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INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY

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Dear Shri Mathur,

Sub: Product Design.

The IRDA is required to protect the interests of policyholders and to ensure the orderly growth of insurance industry. To this end, the IRDA has from time to time issued Guidelines setting out the parameters within which certain specified insurance products must be designed. The insurance companies have designed their products within the parameters of the Guidelines wherever applicable. However, lately, more complex products are being designed and filed for F&U clearance with the IRDA. In the process of clearing these products, the IRDA has noticed that the features of several of the products are not in alignment with the best practices and, frequently, lack clarity. The efficiency of product clearance has been constrained by such features. The Authority is of the view that conceptual clarity in product design would enhance the efficiency of product clearance on one side while ensuring that higher standards are maintained with regard to consumer protection and sound insurance principles on the other. In this background, in order that clear guidelines can be formulated, the IRDA invites the attention of the Life Insurance Council and its Members to this letter and requests their considered response.

I <u>Low Insurance Cover</u>

2. Traditionally, life insurance products have offered a substantial cover on the incidence of death or on survival, which is guaranteed at the onset of the contract; the benefit being payable to the estate in the event of death or to the beneficiary on survival. Of late, however, products have been designed which propose very minimal insurance cover payable on death or on survival. Some examples are:

i) In the event of death, the death benefit is limited to the premiums paid in;

ii) In some products, if the death occurs in the first year of the policy, the death benefit is several times the premium paid. However, if the death occurs in the 2nd or subsequent years, the death benefit as a multiple of the premiums paid is very low.

In both these systems, there seems to be non-compliance with the requirements of the Income Tax Act. The question, therefore,

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arises whether it should not be required that all traditional products should have a minimum death cover as a multiple of premiums paid in lines with the provisions of the Income Tax Act for the entire policy term.

II. <u>Participating and Non-participating:</u>

3. In non-par products, the benefit extended under a policy could be either

a) An absolute amount declared in advance; or
b) A declaration of an interest on the premiums paid based upon some formula or index which is specified in the contract at an agreed frequency vis-à-vis the interest allowed in pricing; or
c) The margin on the profit derived by the investments made from the premium which the insurer would retain –balance being credited to the Policyholders' Account;

4. The essence in all the above is the benefit accruing to the policyholder is a sum defined when entering into the contract. Contrary to the above principle, certain products are being filed as "non-par products" where the insurance company at its discretion declares a certain interest at the end of the year. Products where interests are declared at the end of the year are typical of "par products" and in such products 90% of the profits are to be credited to the policyholders' account.

5. In accordance with the ARA Regulation and Actuarial Profession Material, the definitions of with profits and without profits policies are as below:

	As per the ARA Regulation	As per the Actuarial Profession material
With profits (participating)	"par policies" or "policies with participation in profits" means polices which are not non-par policies as defined under non-par policies	A life insurance contract is with profits if the policyholder is entitled to receive part of the surplus of the company. The extent of the entitlement is usually at the discretion of the company.
Without profits (non-participating)	"non-par policies" or "policies without participation in profits" means policies which are not entitled for any share in surplus (profits) during the term of the policy;	A life insurance contract is without profits if the life insurance company has no discretion over the amount of benefit payable, i.e. the policy document will specify at outset either the amount of the benefits under the contract or how they will be calculated.

6. However, it is noticed that the insurer has significant discretion with respect to the benefits allowed under the products which are being filed for clearance under non-participating business. This is the case both for individual products and group products.

7. It is also observed that certain products are filed as "non-participating" where the benefit is calculated in terms of an index. The formula associated with such index does not indicate what has been priced and what is flowing to the policyholder. The policyholder may not know what benefits would accrue in the policy till the last day of the contract. This may be the case for with profits as well; however, in this case a reasonable expectation is built up over a period of time and these declarations are in annual mode. But for non-participating policies where benefits are offered through interest credits at a chosen frequency like monthly, weekly or in any other lesser frequency at the discretion of the insurer, the entire product design is far more complex. This would add to the operational costs, systems inefficiencies and associated operational risks without any value addition, as these interest credits are declared in relation to an index. The entire process is cumbersome and may also involve issues on fair dealing with the policyholder.

8. In this regard, is it not appropriate that the principles of non-participating products and participating products are adhered to?

III. <u>Group Long Term Products:</u>

9. Recently, it has been observed that insurers are offering products to affinity groups which are of long term in nature, such as savings, term, ULIPs etc. In general, a long term credit insurance product can be seen as value addition to the customer as it eliminates the costs of yearly renewal and over insurance, as in most of the cases it offers a reduced cover which may match closely with a loan installment. The second positive factor is that group yearly renewal products provide insurance at lower cost.

10. But any other long term products offered to groups have many implications, some of them listed below:

- Premium rates are similar to both individual and groups members;
- Intermediaries gain out of higher commission (up to 35%) when compared to yearly renewable products (up to 2%);
- Mostly offered to bank customers where banks are corporate agents, resulting in many complaints of deducting the premiums without specific consent by the policyholder;

- Limited premium payments terms are offered say 2/3/4/5 years so that the commissions are paid on a substantially higher amounts.
- What happens to the policyholder if the agreement is terminated?

11. Many such issues are not addressed under these products. These products virtually work as an individual product as insurers appear to be approaching individual bank customers directly and also offer no value to the policyholder. In addition, it poses additional issues like suiting the products to meet the needs of the corporate agents which may not be in the best interest to the policyholder. Hence, may need to examine on allowing such products under group platform.

IV. Limited Premium Payment Terms:

12. Now-a-days, most of the products offered are having the feature of single premium and limited premium paying terms, rather than having the premium paying term equal to the policy term. This results in receiving the premiums well in advance of the policy term; accelerating commission payments to the intermediaries due to increased premiums;, possible lapses due to high premium size; surrender not being allowed for the first three which mean losing out the money paid in the initial years etc. This poses restrictions to the policyholders in terms of payments capacities, liquidity etc. Earlier such products were designed to meet the needs of customers who have high incomes for short periods, like cinema actors or to reduce the lapse and re-entry option under reducing term insurance products etc.

13. In this regard, is it necessary for any product to have a regular payment option which equals the policy terms, unless designed for certain special categories? If the products has other premium payment frequencies (like SP or LPP), it is necessary to allow customers to change to other options, if requested for. The benefits offered like surrender, paid-up etc under limited premium payment frequencies has to necessarily allow for the receipt of premiums well in advance. The cash flow management could also be an issue in such instances unless assets and liabilities are matched suitably with appropriate reserves built up. What are the Council's comments on this?

V. Reinsurance:

14. Reinsurance retention limits vary by product depending on the risk involved, the overall financial strength of the insurer, the capital available to write the product, the underwriting capacity available for the product, volume of expected new business, previous claims experience of similar products etc. Generally, life insurers write relatively large number of risks. Such business volumes enable them to predict losses relatively accurately.

Hence, life insurers, in general, require less reinsurance. Also, the cost of providing the pure risk protection component in life insurance contracts is relatively small in comparison to the savings component. However, it is seen that life insurers with most of the products oriented towards morbidity and mortality are likely to have relatively more reinsurance than those whose products are oriented towards savings, subject to the other factors mentioned above.

15. If an insurer, without taking into account all the above factors has low retention limits or low retention limits with quota share arrangements with reinsurers, then such insurers only act as an insurance service provider than as a risk bearing insurer. This amounts to fronting. Fronting insurers rely on ceding commission without developing national retention capacity and underwriting expertise necessary for the development of a viable domestic insurance industry. In addition, such arrangements would:

a. mean heavy reliance on reinsurers for each and every product/ for small and big claims etc;
b. be subjected to heavy credit risks-any default by a reinsurer could impair the solvency of the insurer;
c. also damage the trust built on the industry, if the insurer is unable to meet its liability;

16. In India, insurers are free to choose their reinsurers and are free to choose the retentions as there is no mandatory cessions prescribed, subject to the IRDA (Life Reinsurance) Regulations, 2000, though the reinsurance program is filed with the Authority. Reinsurers being dealt by the insurers are also not regulated by the Authority. However, the insurers are responsible for their business obligations. This approach offers high flexibility to cede the risks to the reinsurers.

17. These concerns increase as most products filed for clearance as assign "No Limit" to the maximum sum assured. In general every insurance product should have a maximum SA up to which the insurer ought to accept the risk. By specifying "NO LIMIT", and as a consequence having low retentions, it is a question whether the life insurance industry is moving towards fronting. This needs to be examined.

VI. Benefit Illustrations:

18. Benefit Illustrations have been mandated. For ULIP products, the IRDA has required that this benefit be calculated at a return of 6% and 10%. For traditional products, the Life Insurance Council had vide their circular No. LC/SP/Ver 1.0 dated 3.2.2004 prescribed sales illustrations at 6% and 10%. The IRDA has observed that an unintended side effect of this illustration has

been to raise expectations of policyholders. This might not always be the case. The need for a Benefit Illustration for clarity is part of best practices in most insurance domains in the world. This being the case, it is the design of the Benefit Illustration which needs to be carefully considered and caliberated.

19. In the light of the above, the Life Insurance Council's comments are invited on the following proposal:

(i) In all ULIP products, the Benefit Illustration must be calculated at a percentage which is less than the median return of the fund value calculated on all funds in force in the previous two years for that particular class of products;

(ii) For traditional products which have come to maturity and paid up in the previous two years, the same median return is to be calculated and the illustration should not exceed this figure. In the case of companies for which traditional products have not attained maturity they could arrive at a median paid up value in the previous two years and calculate the corresponding return.

(iii) The returns must be calculated only on the premiums paid and on the basis of a straight line CARG from the date of inception of the policy to the date of calculation of relevant paid up value/fund value.

20. It should also be considered (particularly in NAV products) whether the maximum loss which could be incurred be disclosed.

VII. Series/Tranche of Funds within a product:

21. Presently, the IRDA accords its F&U clearance for a given product. At the time of clearance, a certain set of funds under this product are generally indicated. However, very rapidly the funds under a given product proliferate. Such proliferation has little to do with the size of the fund. This has resulted in a situation where companies have a very large portfolio of funds but the size of each fund could be very small. Is such a practice necessary and does it not create a barrier for effective consumer understanding and communication? Does it not contribute to lower gains?

22. It is also noted that highest NAV guaranteed products and RGF products tend over time towards fixed instruments. While this may be inevitable given the design of the product and the assurances it carries, it is surprising to observe that several products invest largely in fixed

instruments almost from their inception. In keeping with the spirit of what an NAV guarantee product is, would it not be advisable to require all such products to maintain a minimum equity component for atleast a specified period of time? If so, how would issues regarding reserving and pricing of such guarantees be assessed? Secondly, recognizing that there is substantial burden of communication and the likelihood of mis-communication in such products; would it not be advisable to restrict the sale of such products only on a multi pay platform?

With regards,

Yours truly,

(J Hari Narayan)

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