SOCIETY OF ACTUARIES

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India's Insurance Industry Marches Toward Liberalism (Part 2)

by Shriram P. Mulgund

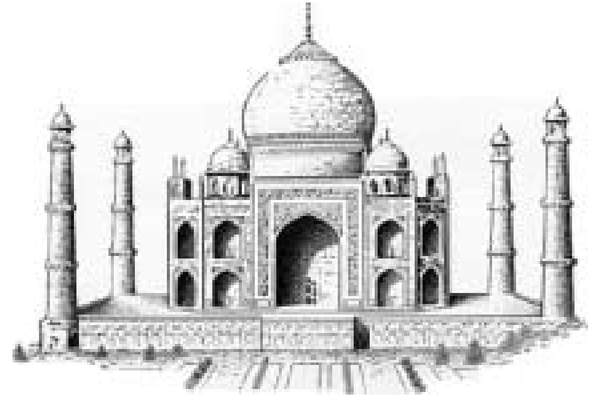
Rapid changes have been taking place in the insurance scene in India. An article describing these changes had appeared in the May 2000 issue of the International Section News. This article provides an update.

Quick Background

India's life insurance industry, which is more than 100 years old, was nationalized in 1956. The business of about 250 life insurers was acquired by the newly set up nationalized insurer Life Insurance Corporation of India (LIC), which then was given the monopoly for life insurance business. General insurance was nationalized in 1972.

The LIC witnessed significant growth in business (particularly in the rural sector—nearly 70% of India's population of one billion lives in villages). It transacts business through 2,050 branches with an agency force of 715,000 and a staff of 123,000. It has over 100 million policies on its books. All benefits are guaranteed by the government of India.

With a view to reviewing the status of the insurance industry in the changing economic conditions, the government of India appointed a high-powered committee in 1992. In its report submitted in 1994, the committee made wide-ranging recommendations that included a recommendation that private players be permitted to compete in the marketplace. Acting upon these recommendations, an interim Insurance Regulatory Authority was set up in 1996 to deal with changes in legislation, etc. Due to political opposition for such liberalization, it took the government until 1999 to get all the necessary legislation passed. An Act passed in 1999 set up the Insurance Regulatory and Development Authority (IRDA), which was formally constituted in April 2000, with Mr. N. Rangachary as its Chairman.



Taj Mahal, India

Set-up of the IRDA

The IRDA consists of the Chairman, five full-time and four part-time members. One of the full-time members has to be an actuary. The tenure of any member is five years.

There is an Insurance Advisory Committee consisting of 25 members, excluding the members of the IRDA, representing the interests of commerce, industry, transportation, agriculture, consumer forums, surveyors, agents, intermediaries, organizations engaged in safety and loss prevention, research bodies and employees' association in the insurance sector. In making any regulations, the IRDA will consult the Insurance Advisory Committee.

The Authority is an active member of the International Association of Insurance Supervisors.

Current Legislative Framework

The current legislative framework consists of three tiers. All of these can be found on the IRDA's web site (shown at the end of this article).

The first tier consists of the primary legislation governing the insurance industry, which is the Insurance Act, 1938 (with amendments to-date) and the Insurance Regulatory and Development Authority Act, 1999.

The second tier consists of the various regulations formed by the IRDA and the rules notified by the Government of India.

The third tier consists of the directives and circulars issued by the IRDA.

IRDA Aims and Objectives

The IRDA Act set out the duties, powers and functions of the Authority. The IRDA is driven by the objectives of protecting the policyholders' interests and of creating an environment that will encourage a healthy growth of the insurance industry.

The requirements for licensing of new insurers, actuarial valuations, solvency margins, investment limitations, etc. are designed with the objective of policyholder protection in mind.

In the new environment, the nationalized insurer, which will continue to enjoy the benefit guaran-

tees provided by the Government of India, will compete with the private players. The IRDA will create a playing field that will be as level as possible within the current framework.

The IRDA intends to maintain transparency in all its operations. It has done so in granting licenses to new insurers. It is contemplating holding regular meetings with industry officials to discuss and resolve industry issues.

Key Characteristics of the New Regime

The following could be considered to be the key characteristics of the new regime:

- High capital requirements for new insurers to ensure that only strong companies enter the marketplace.
- Adoption of the Appointed Actuary system to the fullest extent.
- Requiring the intermediaries to satisfy high educational and training requirements (including CPD).
- Use of current actuarial thinking in setting up the valuation and solvency requirements.
- Liberalization of the restrictions on permissible investments.
- Special requirements to deal with the population living in rural areas and belonging to the socially weak sector.
- Adoption of "file and use" approach for new product introductions.

Registration Requirements for Insurers

An applicant seeking license to transact insurance business, must be an Indian Insurance Company. Even though at the time of start-up, one or more companies or individuals may promote the new company, the new insurer has to go public within 10 years of its registration.

Foreign companies interested to do business in India must do so through a joint venture with an Indian company. The foreign equity participation in the joint venture is limited to 26%.

The minimum paid up equity capital is one billion Rupees (approximately, US $22 million). For insurers who wish to do reinsurance business exclusively, this is two billion Rupees. A Company cannot transact both life and general insurance business - it will need to set up separate companies.

The promoters of the new company must have a good track record. It is necessary to satisfy the IRDA that the promoters have every intention to stay in the insurance business for the long haul.

Applications for licensing are to be accompanied by very detailed business plans for five years. The business plan has to describe, among other things, the products that are to be introduced, their profitability, distribution channels to be employed, anticipated sales, etc. The business plan should also indicate how the future needs for additional capital will be met.

Appointed Actuaries

Each insurer has to have an Appointed Actuary. In the case of a life insurer, the Appointed Actuary has to be an employee. In the case of a general insurer, he/she could be a consultant.

The appointment of AAs is governed by a separate set of regulations. He/she should be a resident of India. He/she has to be a Fellow of the Actuarial Society of India holding a Certificate of Practice issued by the Actuarial Society. While seeking the Certificate of Practice, the individual should possess experience in the relevant field for a minimum period of two or three years and should satisfy the CPD requirements.

The Appointed Actuary should not be over the age of 70 years.

The insurers are required to seek prior approval from the IRDA before any individual is appointed as the Appointed Actuary.

The new regime places very heavy responsibilities on the shoulders of Appointed Actuary. He/she is expected to be the eyes and ears of the IRDA and be a "whistle blower." He is a person who is expected to bridge the gap between the insurer and the regulator.

As a member of the Actuarial Society of India, the Appointed Actuary will of course be expected to comply with all the Standards of Practice set out by the Actuarial Society.

During the nationalization era, the employment market for the actuarial profession had become stagnant and had lost its appeal. As a result, the supply of actuaries has

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almost dried up. With the opening up of the industry, the profession has regained its luster. But, it will be at least five to ten years, before the supply will be able meet the demand. The IRDA has recognized that in the interim, the insurers may experience some difficulty in seeking suitable individuals for the position of Appointed Actuary. In special situations, the IRDA will be willing to give a special consideration.

Distribution System

The thrust of the legislation is to build an agency system where only professional agents are engaged in the distribution activity. In addition, other distribution channels will also be developed.

The agents will be licensed by the IRDA. These licenses will be renewable every three years. The agents can be either individuals or corporations, which will usually be registered companies or firms.

In order to ensure professionalism, the licensing requirements stipulate a minimum academic qualification level along with a minimum of 100-hour practical training from an approved institution and a pass in the qualifying examination. For renewal of licenses, a CPD requirement of 25 hours of practical training is also stipulated.

The legislation requires that an agent represent only one company. Multiple company representations are not permitted.

The IRDA is planning to permit multiple distribution channels. Legislation pertaining to brokers is being worked upon. With regard to qualifications and professional training, this is expected to be similar to agents. In addition, they are expected to have some capital requirements.

Valuation of Policy Liabilities

The IRDA has tried to adopt modern thinking on this question. In valuing the policy liabilities, the actuary should recognize all contingencies under the policy, such as mortality, termination, conversion, maturity, etc. The future liability cash flows should include all premiums and benefits payable under the policy. These could be guaranteed or non-guaranteed. Full allowances should be made for expenses, including a suitable allowance for inflation. The liability cash flows should include all the bonuses (viz. dividends), including terminal bonuses. The policy liability will then be computed by discounting the future cash flows.

In determining the liability cash flows, all necessary parameters have to be taken into account—such as mortality, terminations, expenses, interest, etc. As new products are introduced, new parameters may have to be considered. The value of each such parameter should consist of two tiers—the first representing the expected level and the second representing a Margin for Adverse Deviations (MAD). The expected level should be based on the insurer's own experience, to the extent possible. If no reliable experience was available, it could be based on the industry level. The level of MAD would depend on the degree of confidence the Appointed Actuary had in the expected level.

In establishing the valuation interest rate, the extent of the asset-liability mismatch, the inter-depen- dence between the fund earnings and the benefits payable and the effect of adverse changes in the future interest rates should be taken into account. This would require different considerations to be employed for non-par business, par business and single premium business.

The computed reserve is subject to a minimum of the guaranteed cash value; thus requiring elimination of negative reserves. This seems to go against the concept of "realistic" reserves. This minimum had to be used to meet the discomfort of the Indian actuarial community in accepting the concept of negative reserves. This method will be called "Gross Premium Method."

Required Solvency Margins

The concept of Required Solvency Margins (RSM) has been used. It was thought that the industry was not yet ready for the use of Risk Based Capital approach. A simplified basis has been adopted.

The Insurance Act specifies that the RSM be based on three components. The first component will be expressed as a percentage of the asset value, the percentage being dependent on the risk classification of the asset. The second component will be expressed as a percentage of reserves. The third component will be expressed as a percentage of the net sum at risk. For the time being, the percentage for the first component has been set to zero.

The factor based on reserve for the second component ranges from 1% to 4%. For most individual insurance and annuity business, it is 4%.

The factor based on net sum at risk for the third component ranges from 0.2% to 0.3%. For most individual insurance business, it is 0.3%.

Appointed Actuary's Report

The legislation provides for standard financial statements required for insurance companies. In addition, the IRDA will be asking for a

separate report from the Appointed Actuaries giving detailed background to the valuation assumptions, various indices, etc. Since this report will be confidential, the IRDA will be able to seek information that may be considered sensitive for public disclosure. This will also provide flexibility to the IRDA to change the contents of this report as need for additional information becomes apparent

Investments

For life insurance business, at least 25% of the funds have to be invested in government securities. A further 25% has to be invested in government securities or certain "approved" securities. At least 15% have to be invested in social sector and infrastructure investments. Up to 20% can be invested in investments that meet the exposure and prudential norms set out in the legislation. For the remaining 15%, the insurer has full freedom.

For pension and annuity business, at least 20% has to be invested in government securities. A further 20% has to be invested in government securities or "approved" securities. The remaining 60% can be invested in the "approved" securities and other investments governed by exposure and prudential norms.

Approved Investments

The legislation sets out the nature of "approved" investments other than the government securities. These include securities that have a government backing, instruments that have been issued by very strong companies with good track record, well-secured mortgages, bank deposits, policy loans and so on.

Exposure and Prudential Norms for Investments

The legislation sets out the exposure and prudential norms to be considered by the insurers. The exposure norms are designed to limit the insurer's exposure in a single investment. The limitations relate to factors such as the maximum percentage of assets that can be invested in a single company or a group of companies. The prudential norms are designed to assess the quality of the investment. These are based on factors such as company rating, asset cover, debt-equity ratio, dividend cover, etc.

Rural and Social Sectors

The IRDA's objectives of ensuring that the rural and socially weak sectors benefit from liberalization have been met through imposing certain requirements on the insurers in respect of these sectors.

A rural area is defined as a town with a population of less than 5000. The percentage of business from the rural area should be at least 5% in the first year of operation of the insurer, increasing to 15% in five years.

With regards to the socially weak sectors (viz. the economically vulnerable workforce), the number of lives from this segment has to be at least 5,000 in the first year of operation of the insurer, increasing to 20,000 in five years.

New Product Introductions

The new regime did not wish to impose any impediments in the development of new products. At the same time, they wanted to ensure that any new products would serve the needs of the general public. This was achieved through the adoption of "file and use" approach. While no prior approval of new products is needed, the Appointed Actuary has to provide the IRDA a detailed report setting out the benefits (including restrictions, if any), profitability levels, scenario testing, etc. If the IRDA is concerned about any aspect of the product, they will contact the insurer within one month. One month after the filing, the insurer can introduce the product if no communication had been received from the IRDA.

Taxation of Life Insurance and Shareholder Transfers

Life insurance premiums paid by individuals attract tax benefits. For this purpose, the savings made in other vehicles (such as contributions to the defined contribution plans called Provident Funds and a few other investment vehicles) also attract the same benefits.

Life insurers are taxed on valuation surplus, which is the excess of the assets over the policy liabilities in the policyholders' fund (these liabilities exclude the current year bonus). The tax rate is 12.5%. There is also a surcharge at 10% of the tax rate. The tax rates have remained unchanged for three decades. At present, there is no differentiation made between the surplus emerging from the par business and the non-par businesses. A proposal has been made to distinguish between par and non-par businesses.

The shareholders' share of surplus is limited to 7.5% of the valuation surplus. There is a proposal to increase this share to 10% in case of par business and 100% in case of non-par business.

The Government of India has appointed a committee to look into taxation of life insurers and to recommend changes. The committee has submitted its report to the government. The recommendations seem to indicate that the policyholders' share of surplus be taxed at lower rates, maybe at 5% to 7%, and the shareholders' share of surplus be taxed at the prevailing corporate rate—currently 35%.

Actuarial Profession in India

The present actuarial community in India consists of members of the Institute of Actuaries, London. They are also members of the profes-

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sional actuarial body in India, called Actuarial Society of India. It was formed in 1944. Initially, the Society was only a forum to discuss actuarial issues. In 1984, it became a registered society with specified objectives to promote and develop the profession in India. In 1987, it commenced its own examinations at the Associateship level. In 1991, this was extended to the Fellowship level. The pattern of examinations is similar to that used by the Institute of Actuaries, London.

During the period of nationalization, the actuarial profession had lost its appeal. As a result, very few individuals commenced writing the actuarial examinations. With the opening of the insurance sector and the adoption of the Appointed Actuary system, there is a severe shortage of actuaries.

As of December 31, 2000, there were 213 Fellows, 119 Associates and 473 students. Out of the 213 Fellows, only 11 were below the age of 30, another 45 between the ages 31 and 40, about 100 lived outside India and about 90 were over age 60.

In the years to come, there will be a lot of demand for actuaries in India.

As the new environment places very heavy responsibility on Appointed Actuaries, there is a need to develop the profession very quickly. The Actuarial Society of India has undertaken this challenge. It may take another five to ten years to fully meet the demand for actuaries—not only for the position of Appointed Actuaries, but also to work in different areas of the company. In the meantime, the IRDA expects that the insurers will have to rely on the support from the overseas actuarial profession—primarily from the home countries of the foreign partners of the joint-venture companies.

Challenges in the Years to Come

India is a country with a population of over 1 billion. The middle-income group constitutes 50% of this total. There is a tremendous potential for channeling the country's savings through the life insurance companies. Currently, this is about 1.5% of GDP. Awareness and successful penetration will be the key for increasing the share of the insurance industry. This can be achieved if financially and professionally strong companies enter the market, introduce innovative products, increase the penetration of insurance to the masses and provide efficient service to the consumers.

As the savings channeled through life insurance are increased, these have to be invested on a long-term basis. The existing capital markets may not be adequate to do this. This will require developing the long-term markets. Such increased long-term investments will go a long way in meeting India's requirements for long term investments to meet its infrastructure needs.

Opening up the industry has put new pressures on the IRDA. It has to ensure that the policyholders' interests are well protected. Monitoring the industry without stifling its growth, will be a big challenge.

As indicated above, the benefits payable under the policies issued by the LIC will continue to be guaranteed by the Government of India. This may be construed to be a disadvantage to the new players. A Policyholder Protection Fund can provide guarantees to the policyholders of these players. This fund can be set up from contributions made by the insurance industry.

As the industry grows, it will need to deal with a variety of issues and discuss these with different agencies (including the IRDA). This will require that the industry be able to speak with one voice. This will require the industry to create and develop an industry body to represent its interests. Such a body can also set out a code of ethics to be followed by the member companies and monitor the same.

The actuarial profession in India is relatively young and small in number. Many of the actuaries have a very limited exposure to the current actuarial thinking. Developing this profession will be a big challenge.

Fortunately, there appears to be a friendly and transparent insurance supervisor. The IRDA is committed to make every effort and provide any support to develop the industry and the professions. With strong and innovative players in the marketplace, the future of the insurance industry looks very bright indeed!

Contact Information

Any additional information can be sought from the following addresses:

- IRDA — *www.irdaindia.org* or *www.irdaonline.org*
- Actuarial Society of India - *www.actuariesindia.org*

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