International Section News

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India's Insurance Industry Marches toward Liberalism

by Shiram P. Mulgund

A lot has been happening in the insurance scene in India in recent months. Members of the International Section will find these developments of interest.

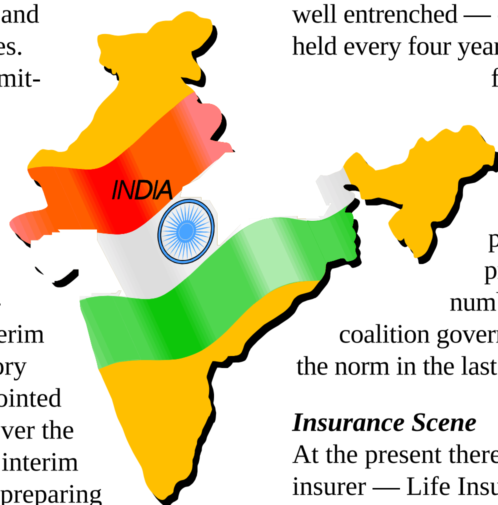
Background

Life insurance industry in India is more than 100 years old. Prior to its nationalization in 1956, there were more than 250 life insurance companies operating in the country. While most of the companies were Indian, there were a few foreign, primarily British, insurance companies as well. After becoming independent in August 1947, changes to the economic environment were to be expected. The first such change to the insurance industry took place in 1956.

Some concerns were being expressed about the life insurance industry at the time. Some questionable investment practices by some insurers were revealed. Products with inadequate premium scales were being sold. Expenses were increasing. Most companies were focusing in the urban areas of the country, leaving the rural areas inadequately serviced. With a view to protecting the policyholder interests and spreading the message of life insurance in the rural areas, the industry was nationalized and a crown corporation "Life Insurance Corporation of India" (LIC) was formed on September 1, 1956. The general insurance was later nationalized in 1972.

After independence in 1947, the leaders had a vision to take the country along the route of rapid industrialization. The early decades saw the opening up of a number of public sector undertakings in key areas. In the '80s, the focus was shifted to the agricultural sector. The process of economic liberalization got a start in the '90s.

The Government of India appointed a committee under the chairmanship of Mr. Malhotra to review the status of the insurance industry and recommend changes. The Malhotra committee's report, published in 1994, commenced the process of insurance liberalization. Following up on these recommendations, an Interim Insurance Regulatory Authority was appointed in January 1996. Over the last four years, the interim authority has been preparing the groundwork for taking the insurance industry into the new environment. The authority got its legal status through passing of the Insurance Regulatory and Development Authority (IRDA) Act on December 7, 1999. The IRDA will now be able to set up the framework needed for the new regime. It is expected that new players will be issued licenses and will be able to commence their operations by late 2000 or early 2001.



Current Environment

A few comments on the current environment may be useful to appreciate the changes that are currently taking place.

The Country

India is a vast country with a an area of 3.3 million sq.km. and a population of 980 million. It has 26 states. It has 23 cities with a population of one million or over and 300 cities with a population of 100,000 or over. About 73% of the population lives in rural areas.

The country has great diversity in religions, languages (there are 16 official languages), culture and traditions. English is the business language. Democracy is well entrenched — elections have been held every four years (some times more frequently) since independence. The legal system follows the British practice. The judiciary is independent. Due to the presence of a large number of political parties, coalition governments have become the norm in the last few years.

Insurance Scene

At the present there is only one life insurer — Life Insurance Corporation of India. Its activities are conducted through the Central Office located in Mumbai (formerly Bombay), seven Zonal Offices (which serve as regional head offices), 100 Divisional Offices and 2,050 Branch Offices. It has a staff of over 125,000 and an agency force of 560,000 agents. The agents are supervised by 19,000 development officers.

LIC's assets are over Rs.1,000 billion (U.S.$24 bn.). The current level of individual insurance new business is of about 12.2 million policies with a sum assured of Rs.570 billion (U.S.$14 bn.). The total business in force consists of 78 million policies with a sum assured of Rs.4,100 billion (U.S.$ 98 bn.), inclusive of group coverages.

In the last 25 years, the LIC's premium income has increased at an annual compound rate of about 17%. In real terms, this will be about 7%.

Insurance Products Sold

The products sold are primarily of the Participating Endowment Assurance type. A standard Endowment Assurance product provides a level sum assured payable on death or survival to the specified endowment period. These periods will generally range from 10 years to 30 years. The dividends are payable in the form of reversionary bonuses. In one variation of this product, the maturity benefit is payable in installments, e.g., 20% payable 10 years before the maturity date, 20% payable 5 years before the maturity date and the balance at maturity. These plans are called "money back" plans. For these plans, even though the maturity amount is payable in installments, the death benefit and the bonuses are based on the full sum assured. About 80% of the business currently sold is of these types. The public views life insurance as a savings vehicle. The adage that life insurance is never bought but sold is very much prevalent in India.

Commissions and Expenses

The maximum commissions payable to the agents are governed by legislation. The maximum first-year commission payable under an Endowment Assurance contract (including bonus commissions) is 35%. Renewal commissions are payable during the full premium paying period. The legislation limits the total first-year expense to approximately 95% of the first-year premium.

Tax Incentives for Life Insurance Premiums

The life insurance premiums attract tax relief (the amount of tax is reduced by 20% of the amount of premium, subject to a maximum premium of Rs.60,000). Some additional tax benefits are provided for a special pension annuity plan. This proves to be an added incentive for purchase of life insurance. Similar tax reliefs are provided for investments in other vehicles.

Taxation of Life Insurance Business

LIC is taxed at 12% of the valuation surplus. The general taxation rate for corporations is 38.5%. This gives a preferred tax basis for life insurance business. There are no premium taxes.

Investments

The current legislation puts severe restrictions on the manner in which the policyholder funds can be invested. At least 75% of the funds have to be invested in government securities or government approved securities. This leaves very little scope for investment in other vehicles.

Economic Conditions

India's GDP has grown over the past 25 years at an annual rate of 13.75% (4.7% in real terms). It is expected to increase at 5.8% for 1999 and at 6% for 2000.

The savings rate has been around 23% of the GDP. About 14% of the savings have been diverted to life insurance.

The penetration rate for life insurance has increased from 0.66% to 1.37% over the last 25 years.

Insurance Regulatory and Development Authority Act

The insurance industry is governed by the Insurance Companies Act of 1938. The nationalization of the industry was achieved through the LIC Act of 1956 and the GIC Act of 1972 that created the monopolistic provisions for the life and general insurance. With the passing of the IRDA Act, the monopoly provisions have been removed, clearing the way for private players. Also, the Insurance Companies Act is being revamped to bring it to be compatible with the current environment.

The IRDA will be charged with the task of supervising the industry. It will consist of ten members — five full time and five part time.

The IRDA will be preparing regulations to cover the various aspects of the operations. The anticipated provisions will be:

New Licenses

Only Indian companies will be able to obtain licenses. A company can seek a foreign company participation up to 26%. The balance of the capital has to be financed by the local partner.

As the nationalization took place more than 40 years ago, very little insurance expertise exists outside of LIC. Hence, most companies may find it necessary to seek foreign participation. At this time, about a dozen companies have entered into Memorandum of Understanding with foreign insurance companies (both life and general). These partners will set up Indian subsidiaries to carry on the insurance business.

The minimum capital requirement will be Rs.1 billion (approx. U.S. $24 million). This is quite high for Indian conditions. The valuation regulations will require the companies to hold minimum solvency margins. If these exceed Rs.1 billion, the company will need to raise additional capital.

Composite licenses will not be issued. A company wanting to get into life and general insurance business will have to set up two separate companies with separate capital requirements.

The licenses will not be localized, that is, the new company will be allowed to sell in any part of the country (for its own reasons, a company may want to focus on certain regions). No limits on the number of licenses to be issued are likely, as long as the applicants meet the regulatory requirements.

The applications for licenses will need to include a business plan for the planned operations.

Distribution Channels

Though insurance is currently distributed through the agency system, the IRDA may permit the use of multi-channel distribution. The new environment will likely allow career agents, brokers, and institutional agents. Appropriate licenses will be issued to these intermediaries. Whether or not to permit the banks to directly distribute insurance products is still being debated. The Reserve Bank of India, which regulates the banking industry, has published proposed regulations specifying stringent norms for the banks to become joint venture partners of insurance operations. It is likely that insurers may be able to use bank branch premises for distribution as long as the insurance operations are kept separate from the banking operations.

The focus of the new legislation will be to develop professional distribution channels. This will require the agents to

(continued on page 10, column 1)

India's Insurance Industry Marches Towards Liberalization

continued from page 9

satisfy certain professional and training requirements. Some continuing professional development requirements are also contemplated.

Appointed Actuaries

The IRDA are planning to introduce the Appointed Actuary concept used in the UK and in North America. The Appointed Actuaries will have to be residents in India. Certain minimum and maximum age requirements may also be specified. The IRDA are planning to rely on the Appointed Actuaries for ensuring appropriateness of new product pricing and setting up of appropriate reserves and solvency margins.

Valuation and Solvency Requirements

The current actuarial practice is very much influenced by the UK practice. A number of issues are currently being discussed. Indications are that the following practices may be adopted:

- The valuation will need to take into account all cash flows in an explicit manner (including future bonuses).
- The valuation bases will need to include margins for adverse deviations.
- The method used for the valuation of assets may need to reflect the unrealized capital gains.
- The minimum solvency margin requirement will consist of three components — a percentage of the asset value depending on the asset class and quality, a percentage of the net sum at risk, and a percentage of reserve. These percentages have not yet been specified.

At the time of annual filing, the Appointed Actuaries may have to prepare a separate report setting out additional background data for the benefit of the regulators.

Introduction of New Products

The current indications are that introduction of new products may not need any pre-approval by the IRDA. Instead, the Appointed Actuary will have to provide a certification of appropriateness of pricing in the material to be sent to the IRDA. With this "file and use" approach, the insurer can file the necessary information, wait for a period (say, 30 days) and launch the product if nothing is heard from the IRDA. This will effectively be a self-regulatory process whereby an insurer will be responsible for its own actions.

Investments

It is expected that the investment restrictions will be diluted and made more progressive in accordance with the new economic norms. That will permit investments in vehicles not previously permitted. This will help the corporate debt and other markets to develop.

Social Obligations

As discussed above, a majority of the Indian population lives in rural areas. If the new players were to concentrate only on the urban sector, the rural sector will be left out from the benefits of liberalization. To avoid this, some requirements are expected for a portion of business to be sold in the rural sector.

Implications of Liberalization

Liberalization of the insurance sector will have a number of implications:

- The entry of private players will increase competition. This will result in introduction of new generation of products, reduced premiums, and more efficient service to the policyholders. These will all benefit the consumers.
- The relaxation of the investment restrictions will help develop the investment market place.
- India has tremendous capital requirements to meet its infrastructure needs. This requires availability of long-term investments. It is hoped that with the development of the life insurance market, this will be possible. With an increase in the penetration rate from 1.37% to 1.7% and an increase in the savings rate to 26% to 27%, the resulting increase in the premium income will be able to meet about 90% of the capital needs in the next 10 years.
- The increase in the insurance activity will increase employment and bring about the prosperity that the liberalization process had envisaged.
- The regulators are planning to create a level playing field for all players. This will create a healthy environment for the insurance market place.
- The liberalized environment will no doubt see the introduction of new technology in the industry. This will help the consumers.

Role Played by Actuaries

The IRDA are expecting that actuaries will play a very key role in the new environment. Actuaries will serve as "eyes and ears" for the regulators. The IRDA will rely on the Appointed Actuaries for the key aspects of the insurance operations, e.g., appropriateness of new product pricing, appropriateness of the liability valuation method and bases, accuracy of the calculation of solvency margins and asset-liability management.

Unfortunately, the nationalized environment in the past 45 years had reduced the appeal of the actuarial profession as a career alternative. This has had a serious impact on the number of new entrants for the profession. There are a handful of actuaries in active service. The profession will likely have an uphill battle to built up an adequate supply of actuaries to meet the needs of the insurance companies.

The actuarial profession is organized under the Actuarial Society of India. It is

(continued on page 11, column 3)

6th Annual Conference of the International Association of Insurance Supervisors

by Hans Wagner

Where do insurance regulators from countries like Lithuania and Lesotho, Malaysia and Malta, or the United States and the United Kingdom, gather to compare notes? At the International Association of Insurance Supervisors (IAIS). The IAIS, along with the Basel Committee on Banking Supervision (Basel Committee) and the International Organization of Securities Commission (IOSCO), form a key link in improving government supervision of the financial services industry worldwide.

The IAIS held its 6th Annual Conference on December 7–10 in San Francisco, hosted by the NAIC, with about roughly 300 insurance supervisors and other professionals in attendance. The IAIS includes representation from the supervisory authorities of more than 90 jurisdictions worldwide. In addition to its annual meeting, the IAIS holds other working meetings throughout the year.

The agenda included panels on seven topics, a general business meeting, and a plenary aession. The panels covered the following topics:

- Catastrophic occurrences
- International insurance accounting
- Privatization
- Needs and concerns of supervisors and the insurance industry in emerging markets
- Insurance taxation
- Insurance fraud
- Pressures for changes in supervisory structures

The panels presented a wide variety of perspectives from around the world. These brief summaries might give a small sense of the spectrum of the presentations.

Panel on Catastrophic Occurrences

The discussion was in two sections, one "Technical" and one "Regulatory." Four speakers addressed each: Werner Schad (Swiss Re), Takaaki Tamai Tokyo Marine), Mario Ordaz National University of Mexico), Manuel Aguilera Verduzco Commission Nacional de Seguros y Finanzas (Mexico)), Anselm Smolka Münich Re), Miguel Jimenez de Cordoba Consorcio de Compensación de Seguros, Spain), Paul Kovacs Insurance Bureau of Canada/Institute for Catastrophic Loss Reduction), Kevin McCarty Insurance Commission of Florida). It was noted that the insured catastrophe losses have been greatly increasing, for a variety of factors: 1) greater insurance penetration, 2) greater building in vulnerable areas, and 3) perhaps greater frequency and magnitude of disasters including potential impacts from global warming and climate change.

The various types and locations of disasters have had their potential total and insured losses estimated. It was interesting to note, for example, that a major Japanese earthquake potentially creates a three times larger total loss than a major California quake, but that California might suffer twice the insured loss. Disasters discussed included earthquake, flood (including tsunami and storm), fire, and storm (typhoon/hurricane, ice, wind, hail). Ice and hailstorms may have historically been relatively ignored, as evidenced by recent losses in Quebec and Sydney.

Different countries have developed a variety of models for quantifying "levelized" risk charges and maximum possible exposures to catastrophes. Mexico has a very sophisticated earthquake model factoring in lots of local geologic data, as well as building data.

(continued on page 12, column 1)

India's Insurance Industry
continued from page 10

an examining body, and first group of Fellows of the ASI qualified a couple of years ago. The legislation will require that the Appointed Actuaries will have to be Fellows of the Actuarial Society of India. In the years to come, the ASI will need to expand on the guidance that the Appointed Actuaries will need in their work. For this purpose, the ASI will no doubt welcome any help they can get from other actuarial bodies.

Conclusion

The insurance market will have exciting times in the years to come in India. The IRDA intend to use the liberalization process as an opportunity to bring the insurance industry in India into modern times. In this process, they want to place the greatest reliance on the actuarial profession. Hence, actuaries will have a very important role to play in helping the IRDA achieve their objective. Due to the paucity of the number of actuaries in India at the present time, any help that can be provided by the actuaries and actuarial bodies outside of India will be welcome.

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