aim to create smokescreen for the client. This is very important as insurance sale is always push sale and much that the policyholder believes is based trust in the intermediary and value brand of the insurer. Byb the time that the policyholder realizes inappropriate of the product "it is too late".

5) Product Transparency: A good quality product illustration at the point of sales and seeking consent of the customer has no substitute The risks and benefits should be transparently illustrated to the customer and made part of the policy contract.

6) Sales Conduct: The intermediary remuneration should be designed in a manner that it is neutral to all products leading to only those product sales that are best fit to the customer needs.

7) Insurer profitability: The product design should aim to through up premiums that are appropriate making the products financially viable generating acceptable level of returns on capital, if the products are well managed.

PRODUCTS – A PEEP IN TO THE PAST:

Key Issues: The IRDA letter in its opening para, essentially brings out the following key issues;

1) Lately more complex products are being designed.
2) Features of several products are not in alignment with "best practices".
3) Frequently products filed for approval lack clarity.

The above has resulted in inefficiency of the product approval process.

PRODUCTS – what is required for the future:

1) Conceptual clarity in Product Design.
2) Products designed on sound insurance principles.
3) Product architecture to aim at high standards of policyholder protection.

THE SEVEN DRIVERS OF PRODUCT DESIGN BEHAVIORS:

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The IRDA letter has brought out seven key issues for comments that essentially capture the current state of affairs in the life insurance industry. The route and manner through which these seven issues are addressed will define the stability and growth of the life insurance industry. Our response is restricted to the content of IRDA letter within these Seven Key Issues.

I Low insurance cover:

a) A life insurance product (other than an annuity) by definition should carry adequate life cover and no more. Inadequate life cover (Sum Assured) would deprive the policyholder complete financial security where as an amount of Sum Assured in excess of the required would lead to moral hazard. Life insurance marketing concepts such as Human Life Value and Capital Needs Analysis provide tools to determine the appropriate Sum Assured and other measures of policyholder needs. All products should be designed around these measures within the framework the Principles of Product Designs and apparent lack of such rigors in the immediate past some years has resulted in to the situation that IRDA letter captures well. While stating this, it may be mentioned that there is need not only to set right the future path, its desirable to screen the products cleared in past with a view to have these dropped or modified with consequential re-look at adequacy of reserves.
b) The current ULIP/VIP products already carry a minimum life cover stated in the form of a multiple of the premium. Term covers, individual or group, carry life cover that are decided on principles of underwriting if absolute or as multiple of salary in Group insurance. For savings products, stating a minimum life cover could be challenge if measured in terms of pure risk cover, however it has been a practice to take Sum Assured as a indicator of adequacy of risk cover whether payable on death or maturity.
c) The tax consideration as arising from Tax Laws or any other State policy instruments should not be a consideration in product designing. However, the Insurers should be free to design products that have element of tax efficiency provided such products confirm to Principles of Product Design. The product's non-compliance with the tax requirements should not be consideration for approval.
d) We suggest that it would be for the IRDA to decide what constitutes a permissible sum assured, within the terms of the Insurance Act, 1938, and the IRDA Act, 1999, and for the tax authorities to decide the appropriate tax treatment, within the terms of the Income Tax Act.

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As a practical measure, a broad thumb rule could be applied for the traditional policies to meet the minimum sum assured requirement, for example –

- For Regular Premium products, 50% of the total premium payable over the term. We suggest that adoption of the rule that is applicable to regular premium ULIPs could have adverse consequences for conventional business. In order to comply while retaining a reasonable bonus loading in the premium, companies may sell longer term policies than needed by the customer. This could result in early surrender. While a ULIP would protect the policyholder in this case, by virtue of limits on surrender penalties, much more limited protection would apply in a conventional participating product.
- For products with money back features, the premiums payable could be netted by the survival benefits payable over the term. For single premiums, the minimum life cover could be fixed at 1.25 times the premium which would generally align with the sum assured payable at maturity. We note that this rule already applies to single premium ULIP products.

e) In savings products, the Sum at Risk reduces over the term of the product as the underlying reserve increases. In this context, an artificial reduction of the sum assured in the 2^{nd} year is not warranted as it would hardly ever be based on the client's requirement. However, greater policyholder interest is served by providing necessary flexibility in the level of future cover which would match the customer requirement of higher cover for an initial period of years e.g. Indian expats working abroad and entrepreneurs. We suggest that such flexibility may be provided subject to meeting a prescribed minimum level of cover as discussed above.

f) We note that term assurance business that is written in conjunction with the issue of a loan typically provides reducing levels of cover, in line with the expected amortization of the loan. This decline in cover is not arbitrary but rational and serves to reduce the cost of the cover. Approaching the end of the period of cover, the sum assured on death would approach zero but we see no need for application of a floor, which would itself be arbitrary.

II Participating and Non-participating:

We agree that the demarcation between Par and Non-par should be clear. For a non-participating contract, there should be no discretion over the benefit payable i.e. the benefit amount should be stated or the basis for calculating the benefit amount should be clearly set out in the contract.

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In current circumstances, it is worth considering what has prompted the plethora of non-par products in which the benefits depend on investment conditions;

1. If classified as a par product, a mature company (defined as over 10 years since first licensed) must have a surplus in the Par fund before any distribution is made to policyholders.
2. With the sharp reduction in Unit Linked volumes, most companies have seen unit sales costs rise. This translates into expense overruns.
3. If new business volumes switch to Par policies, the expense overrun will be carried by the Par fund and result in insufficient surplus to support reasonable bonus rates.

In the light of these issues, it is logical that insurance companies should attempt to file products as non-par, with linkage to an index, as expense overruns are passed on to shareholders. Furthermore, most companies and many policyholders would want a non-par endowment because;

1. It is capital efficient since emerging surplus is fungible;
2. It is tax efficient since any augmentation of policyholder benefits is from gross returns, unlike for par policies where the bonus is paid from a net of tax surplus;
3. By defining the basis of such future augmentations, as well as the basis of surrender values, such products protect the policyholder from discretionary actions on the part of the company, such as reviews of bonus rates and surrender value scales.

The Authority's concern about uncertain end-benefits is legitimate, but where products are linked to G-Sec rates, and provide illustrations at appropriate interest rates, the client is given a reasonable sense of what he/she can expect (at 2 different illustration rates). The illustration rates can be set with reference to current market conditions so that the illustrations are meaningful. Furthermore, many clients can relate to G-Sec rates (and indices relating to these). The Appointed Actuary is required to sign-off the benefit illustration, which largely addresses this concern, but guidelines can be tightened further.

We note that unit linked contracts also provide benefits that:

1. Are not known until the date of claim;
2. Are linked to an (internal) index, the unit price.

However, the difficulties are met by benefit illustrations and transparency of the unit price (it must be on a mark to market basis, its calculation is prescribed, the asset mix is disclosed, etc.)

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We also note that in the mortgage market, variability of outcomes of a long-term product, dependent on various indices, has become the norm. The market has moved in recent years to largely variable rates, where these may be benchmarked to some index. Customers can understand such a structure so long as the disclosures are clear.

We are in complete agreement with the conclusion that individual non-participating products should adhere to principles of non-participating products, which can be summarized as "protection of the interest of the policyholders are defined in the contract or the basis of calculating the benefits is set out clearly in the contract; in either case no discretion is available to the company in arriving at the benefits". We also believe that there should be improved disclosure of the way in which product benefits are calculated.
In respect of traditional group business, we suggest that products where the interest rate is declared annually in advance and there is no discretion over the surrender value be treated as non-participating, for the following reasons:

1. While there may be discretion over the rate of interest to be declared at the start of each year, the policyholder can decide whether to continue the policy and thereby be subject to that discretion. We note that the typical policyholder in group business would be financially aware and also that the surrender value would be non-discretionary. Thus, if the policyholder were not content for any reason, he would be expected to leave and would do so on guaranteed terms. Thus, though the product is typically long term, we may view it as if it were a 1-year renewable product. From this perspective, at the start of each year, the benefits arising from the product would be fully guaranteed. Thus we may regard the policy as non-participating.
2. The traditional non-participating group market is already well established. It would be an unnecessary disruption for this business to be re-categorised as participating.

III Group Long Term Products

We understand that the letter is referring to term products, credit life products with reducing cover, group savings products, group ULIP products (all with term longer than 1 year) on the group platform. While IRDA appears comfortable with the credit life product structure, the others seem to cause some concerns.

While the concern around group savings products is not very apparent in the letter, our contention is that being on the group platform, such products would be more efficiently administered and hence would generally be more cost effective. As long as such products meet the regulatory requirements of the respective product types and

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are priced appropriately, we do not see any reason for concern. Our recommendation would be to approve such products based on the merits of each product, provided that the conformity to PRINCIPLES OF PRODUCT DESIGN is demonstrated.

Further, the long term 'Term Assurance' products have significant advantages as shown below and the one year renewable term assurance product would not always serve as an alternative –

a. These products are guaranteed for the entire term; meaning that there is continuity of protection and no renewal is required
b. Level regular premium offers continuity and certainty of the premium amount
c. Group platform provides the ease of administration, cost efficiency in terms of premium collection as the administrative effort is significantly lower
d. Large groups / compulsory groups minimize anti-selection, hence underwriting can be fairly liberal
e. The alternative of the one year renewable term product is complicated by the process of yearly renewal of cover, and review of premium rates leading to uncertainty in the premium levels as the premiums can go up on review. Such a structure may be suitable for sponsored schemes but not where the member pays the premium.

Response to the other issues raised under this point are;

***Premium rates similar to both individual and group members*:**

The expected mortality is a key component of the premium. This would depend on the profile of the target group and the level of underwriting. Individual term products with high minimum sum assured targeted at the high end customer and stringently underwritten (preferred life term) could have a much lower premium than a group term product targeted at the social sector clients and with minimal underwriting. Similarly group term products offered to employees and sponsored by the employer (compulsory participation) would have very low premiums because of the absence of anti-selection and active-at-work employees even though the underwriting could be minimal.

Intermediaries gain higher commission:

More commission is allowed as per law. The justification would be that commission rate is commensurate with the sales effort and a regular premium product is tougher to sell and service from the intermediary's point of view.
It is worth noting that a general insurance company that effectively sells term insurance cover (cover for critical illness and accidental death) is allowed to pay 15% commission on each and every premium.

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***Mostly offered to bank customers…….*:**

This a market conduct issue. Such practices as the deduction of premiums without specific consent could be curbed by building in safeguards and disclosure at the point of sale. The structure of the product does not in any way contribute to this malaise.

Limited premium payment terms…..

Our response is the same as under 'Intermediaries gain higher commission'. We suggest that IRDA may wish to regulate the commission under LPPT products so that the maximum commission levels may be between those for regular and single premium products OR may set limits to the premium payment periods to (say) more than 3 years etc.

What happens if the agreement is terminated?

We appreciate the comfort that the group master policyholder provides by facilitating the premium collection and that remittance could stop on termination of the agreement. However, there are multiple payment modes available to the customer including ECS, standing instructions, direct debit etc. which can be organized by the insurance company. If a bank is the master policyholder, the process could be even easier.
It should be possible to extend a guaranteed insurability option to the member who has lost cover following the termination of a group policy. In such circumstances, this may be mandated.

IV Limited Premium Payment Terms:

a) Apart from being a tool to sell products that better suit the specific circumstances of customers (for example policyholders with irregular income or policyholders settling overseas after inception of a policy), there are also other important reasons why products with limited premium payment term (LPPT) options should continue to be allowed as part of life insurers' product baskets, as outlined below.

b) The inherent risk of some product features increases with an increase in premium payment term, for example where profitability is extremely sensitive to future interest rate levels. In such an instance, LPPT is an effective risk management tool which reduces uncertainty and gives insurers the ability to provide benefits at lower cost to policyholders compared to where premiums are paid for the full policy term. In some cases where premiums are paid for the

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full policy term, product features cannot be made available at economically viable premium rates after allowing for the extent of the uncertainty.

c) If level premiums are charged throughout the policy term on decreasing term insurance policies, the cost of death benefits will likely exceed premium payments at early policy durations. Furthermore, policyholders may be inclined to lapse policies at later durations when the level premiums are high compared to the reducing risk coverages at the time, and life insurers may be exposed to losses as a result.Since LPPT reduces the risk of later duration lapses, this payment method may be considered appropriate for decreasing term insurance policies.

d) The impact and timing of the Direct Tax Code are still very unclear. The continuing uncertainty in the tax environment makes it extremely difficult for policyholders to commit to policy contracts with premium obligations well into the future. LPPT policies allow customers to enjoy life insurance coverage whilst the tax environment is yet to become more certain.

e) We suggest that concerns relating to acceleration of commission payments be addressed by reviewing the regulation of commission, rather than limiting the flexibility and choice of product features.

f) We believe that changes in premium paying term could be allowed, so long as the policy alteration also allowed a review of the benefits.

g) It is evident from the favourable persistency experience of LPPT policies to date compared to other policies, that LPPT policies are meeting real policyholder needs.

V Reinsurance:

The IRDA will agree that reinsurance is an important risk management tool for life insurers. For example, it would be inapproriate for life insurers, big or small, to hold a number of very large risks relative to the rest of their portfolio. Reinsurance is also an important risk management tool for the life insurance industry as a whole, as it provides the industry the ability to share and place risk globally with reputable reinsurers with high credit ratings. Reinsurers in turn, havethe mechanism to share risk with more markets by retrocessions.

The development and growth of the Indian life insurance industry over the last number of years, especially in the areas of pure term coverages and benefits such as critical illness and disability, would not have been possible without significant support from the reinsurance market. Without this support, the protection market would have lacked

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growth momentum, premiums would have been expensive and many policyholders' needs would have remained unmet since life insurance companies' capacity to accept the levels of risk sought would have been lesser.

We believe that reinsurers will remain a critical component in the growth and development of the Indian life insurance protection market. Imposing reinsurance constraints on life insurance companies will significantly reduce life insurers' ability to manage their existing risk appropriately. Life insurers would need to drastically reduce risk cover made available to customers, load premiums with significant margins or even exit certain lines of business, as accepting the level of risks would be irresponsible without appropriate reinsurance arrangements.

Parameter mis-estimation risk could arise in the pricing of new benefits such as critical illness and new distribution channels such as on-line. Quota share reinsurance is a simple way of mitigating this risk, while also getting reinsurers' expertise in product design, pricing and, if appropriate, in marketing.

The IRDA mentioned that it believes every product should have a specified maximum sum assured compared to the current practice of specifying "no limit". Arguments have been advances against such a proposition. Depending on the reinsurer's capacity, with a "no limit" condition even very large risk coverages can be extended to policyholders which would not have been possible on a product if a lower maximum sum assured was specified at the time of product filing based on the life insurer's capacity. The "no limit" condition provides flexibility in meeting policyholder needs and does not increase the risk for the life insurer, when transferring risk to a reputable reinsurer. However, it is also appreciated that from regulatory perspective specified maximum Sum Assured may be desirable and so is the case of specified leval of minbmum reteined Sum at Risk. This may be based on case to case basis factoring in to capitalisation of the Insurer, the objective being to eliminate, if there is, the possibility of "fronting". There being no sytem of reinsurance commission in the Indian market which is the primary tool of fronting mechanism, it has to be seen if the market conditions have forced evolution of proxi-fronting mechanism.

VI Benefit Illustrations:
The main aim of benefit illustrations should drive the approach followed. We believe that the objectives of industry standards for benefit illustrations are:

1) To ensure that companies do not compete on the basis of projected investment performance in the market place.
2) To demonstrate that the benefits received are heavily dependent on the investment returns earned, and that a wide range of outcomes is possible.
3) To demonstrate the effect that the actual charging structure (or allocated expenses) will have on the resultant maturity benefits.

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4) To try to ensure that different product types are compared on a similar basis.

If the company can amend its benefit illustration rate by removing an under-performing fund from a product, or can illustrate different ULIP products at different rates because the performance of the underlying funds has varied, business will tend to get directed into the products that have performed well in the recent past. So, for example, during a period of volatility, a highest NAV product may look very good over 2 years, and will have an attractive benefit illustration; but this is unlikely to be indicative of future performance. Similarly, during a period of falling interest rates, the mark-to-market performance of a bond fund would be very good. But at the end of this period, its prospective yields would be low. It would be misleading to project its future returns on the basis of its recent performance. In general, we submit, it would be dangerous to make a long term projection on the basis of the last two years' returns.

We suggest that industry standard illustration rates are reviewed periodically and set with reference to an external index, for example cash rate ± spread.

Many companies use illustration rates for participating products that are consistent with the investment scenarios for Unit Linked products. This does not mean that they illustrate at 10% and 6%, but that they calculate bonus rates consistent with gross investment performance of 10% and 6% (taking into account tax and shareholder portion of surplus). The historical approach proposed is dangerous because companies may be tempted to boost maturity benefits for the small number of maturing policies, in order to get a much better illustration basis for new business. Even in the absence of any such maniuplation, there will be environments where it is accepted that bonus rates are expected to fall. To issue illustrations on the basis of recent bonus rates or maturity values would then be misleading. (We note that this problem exacerbated the endowment mis-selling scandal in the UK.) The same concerns apply to using the performance of paid-up values, which are also subject to manipulation (and are in any case not available when a company first starts offering participating policies). We really believe that this needs more thought, and suggest that it be referred to the Institute of Actuaries of India, who can revise the Guidance Note / Practice Standard on Benefit Illustrations.

It is not clear as to what is meant by "It should be considered (particularly for NAV products) whether the maximum loss which could be incurred be disclosed". Is this a reference to all unit linked products or to HNAV products? If the latter, it is invariably true that no loss can be incurred. However, to communicate the risk to the policyholder we suggest including a statement that the risk mainly depends on the choice of fund.

VII Series/Tranche of Funds within a product:

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The Regulator's concerns around the highest NAV guarantee product appear to be three fold: i) the issue of a large number of small tranches of funds, ii) the sub-optimal equity exposure and iii) customer miscommunication or non-disclosure.

1. The letter expresses concern over the proliferation funds where the funds may not attain a critical size. We do not see a problem around what is pointed out as being a barrier to effective consumer communication. There is apparently no communication issue as the customer is invested in one single fund right through to the fixed date of maturity.

   We can see a problem in terms of administration of the large number of small funds. However, given that a company may come with (say) two funds in a year, we may see 10 funds in 5 years' time which is not such a big problem given the level of automation and IT support that are available today. As a matter of caution however, the Regulator could stipulate and agree with the company a specific minimum fund size and if the company does not reach that size in the stipulated period, not allow that company to launch future tranches. We believe that neither the number of such funds nor the size is an issue as far as customer communication is concerned nor would they specifically lead to lower gains.

   We note that where guarantees are offered, tranches defined by the date at which the guarantee applies are typically necessary for effective risk management. This allows the bond portfolio in the fund to be held at an appropriate duration. In the absence of such tranches of a fund, all the bonds would be fungible among all its unit liabilities, since a unit linked fund would not allow hypothecation of specific bonds to specific guarantee terms. As a result, the risk exposure would increase significantly.

2. We distinguish between Return Guarantee Funds and Highest NAV funds, which are quite different in nature and which require quite different investment strategies.

   Many of the Return Guaranteed Funds (RGF) are generally meant to be fully invested in debts and state so clearly to the customer.

   Stating a minimum equity exposure under the highest NAV (CPPI) products would be difficult to achieve as invariably the statistical minimum would be zero from a risk management point of view. Further, the equity exposure would generally start off at the highest level and gradually reduce over the term of the product. Without conveying to the customer a specific minimum level of equity, a sense of this can be given by disclosing the critical aspects of the underlying dynamic asset allocation process.

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A simple statement explaining that the equity backing ratio is expected to decline over time and that the fund should not be considered an equity only fund could be appropriate.

3. The disclosure to the customer should attempt to sensitize the customer to the key aspects of the product, and the nature of the guarantee. It should be made clear that the guarantee offered is neither a capital guarantee nor a guarantee of the capital market returns.

   The disclosure to the customer in respect of a Highest NAV fund or product should also attempt to make him understand the risks inherent in the product;

- That the guarantee is available only at maturity
- That depending on the future market conditions, there could be substantial investment in fixed interest securities and in an extremely depressed market this could be as much as 100%
- That returns may be as a result, lower than the equity market returns
- That there is a charge for the guarantee provided

4. A further point not raised in the context of the highest NAV guarantee product is the pro-cyclic nature of the fund i.e. when the market goes down, the dynamic asset allocation requires divestment of equity. The sales trigger would by and large be similar across companies having such products. The risk would be that there would be a large scale shift from equity to bond which would cause liquidity issues in the market and also move prices of both assets. While it is expected that the individual companies would incorporate this restricted liquidity of equity assets in their asset allocation models and risk management process, we suggest the Regulator may monitor the aggregate equity exposure of all such products so that the inherent systemic risk does not get out of hand.

We thank IRDA for the opportunity to comment.

Regards,

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