01 Nov 2012

Submission to IRDA

A conceptual note on Product Regulations

Scope

We thank the Authority for the invitation to comment on the draft regulations on linked and non-linked insurance business. In this brief note, we address at a conceptual level, certain issues raised by the draft regulations. In particular, we consider:

- the arbitrage between conventional and other forms of savings contract, and how this may be managed;
- the possibility of writing non-participating non-linked conventional endowment assurances;
- the structure of participating Variable Insurance Plans and,in particular, how they may be constructed to optimise both policyholder protection and shareholder returns; and
- Whether a cost-benefit analysis should be conducted to assess the utility of regulatory change.

Conventional endowment assurances and other savings products

We recognise that in the last two years, the treatment on early lapse of unit linked business has been transformed. Where formerly, companies could generate significant lapse surpluses, now, there is typically a loss of value to the company on early premium discontinuance. The risk of poor quality selling, which would typically result in early premium discontinuance, is now borne by the company, whereas formerly it was borne by the policyholder. We also note that the investmentrisk continues to be borne by the policyholder. This apportionment of risks appears quite fair, as the quality of selling is, or should be, in the company's control, whereas investment risk is not. Any investment loss or gain crystallised, on the other hand, is in the policyholder's control, not least because the timing of the surrender is up to him or her.

We note that the draft regulations would bring to bear on Variable Insurance Products (VIPs) the same limits on charges and reduction in yield that currently apply to Unit Linked Insurance Products (ULIPs). We welcome this, as it avoids any arbitrage between the two categories.

On conventional endowments, however, it is proposed that the surrender value be acquired, at earliest, only after two years' premiums have been paid, and that:

1. the guaranteed surrender value, which is required under the Insurance Act, 1938, be set at a higher level than is currently common; and
2. a special surrender value be calculated that is related to the asset share.

Now, we acknowledge that conventional contracts, being bundled, are different from VIPs and ULIPs, which are unbundled, and it is difficult to achieve exactly the same ends in all these product categories. However, we also note that the requirement for policyholder protection is similar, if not identical. Conventional contracts, both participating and non-participating, generate significant lapse surplus if the quality of sale is such as to lead to high early lapse rates, in particular if the second year's premium is not paid in an annual premium contract. We believe the risk of poor quality sales of conventional business to be quite as high as that of ULIP or VIP. We also suggest that, in this context, whether an endowment assurance is participating or non-participating is largely irrelevant, and both should be regulated similarly.

We believe that higher guaranteed surrender values will not address the problem. The guarantees themselves are unlikely to be attractive to policyholders. We note, for example, that the guaranteed return after five years in-force of a regular premium endowment assurance, is proposed to be 50% of the total premiums paid. While this would have a reserving cost to the company, it does not appear to offer any meaningful protection to the policyholder. The proposal is sub-optimal from both perspectives.

There are, in principle, two ways to deal with poor persistency, and to protect policyholders from its consequences:

1. Regulation of the quality of sales.
   We note that IRDA has made various proposals in the draft regulation on linked business in respect of market conduct, disclosure norms and advertisements. Regulation of market conduct, while cumbersome and potentially expensive, has been used, for example in the UK, to seek to promote a higher quality of sale. However, it is difficult to see why, if it should be required in linked business, it should not be equally necessary in conventional business. In both, the future payout to the policyholder is typically indeterminate, but dependent on future conditions.

   Indeed, given the requirements in Sections 26(i) and 30(c) of the draft on non-linked business, on both surrender and maturity, the claim value is to be related to the asset shares, or proxy asset shares in case of non-participating business. Thus the asset share, or its proxy, will fulfil a similar function in conventional business to that of the unit fund in ULIPs.

   It would appear reasonable then for the training of the sales force and for policyholder disclosures to address the asset share, and what its value is dependent on. Both policyholders and distributors ideally should be as well-informed of the workings of a conventional endowment contract as of a unit linked contract. In fact, given the level of discretion that operates in administering a participating contract, arguably the level of understanding needs to be higher.

2. Regulation of product.
   The approach adopted hitherto, for example in ULIPs, has largely been to regulate the product. In practice this means regulating the charges that may be levied on the unit fund and on the premiums. If it is mandated that the special surrender be related to the asset share, we recognise that the asset share plays a similar role in conventional with profits business to that played by the unit fund in ULIPs. Then similar ends can be achieved by regulating the expenses –per premium, per policy, per unit assets under management, etc. - and the cost of risk benefits that may be allocated to the asset share.

We recognise that an immediate move to limit the expenses allocated to asset shares to a similar extent to that to which charges are limited in unit linked business may be disruptive. We believe however that it would beneficial to set out a roadmap towards affording an adequate degree of protection to holders of conventional endowment assurances who lapse their policies at an early stage.

We note a difficulty: in a conventional endowment assurance, any surplus or deficit from persistency variances arises in the same fund. Thus, if the limits on expense allocations led to the generation of a deficit, the company could recycle it to the continuing asset shares. Arguably, where in the past lapse surpluses have been so recycled, this would be consistent with policyholders' reasonable expectations.The Regulator would need to take a view on whether this would be legitimate.

We note also that, in case of non-participating endowment assurances, the draft regulation on non-linked business has introduced a concept of a proxy asset share, and the special surrender and maturityvalues should be related to this. (See Sections 26(i) and 30(c).)Broadly, we believe the proxy asset share should reflect the accumulation of premiums, net of allocated expenses, profit loadings and risk charges, at the rate of return earned on the assets hypothecated to these liabilities. However, there is a considerable amount of work remaining in refining the detail of such a definition - for example, what should the allocated expenses be? Once again, if the approach taken is to regulate the product similarly to ULIPs or VIPs, limits could be set to the expenses and risk charges allocated to this proxy asset share. Being a non-participating contract, of course, the question of participation in lapse surplus or deficit would not arise.

We note that regulation of the special surrender value along the lines discussed above would result in the allocation of investment risk on surrender to the policyholder and the persistency risk to the company. It would also require the special surrender values to be reviewed periodically, in particular so that they may reflect investment conditions.

Lastly, but arguably most importantly, we suggest that the most egregious forms of poor quality sales result in discontinuance of premiums after one annual premium or in the first year itself. However, the draft guideline does not appear to offer any protection to policyholders who are in this category. It should be possible to require conventional endowment assurances to acquire surrender values immediately on issuance, though as with ULIPs, the settlement may be deferred. We recognise that this would be expensive in two ways:

a. It would shut off a source of surplus to the company from early lapses; and
b. It would require the company to offer a paid-up sum assured, in line with Section 113 of the Insurance Act, 1938.

However, it is arguable that these are costs of poor quality sales and should be borne by the company.

Non-participating non-linked conventional endowment assurances

We note that Section 5(a) of the draft IRDA (Non-linked Insurance Products) Regulations requires benefits under such contracts to accrue at regular intervals but these must not be linked to any index. We also note that Sections 26(i) and 30(c) of the same draft requires benefits on both surrender and maturity to be related to 'proxy asset shares.' These latter Sections would imply that the benefits cannot be fixed in Rupee terms at outset, since the proxy asset share will, presumably, reflect future investment returns, which cannot be known in advance. Therefore, we understand that the statement in Section 5, that the 'benefits assured to be payable … or additional benefits accrued … are explicitly stated at outset,' means that these benefits must be explicitly linked to some internal fund, with no discretion over their distribution, but that they need not be fixed in Rupee terms. Effectively, any future addition to benefits would be of indeterminate amount at outset, but guaranteed by reference to some internal fund.

We suggest that while such structures are workable, it would provide considerable reassurance to the policyholder if the point of reference for any additional benefits could be made external, so that it was clearly free of any potential manipulation on the part of the company.

The problem appears to be that IRDA (Registration of Insurance Companies) Regulations, 2000, states that linked business means contracts where benefits are wholly or partly determined by reference to an approved index. Therefore a conventional endowment with benefit accrual linked to an external reference would appear to be 'linked.'

Let us consider the arguments in more detail. They are set out below:

1. Schedule II-A of ALSM states that universal life contracts are those presented in unbundled form;
2. Further, linked business is a subset of universal life;
3. Therefore, linked business is also unbundled;
4. Since a conventional (non-par) endowment is not unbundled, it cannot be linked;
5. If it is not linked it cannot be index linked.

However, we note that IRDA (Registration of Insurance Companies) Regulations, 2000, states that linked business means contracts where benefits are wholly or partly determined by reference to an approved index.

Therefore, non-participating endowments that benchmark their benefits to such an index appear to be linked.

We therefore have a paradox: such products could be considered to be both linked and non-linked. Given the paradox, we need to consider the intent behind the regulations, rather than be limited by their drafting.

The intent behind the reference in IRDA (Registration of Insurance Companies) Regulations, 2000, is indicated by the reference to 'underlying assets'. It appears to be making provision for 'linked business' where the linkage will not be to the value of units in an internal fund, but instead to an external index. In other respects, one might expect the product to resemble a unit linked product.

However, the conventional non-par endowments on the market now are not of this form. They are designed to mimic, in most respects, conventional participating contracts; not unit linked contracts. They are bundled (i.e. charges are not explicit), they have a sum assured on maturity, and the benefits are subject to periodic augmentation, but not based on emerging surplus or on a discretionary basis. Instead, augmentations are formulaic and contractual.

We suggest the paradox is a consequence purely of a drafting oversight, or rather, of an understandable lack of foresight in that conventional non-participating endowments linked to an external index or reference were probably not conceived of at the time of drafting. Arguably, in drafting new regulation now, it would inappropriate to be bound by an apparent mis-application of existing regulation to circumstances that were not envisaged.

We note also that a non-participating endowment assurance has certain advantages relative to a participating endowment:

1. It is more tax-efficient, since any benefit augmentations are funded by gross of tax returns, not from net of tax surplus;
2. By removing discretion from the company, it offers stronger policyholder protection.

We suggest that this type of product be retained, subject of course to whatever regulation is deemed appropriate in respect of conventional endowment assurances in general.

Non-linked Participating Variable Insurance Plans

We note that the draft IRDA (Non-linked Insurance Products) Regulations, Section 11, propose that companies be allowed to write participating VIPs. We suggest that it would be to both the policyholders' and the companies' advantage if these contracts were to be written in a non-participating fund.

We note that this form of business would, in the UK, be known as accumulating with profits, and it is fairly common for such policies to be written in a non-participating fund, with only the equivalent of the account value held in the participating fund.

We firstly discuss the structure, and then consider its advantages.

Structure

The policy would be written in a non-participating fund. All expenses incurred and commissions paid in respect of this business, except as noted below, would be allocated to this non-participating fund. Any charges on the policy, other than risk charges, would also emerge as revenue items in this non-participating fund. A reserve in respect of the excess of future expenses over chargeswould be held in the non-participating fund.

The net premium, after deducting any charges, would be allocated to the participating fund. The liability in respect of the account value would be held in the participating fund. Expenses in respect of the investment management of the assets backing this liability could be allocated to the participating fund. In accordance with regulations on the distribution of surplus, one ninth the cost of any bonus interest rate declared would be appropriated from the participating fund to the shareholder fund. The bonus interest rate would reflect only the distribution of investment surplus.

Mortality (and any other risk) charges could be allocated to the non-participating fund. This would be reasonable if and only if risk benefits in excess of the account value were also paid from this fund. However, this could become problematical in respect of paid-up business, since no premium would be available to meet the risk charge. An alternative arrangement would be that the risk charge be deducted from the account value but retained in the participating fund. The participating fund would also meet the excess of any risk benefit above the account value. In this case, the bonus interest rate could reflect both mortality and investment surplus.

Advantages

The structure will force expense and persistency surpluses or deficits to emerge in a fund other than the participating fund. It will therefore be impossible for the company to recycle any deficit arising to its participating policyholders; any such cost would have to be met by shareholders.Given the current state of most companies, one would expect deficits to arise in respect of acquisition expenses. We also note that the proposals will give rise to considerable persistency risk, and deficits from this could arise at any time. It is arguable that it is reasonable to protect participating policyholders from such deficits.

For the company, the structure offers the prospect of a profitable contract. Currently, profit margins are under considerable pressure in unit linked business, because of the combination of charge caps and expected persistency. However, most companies will have a plan to achieve expense targets that will render that new business profitable, albeit at lower margins than those that applied before 2010. However, if similar charge caps are applied to a participating contract, and both charges and expenses are allocated to the participating fund, the shareholders will see very little benefit from the eventual achievement of expense targets. At best, they will have access only to one tenth of any value generated. Given the pressure that already exists on profit margins, it is arguable that companies will simply not write this type of business.

However, we believe that would be a wasted opportunity, since an alternativeattractive product offering could be made, given the structural changes suggested above.

Cost-benefit analysis (CBA)

The last three years have seen a considerable amount of change in product regulation, much of it with profound consequences, especially for unit linked business. As another round of regulatory change approaches, we suggest that it would be beneficial for the industry if the costs and benefits of implementing the change were quantified and compared, so that the benefits were demonstrated to be commensurate with the costs.For example, under the Financial Services and Markets Act

(FSMA) in the UK, the Financial Services Authority (FSA) is obliged to undertake CBA of the policy and regulatory reforms implemented by the FSA.

We note that in the draft regulations circulated by IRDA, there are certain aspects that would give rise to considerable cost, not least in implementation, such as:

- the changes to minimum death benefits to be at least 105% of premiums paid for non-linked business,
- the latest proposals on the discontinued policy fund, whereby it is mandated to be unit linked when it could, with equal merit, be left to each company’s judgement, in particular since the policyholder return is prescribed,

without, it would appear, bringing any discernible benefit either to policyholder or company.