REVIEW OF REGULATIONS – LIFE INSURANCE

Report of the Committee constituted by IRDAI

Part I

September 2015

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Background:

The Insurance Laws Amendment Act 2015 has brought about numerous amendments to the existing Insurance Act 1938. This has necessitated a revisit of the provisions of the various existing regulations specifically the Regulations around the actuarial valuation of the policy liabilities, provisioning for Solvency and Actuarial Reporting for the Life Insurance companies.

Solvency of an insurance company relates to its ability to meet its liabilities to the policyholders etc. as and when they fall due. In other words it means that the life insurance company has sufficient financial resources to meet its policyholders' obligations even under adverse circumstances. The two key aspects of this is the sufficiency of the technical reserves to be set aside to meet such obligations and adequacy of the additional solvency capital in order to provide a cushion in case of adverse events taking place. This is particularly critical for a life insurance company as the liabilities are generally long term; given the uncertainty around the various economic and operating assumptions applying over the long term.

The existing valuation regulations and the solvency framework are relatively simplistic but prudent in nature and do not sufficiently reflect various risks inherent in the business. Moreover, it has not been updated to consider various developments in terms of new classes of products and methodologies. That aside, the Regulations are 'one size fits all' and hence do not take into consideration the specific risk exposures of the life companies.

Terms of Reference:

By its order dated 22nd July 2015, this committee has been constituted to review the existing Regulations relating to actuarial valuation, solvency and reporting requirements and to draw a framework for most appropriate regulatory directives in each area.

The terms of reference of the committee shall be to study and review the following set of Regulations/Provisions, in particular and any other regulation, if need be, and recommend suitable regulatory approach / changes so as to adopt such changes suitably in the regulatory system.

The following Regulations will be reviewed by the committee –

1. IRDA (Asset, Liabilities and Solvency Margin) Regulations 2000
2. IRDA (Actuarial Report and Abstract) Regulations 2000
3. IRDA (Life Reinsurance) Regulations 2013
4. Appointed Actuary Regulations, 2000 to the extent applicable to Life Insurance
5. Circular of IRDAI on the Appointed Actuary Annual Report

6. Any other related matter that the committee feels necessary to address in this context.

Members:

1. Sanjeev Pujari (Chairman)
2. B N Rangarajan (Member)
3. D Sai Srinivas (Member)
4. P K Arora (Member)
5. Sanjeeb Kumar (Member)
6. Satyan Jambunathan (Member)
7. Vivek Jalan (Member)
8. Sudipta Bhattacharya (Member Convenor)

Executive Summary:

While the Insurance Amendment Bill 2015 necessitated a review of the current set of prudential regulations around the Life Insurance business in India, there was already a need felt to review and update these regulations and other regulatory prescriptions in line with domestic and international developments and the specific requirements of the Industry.

The committee worked with this aim in mind. Besides where ever possible, there has been an attempt made to review and consolidate various regulations, circulars and guidelines so as to bring in simplicity and greater clarity on the subject.

There was a need to align the regulatory framework to the IAIS Core Principles. A consistency in approach in the valuation of assets, liabilities and solvency capital requirement is fundamental to this. The Control Solvency Levels and the regulatory interventions are such as to balance between policyholder's protection and effective operations of the Industry. Besides, the control levels would trigger different degrees of intervention by the Regulator at a sufficiently early stage so that the prospect of rectifying the situation is realistic.

While it was felt that a RBC framework of solvency assessment needs to be adopted as part of the prudential norms, there is a need for a smooth transition over a period of few years during which a concurrent framework could be in place. The ALSM[1] Regulation has been suitable amended to enable the implementation of a RBC framework concurrently with the existing norms.

The Committee in its report has examined the various possible approaches to asset recognition (Market Value / Amortized Purchase Cost etc.) in the P & L and the Balance Sheet; consistency in the valuation of liability has also been examined. These are broadly for discussion purposes, the regulations have been retained and modified where ever applicable with the clear understanding that the current asset valuation and recognition norms would continue. It has been recognized that if there is any change in the

[1] Asset Liability and Solvency Margin

methodology to value the assets, the principles of the valuation of liabilities should be reviewed so as to achieve consistency between the two.

The Regulations have been pruned to a certain extent by retaining only the minimum essential reporting forms within them; most of the basic reporting formats and the solvency factor prescription have been taken to a draft circular to be issued by the Regulator. This will provide the flexibility to the regulator to modify the forms and factors as and when required e.g. in response to new product classes etc.

Two other issues were also referred to the committee for its response and recommendation, (a) the use of solvency ratio as a tool to monitor and control some critical performance parameters (b) Possible IRR structure similar to the ULIPs for the Traditional Participating Business. The committee's response to these issues has been included as annexure to this report.

Health Insurance business has been largely kept out of the committee's subject matter of deliberation owing to the understanding that the norms for this line of business would be considered separately. However, the view of the committee is that there should be a level playing field for life, non-life and health insurance companies and the reserving and capital norms should be such as not to create any artificial arbitrage between such insurers.

The report covers the Asset Liability Solvency Margin and Actuarial Report and Abstract Regulations and the Appointed Actuary Annual Report. The other regulations (Reinsurance and Appointed Actuary) would be reviewed in the next phase; they are hence not a part of this report and would form the part 2 of the report.

Chapter I. Amendments in the Insurance Laws (Amendment) Act, 2015 relating the Regulations under review:

1. Section 13: Every Insurer carrying Life Insurance Business shall, once every year cause an investigation to be made by an actuary into the financial condition of the life insurance business carried on by him, including a valuation of its liabilities in respect thereto and shall cause an abstract of report of such actuary to be made in accordance with the regulations...............

   Provided further that every insurer on or after the commencement of the IRDA Act 1999, shall cause an abstract of the report of the actuary to be made in such manner as may be specified by the Regulation.

   There shall be appended to every such abstract a statement prepared in such form and in such manner as may be specified by the Regulations.

2. Section 64V A:

   (i) Every insurer and re-insurer shall at all times maintain an excess of value of assets over the amount of liabilities of, not less than fifty per cent of the amount of minimum capital as stated under Section 6 and arrived at in the manner specified by the regulations.

   (ii) An insurer or re-insurer, as the case may be, who does not comply with sub-section (i), shall be deemed to be insolvent and may be wound-up by the court on an application made by the Authority.

   (iii) The Authority shall by way of regulation made for the purpose, specify a level of solvency margin known as control level of solvency on the breach of which the Authority shall act in accordance with the provisions of sub-section (iv) without prejudice to taking of any other remedial measures as deemed fit:

   Provided that if in respect of any insurer the Authority is satisfied that either by reason of an unfavorable claim experience or because of a sharp increase in the volume of new business, or for any other reason, compliance with the provisions of this sub-section shall cause undue hardship to the insurer, it may direct that for such period and subject to such conditions as it may specify, the provisions of this sub-section shall apply to that insurer with such modifications provided that such modifications shall not result in the control level of solvency being less than what is stipulated under sub-section (i).

   (iv) If, at any time, an insurer or re-insurer does not maintain the required control level of solvency margin, he shall, in accordance with the directions issued by the Authority, submit a financial plan to the Authority, indicating a plan of action to correct the deficiency within a specified period not exceeding six months.

(v) An insurer who has submitted a plan, as required under sub-section (iv), the Authority shall propose modifications to the plan, if the Authority considers the same inadequate, and in such an eventuality, the Authority shall give directions, as may be deemed necessary, including direction in regard to transacting any new business, or, appointment of an administrator or both.

(vi) An insurer or re-insurer, as the case may be, who does not comply with the provisions of sub-section (iv) shall be deemed to have made default in complying with the requirements of this section.

Chapter II. Brief outline of the current Valuation Regulations and basis of Regulatory Capital Requirement:

1. The current valuation and solvency framework is perceived to be conservative, partly due to the prudence in the valuation methodology and assumptions and partly due to such amount the additional solvency capital requirement.
2. The Solvency Margin is the amount by which the value of the assets is required to exceed the value of the liabilities. The Solvency of life insurance companies is governed by Sec 64VA of the Insurance Act 1938.
3. IRDAI has mandated the insurers need to maintain Solvency Ratio at 150% of the Required Solvency Margin (RSM). The RSM is loosely based on the Solvency I regime factors which is a formula based requirement and constitutes a stated percentage of the mathematical reserve and sum at risk. The former is meant to provide risk capital for market risks etc. and the latter for mortality risks etc. There is a third factor which is applicable to the assets which is currently set at zero.
4. Current solvency regime however is not risk based as it does not seek the identification of the specific risks of the company nor any provision of capital against the risks identified. The current regime is hence a 'one size fit all' approach.
5. The valuation of assets and liabilities are governed as per the following regulations - 'Asset Liability & Solvency Margin Regulations', 'Actuarial Reports & Abstract Regulations' and the 'Preparation of Financial Reports and Auditor's Report Regulations'.
6. Determination of Mathematical Reserve:
   - ✓ Mathematical Reserves shall be determined separately for each contract by a prospective method of valuation taking account of all prospective contingencies and any future premiums.
   - ✓ Amount of liability will be based on prudent assumptions; a margin for adverse deviation over the expected experience

- ✓ Negative Reserve to be eliminated and the reserve to be underpinned by the surrender value.
- ✓ If any other methodology other than Gross Premium Valuation (GPV) is used, then the amount so calculated would not be less than the amount that would have been calculated by the application of GPV.
- ✓ An additional provision to take into account the nature and term of the assets representing the liabilities. This would require the inclusion of prudent provisions for the effects of possible future changes in the value of the assets on account of change in market conditions and their ability to meet the liabilities as they fall due.
- ✓ The valuation rate of interest to be used for the statutory valuation shall not be higher than the rates of interest determined from the prudent assessment of the yields from existing assets attributable to blocks of life insurance business and yield expected from future investments to take care of reinvestment risks.

7. Valuation of assets:
    - ✓ The ALSM Regulations defines certain assets as non-admissible for solvency purposes
    - ✓ Other assets have to be valued in accordance to the 'Preparation of Financial Statements and Auditors Report Regulations'.
    - ✓ The above Regulation requires debt securities to be considered as held to maturity; to be measured at historical cost subject to amortization.
    - ✓ Equity stocks are measured at fair value, subject to impairment. The unrealized gains do not flow through the profit and loss account nor are they counted for solvency purposes, but are taken to equity in the balance sheet as the fair value change account. Property investment is determined at book value subject to periodic revaluation; any change in carrying amount is taken into revaluation reserve. IRDAI may direct specific amounts from the revaluation reserve to be released for the purpose of declaration of bonus to policyholders.
8. The mathematical Reserve is reported at the product level in formats described by classification, category, division, Sub Class and group of products. There are formats at different level of aggregation of the results and a format to estimate the Required Solvency Margin.
9. The factor based solvency capital does not specifically recognize any credit for the level of prudence in the basis of valuation; the solvency capital requirement increases with the increase in the level of mathematical reserve. This directly means that with higher prudence in valuation assumptions, company need to keep higher solvency margin.

10. The assets are by and large valued at book value and so are the liabilities as the yields of the existing block of asset is used as the valuation interest rate with an allowance for future reinvestment. Even though there is an element of consistency in the asset valuation and the determination of the liability, both are passive and not consistent with a fair valuation of assets and liabilities. The additional reserve that is proposed as part of the mathematical reserve in order to provide for mismatches in the assets and the liabilities so as to take into account the nature and term of the asset; may be considered to be redundant.

Chapter III. Objective of the review process & Policy Issues:

Committee is mandated to review the existing regulations and recommend changes and regulatory approaches. The key objectives of the review process would be the following:

1. Incorporate the amendments to the Insurance Act 1938 and their implications on the actuarial valuation related regulations.
2. Achieve a measure of alignment with regards to the valuation of assets and liabilities for solvency purposes, Supervisory Review and Reporting and Capital Adequacy norms with Core Principles of IAIS[2].
3. Consistency with IASB'[3]s proposals as they develop, assuming that India's accounting standards would converge to these. While these may affect the financial statements only, it is always desirable that both General Purpose and Solvency Reporting broadly correspond so as to avoid duplication of effort.
4. Update various provisions of the liability valuation regulations so as to allow specifics of certain products which the current set of regulations do not adequately address.
5. Review Gross Premium Valuation as the primary valuation methodology; recommend alternate methodologies for products (e.g. VIP, One Year Term Assurance) where the GPV method may not be entirely suitable.
6. Strengthen the valuation approach to With Profits business, refine the same for linked business and lay down specific valuation methodology for VIP business.
7. Simplify the regulations and the reporting formats; eliminate duplications. Review the current reporting requirements in the Appointed Actuary Annual Report and recommend a more qualitative and technical basis reporting than the largely factual reporting existing currently.

[2] International Association of Insurance Supervisors
[3] International Accounting Standard Board

8. Recommend standard definitions of the various terminologies used for completing the actuarial report so that a level of consistency and uniformity is achieved across the industry.

9. Explore and suggest alternative forms of capital for Solvency considerations.

10. Recommend adoption of latest valuation norms looking at recent global developments specifically Solvency II which now has a firm time frame for implementation. Thus, recommend incorporation of a risk based capital adequacy basis into the current set of regulations.

11. Review the prevalent set of solvency factors as currently existing as part of the regulations and in the form of circulars issued by IRDAI and recommend a more rational approach.

12. Recommend minimum capital & control levels of Solvency which would trigger different levels of supervisory interventions -

    - ✓ above which no regulatory interventions would be required (PCR)[4].
    - ✓ below which severe regulatory interventions would be required (MCR)[5].

13. Introduce materiality into the valuation approach. The concept of materiality will apply to calculations in line with the International Accounting Standards - Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the statements containing such information.

Chapter IV. Committee's Approach to the Review of the Regulations

Solvency Structure:

1. The committee feels that the core of the current supervisory structure should remain broadly unchanged for the time being, the risk based approach would form another layer so as to supplement the existing solvency structure in the near future. This is felt to be an appropriate approach as it would avoid a sudden change in capital/profit levels, acceleration of tax thereby and also maintain the level of policyholder protection the current prudential regime gives through the inbuilt prudence in its approach. The current prudential norms could continue to form the benchmark for MCR.

2. Sec 64VA prescribes a 'Minimum Capital' i.e. the minimum of the excess of the value of assets over the amount of liability estimated below which a life insurance company

[4] ICP 17: PCR – Prescribed Capital Requirement
[5] ICP 17: MCR – Minimum capital Requirement

would be declared insolvent and will be liable to be wound up by the court on an application made by IRDA. Such a level would the higher of the following

- ✓ 50% of the amount of minimum capital as stated under Sec 6 of the Act.
- ✓ Amount arrived at in such a manner as specified by the Regulations.

The amount, in our view to be stated in the Regulations would be 100% of the factor based Required Solvency Margin. A company falling below this level of capital would be deemed insolvent.

3. Sec 64VA also requires that a 'Control Level Solvency' to be specified by the Authority. The Control Level would trigger different degrees of intervention by the Authority at a sufficiently early stage with an appropriate degree of urgency so that there would be a realistic prospect for the situation to be rectified in a desirable manner[6]. There would be a certain degree of consistency between the solvency level established and the associated corrective action that the Authority may initiate. This may internally decided by the Authority’s office and the committee feels no need to offer a prescriptive view on this except for the following listing of the various course of action open to the regulator.

4. The various levels of corrective actions by increasing severity of the breach would be

    - ✓ Submission of a financial plan detailing corrective action on the part of the insurer
    - ✓ More frequent investigation into the solvency position and reporting than is normally required
    - ✓ Closure of a specific channel to New Business
    - ✓ Closure of the company to New Business

5. The Control Solvency Level would be based on the current factor based 'Required Solvency Margin' with an under-pin which would come from ‘Risk Based Economic Capital estimation’. The capital resource required in order to comply with the Control Solvency Requirement would be -

    - ✓ 150% of the RSM which would be estimated as is done under the current Supervisory norms. The two factored approach would have one factor applying to the mathematical reserve and the other factor to the Sum at Risk. The 3rd existing factor applying on the assets not currently in use need not be pursued with.
    - ✓ This would be underpinned by a percentage of the Solvency Capital Requirement estimated to provide for the various risks identified at a prescribed confidence level over a period of one year. The details of the risk based economic capital norms and the calibrated stress levels would be worked out by a working committee with members drawn from the IAI and the IRDAI.

    Capital resource is the excess of the value of the assets over liabilities estimated, specific to the approach being undertaken.

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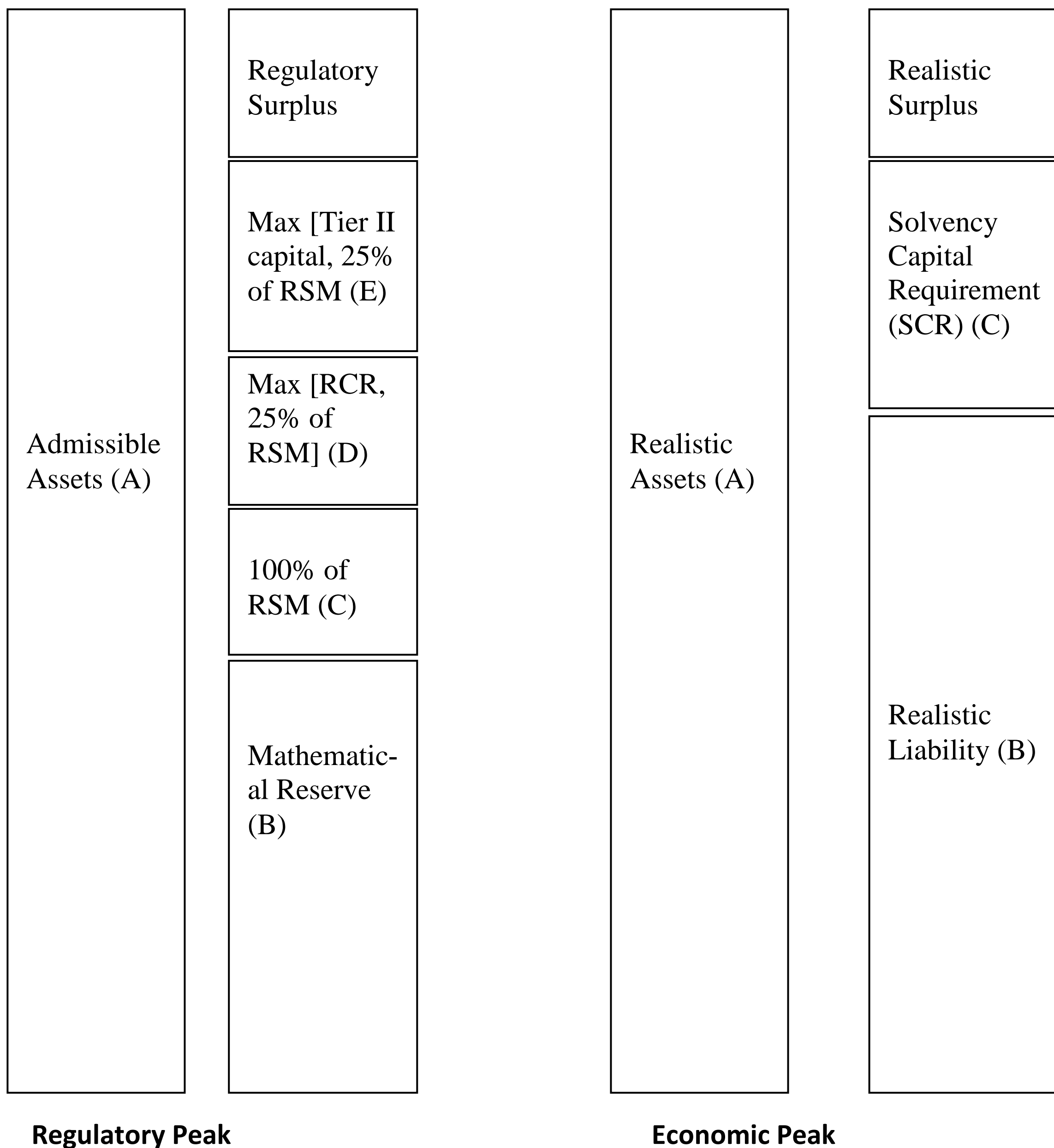
[6] ICP 17 Capital Adequacy

The control Level of Solvency would hence follow a **Twin Peak** approach. The Regulatory intervention would happen on the earlier of (a) breach of the minimum 'Regulatory Solvency Ratio at a level of 150% of RSM or (b) the breach of the minimum of the percentage of 'Economic or Risk Based Solvency Ratio' to be specified.

6. Currently the factors being used to estimate the regulatory Required Solvency Margin are somewhat fractured and come partly from the Regulations and partly through IRDAI circulars. The committee feels that there is no need for such multitude of different factors for the various product classes and would recommend a more rationale set of factors which need not be placed in any Regulations i.e. they could be prescribed through a circular which would make the process much more flexible for the regulator.



Regulatory Peak **Economic Peak**

Figure 1

Regulatory Solvency Ratio = [A-B- (D+E-50% of RSM)]/C

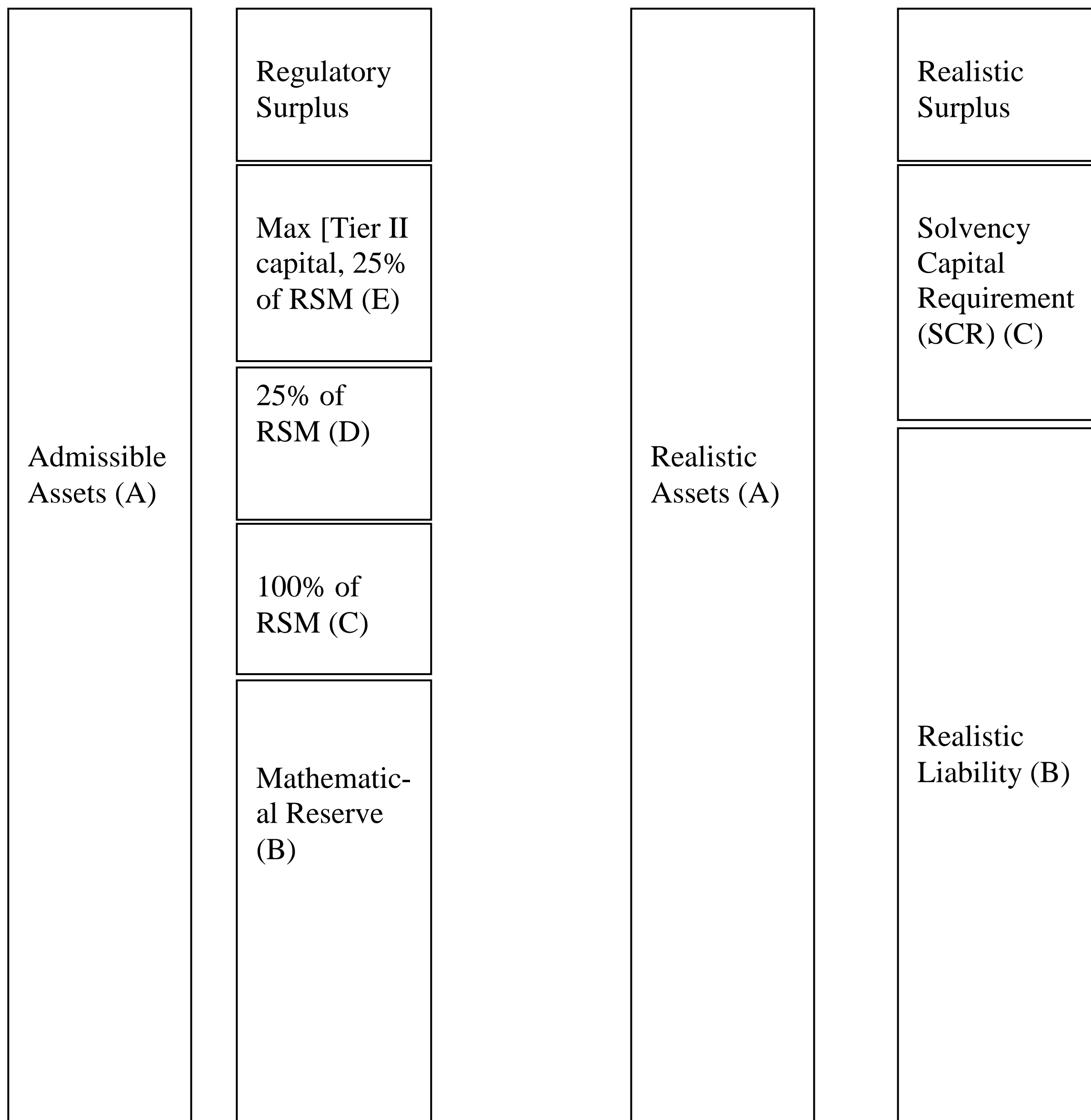
Economic Solvency Ratio = (A-B) / C

RSM = Required Solvency Margin

RCR = Resilience Capital Requirement

Tier II Capital allowed for Solvency to the extent of 25% of RSM

Resilience Capital allowed for Solvency to the extent of (say) 25% of RSM



Regulatory Peak **Economic Peak**

Figure 2

Regulatory Solvency Ratio = [A-B-(E-25% of RSM)]/C

Economic Solvency Ratio = (A-B) / C

RSM = Required Solvency Margin

Tier II Capital allowed for Solvency to the extent of 25% of RSM

Asset admissibility & Asset Valuation:

1. The current asset admissibility rules as stated in the ALSM Regulations will broadly continue with certain items carrying no value.

   We however recommend that the depreciation of Computer equipments and software be aligned to that of the Accounting Standard requirement so that the need for reassessment of the value of these in the solvency assessment is not required.

2. IFRS 9 (Financial Instruments, earlier IAS 39) is being implemented starting January 2018. We would expect some convergence of the Indian Accounting Standard to this global standard. The IFRS 9 is built on a single classification and measurement approach for financial assets that reflects the business model and their cash flow characteristics.

3. Assets for Solvency purpose are currently being recognized as per the Preparation of Financial Statement & Auditor's Report Regulation except to the extent of the inadmissibility. Currently equity and property assets are recognized at fair value in the balance sheet and at purchase cost in the P & L. Debt is recognized at amortized cost in both the balance sheet and revenue account. We suspect that this may change in future in response to a possible convergence to IFRS 9.

   (a) One view would be to recognize all equity, property and debt instruments at fair value in the P & L and the balance sheet.

   It is appreciated that the recognition of capital gains and losses in the Revenue account would make the profit recognition much more volatile because of the inherent volatility in such asset valuation on account of their sensitivity to market conditions. There would be hence, an additional need to marry the volatile nature of the assets with a smooth recognition of profits in the revenue account. This could be achieved by (a) adopting a valuation basis that is consistent with the fair valuation of the liabilities (b) setting a requirement for resilience capital / reserve at least for the savings oriented products alongside the mathematical reserve, the resilience testing parameters being set by the Authority being linked to the market conditions, (c) for savings products where discretionary benefits are declared, by making transfers to and from the smoothing / investment reserve (being the parking slot for excess unrealized capital gains) that the Appointed Actuary would maintain within the overall mathematical reserve. The resilience reserve would be an additional solvency requirement, but could be considered as capital resource to cover solvency margin up to (say) 25% of the RSM.

   (b) As an alternative, the assets may be recognized at the purchase cost (amortized for debt) in the revenue account, the fair value of equity and property may be taken in the balance sheet as is currently done; however, the fair value change account be taken into consideration for solvency purposes. This would preclude the

requirement of resilience reserve in the revenue account alongside the mathematical reserve, however, the resilience reserve would be an additional solvency requirement, but as before could be considered as capital resource up to (say) 25% of RSM (i.e. resilience reserve would be an additional solvency requirement to the extent it is in excess of 25% of RSM).

(c) A third alternative would be to continue the asset recognition in the same manner as prescribed in the existing regulations. In this case, resilience reserve requirement would be irrelevant given the passive nature of such assets and liabilities.

Liability Valuation:

Total Balance Sheet approach is to be ideally used in the assessment of the Solvency to recognize the interdependence between the assets, liabilities, regulatory capital requirement and Capital Resources required so that the risks of the business are appropriately recognized and provided for. Such an approach ensures the determination of available and required capital is based on a consistent assumption for the recognition and valuation of assets and liabilities for Solvency purposes[7].

Technical provisions are a significant component of the valuation for solvency purposes. They include a margin for risk appropriate for Solvency purposes. Regulatory Capital requirement is another component of Solvency assessment, and they include further allowance for risk so that when taken together, they are sufficient to ensure that policy obligations are satisfied with the probability of sufficiency required by the Supervisor[8].

Solvency assessment based on consistent valuation of assets and liabilities is a pre-requisite for obtaining a meaningful insight into the asset-liability position of an insurer and an understanding of the financial position of an insurer relative to other insurers. It provides reliable information on which to base the actions that are taken by the insurer and the supervisors in respect of those positions[9].

An Economic Valuation is a valuation such that the resulting assessment of an insurer's financial position is not obscured by hidden or inherent conservatism or optimism in the valuation. Such an approach is appropriate in the context of a risk based solvency requirement[10].

1. Observed market valuations or amortized cost valuations may be used for asset liability valuation as long as they are used consistently across assets and liability. The discount rates used in the valuation of liability would reflect how the assets are recognized in the revenue account.

[7] ICP 14 Valuation
[8] ICP 14 Valuation
[9] ICP 14 Valuation
[10] ICP 14 Valuation

(a) The discount rate used in valuation of assets under an amortized cost/purchase price method equates the present value of the expected contractual cash flows with the amount paid to acquire the asset. When valuing asset and liability under this method, the appropriate discount rate may be based on the expected (income) yield of the asset portfolio at purchase price, the current yield adjusted for default risk (credit spread) and any future reinvestment.

(b) Fair market valuation of the asset and liability would involve recognizing the assets at the currently quoted market price. The consistent discount rate for liabilities would be a 'risk adjusted yield'. This for debt instruments it is the gross redemption yield adjusted for default risk (credit spread) and future reinvestment. For equity and property this would be rental and earnings yield respectively on the market value of property and equity.

The valuation discount rate would hence be a blended rate which would be a weighted average of the earning/rental yield of equity / property, gross redemption yield of debts securities held at fair value.

2. Resilience Reserve would be required to be held to cover market risk on Non-Linked savings products where assets and liabilities are not entirely matched by nature and duration. This would ensure that companies hold sufficient technical Reserve to cover impact of fall in the value of assets such as the value of equity, property and change in market interest rates.

   The Resilience Test scenarios, if applicable could be indicated by IRDAI through a separate circular. The stress parameters for equity/property/debt would be stated to be within a minimum and a maximum range and the actual parameter applying should be based on the then current market conditions (through the use of dampers) and should be reviewed periodically.

   The resilience test in practical terms would apply on that part of the assets which is held at fair market value only. The resilience reserve would form a part of the overall mathematical reserve where assets are recognized in the P & L at market value. It would however be considered for capital resource purposes to the extent of (say) 25% of the RSM (see Solvency Balance Sheet, figure 1).

3. Solvency Balance Sheet: Resilience reserve would be irrelevant when assets are recognized at purchase cost.

   The above is for the purpose of larger discussion. The presumption that the committee has taken is that of continuance with the existing asset recognition norm. The fact that a risk based capital norm is being brought into consideration, a market consistent valuation of assets and liabilities would form another layer of the prudential norm

alongside the existing one. The committee's approach to the review has henceforth been on the basis that the assets continue to be recognized and valued as per the current norms, the resilience reserve would hence be redundant and the 'twin peak' norm applying would be as per figure 2.

4. Variable Insurance Products (VIP) would be valued as a policyholder account plus, if necessary a non-unit type additional reserve to provide for expected future deficiencies in cash flows. Where implicit guarantees borne out of policyholder reasonable expectation exist on contracts, the cash flows of the policy may also be projected on a prospective basis to ensure that the non-unit reserve covers such implicit guarantees.

5. Valuation reserves must be established using prospective valuation, where appropriate, on prudent assumptions, including sufficient margin for adverse deviation to ensure that the mathematical Reserves is prudent.

   On One Year Reviewable Group Term Insurance (OYRGTA) type business, the reserve would be the unearned premium Reserve (UPR) with appropriate provision for any future deficiency and provision for Incurred but not reported (IBNR) claims, aside any additional reserve, as applicable.

6. The valuation maintenance expense assumptions must have regard to the company's actual current level of expense along with appropriate margin for adverse deviation. The Appointed actuary would consider the effect of inflation on future expenses on the basis of prudent assumptions as to allow for future increase in prices and earnings.

   Where expense assumptions are lower than the actual current experience on account of a view taken of future economy of scale, the Appointed Actuary would take a view as to the reasonable time that would be required by the company to reach the expected long term level and reserve for the expense overruns till such period.

7. Reasonable allowance for future annual bonuses on With Profits business would be built in the valuation basis. Such allowance should be in form of regular annual bonus and terminal bonus which would be considered sufficient to meet policyholder reasonable expectations in the event that the experience was to be as in the valuation basis.

8. Mathematical Reserve may be determined separately for each contract; however Appointed Actuary may decide to group or aggregate similar contracts for valuation purposes on an appropriate basis. In the latter case, due care needs to be taken such that the valuation estimation on a grouped basis does not materially change if was done for each contract.

   Grouping of data is recommended to ease the time required to carry out the valuation process, specifically for larger companies where time required for each run is

substantial. This is also important for all companies because of the need to carry out repeated runs to test resilience, sensitivity or stress scenarios, carry out surplus analysis etc.

9. Options or guarantee where they exist, should be provided for. Time Value of such options or guarantees should be estimated using stochastic methodology or any other method considered appropriate by the Appointed Actuary.

10. Reserve for Riders may be estimated on a prospective gross premium method or any other method considered appropriate by the appointed actuary. If a prospective method is used, then the reserve for the rider needs to be floored at zero or the surrender value if higher.

11. A suitable reference in the Regulations or any other guidance may be issued to require companies to have a Board approved With Profits Governance Document / Bonus Policy. The With Profit Committee constituted under the Product Regulation 2013 would look into the adherence by the company to its With Profits Governance / Bonus Policy covering areas such as nature and methodology employed in determination of bonus, asset share estimation methodology and historical / current assumptions going into the asset share estimation, smoothing policy, expense allocation, and approach to investment, asset share targeted for payment at maturity or earlier surrender, allowance for Policyholder reasonable expectation and suitable periodic communication to the policyholders on such matters.

    IRDAI may recommend the minimum level of content in the communication to the prospective and current with profit policyholders by the insurers both at point of sale as well as periodically as part of an effort to enhance transparency of the With Profits business. The communication would include an extract of the Bonus Policy as well as periodic information such as bonus accrued to date, surrender value, nature of investments, return on investment etc.

    The committee has deliberated on this issue in response to a reference made by IRDAI. The detailed recommendation on this matter is included in annexure F. That apart, this matter has not been considered as part of the review of the regulation; the committee feels that it has to be debated across the industry before suitable guidance can be issued on this matter.

12. Products, lines of business whose contribution is not of material significance to the overall liability of the company or they do not make any material financial impact on the insurer as a whole may be exempted from complying with the valuation regulations in its entirety as long as the Appointed Actuary is satisfied that the methodology and assumptions used would give reasonably accurate liability values. The alternate methodology along with the justifications should be disclosed by the Appointed Actuary in Actuarial Report and Abstract.

Alternate Capital Resources:

While Permanent Share Capital, Profit & Loss Account, other reserves and FFA would count as Tier I capital, the sources of Tier II capital could be the following -

- ✓ Perpetual Non Cumulative Preference Shares
- ✓ Perpetual Subordinated debt and securities

Tier II capital may be made admissible for consideration as capital resource to cover the Required Solvency margin up to certain percentage (say 25%) of the RSM.

Actuarial Reporting:

1. The committee has attempted to simplify the Reporting formats (ARA[11] & AAAR[12]) by removing material which have little or no actuarial content or are mere statement of facts which are not perceived to be relevant to the actuarial reports; are included in other actuarial reports (e.g. New Products are reported in the F & U), or in other reporting formats filed with the Authority by other departments (e.g. expense, claims etc.).

2. Improve the investigative and qualitative content of the reports vis-à-vis just stating of facts and figures.

3. Provide Standard definitions of various terminologies used in various formats (e.g. Sum Assured, Premium etc.) so as to achieve a degree of standardization in reporting.

4. Simplify the structural hierarchy of the ARA report by streamlining the classification/category/division/sub-class/group structure and change to a simple reporting structure by segments of business, segmented by prevalent product classification and RSM requirements, reduce the hierarchy of aggregation of mathematical reserves.

5. Reporting of Mathematical Reserving at products segments rather than at product level.

6. Rationalize the number of D Returns; suggesting only the DDD format to be retained.

7. Propose new sets of formats for reporting VIP/Fund Based/GSLI and OYRGTA products, they do not fit into the current reporting formats.

[11] Actuarial Report and Abstract
[12] Appointed Actuary Annual Report

8. Appointed Actuary would be required to comment on the quality of data, various steps taken to validate the data and based on this, any need for setting aside provision for Data quality Inadequacy. Steps being initiated by the insurer to improve the data quality also to be stated.

9. The AAAR overlaps with the financial condition report which the appointed actuary submits to the Board and other reports submitted by different functional areas. The committee feels that such duplication of effort could be avoided by dropping some of the content of the AAAR; the residual relevant information may be taken to the ARA as annexures.

Chapter V. Specific Recommendations for changes in the Regulations:

ALSM Regulations:

1. Changes are specific to Life Insurance Business only, keeping in mind that there would be separate Regulations for Health Insurance Business; Regulations relating to these have been excluded from the review process.

2. Concept of materiality in order to provide flexibility in terms of valuation of business outside India, grouping of data to carry out a valuation of liabilities or applicability of a specific valuation methodology to a small segment of business or providing for options and guarantees.

3. Forms are excluded from the content of this Regulation, so the AA (statement of Assets) form has been deleted and included in a revised format as a part of ARA.

4. The specific requirement of depreciation of computer hardware and software has been excluded. Intangible assets and receivable of unrealizable nature to be taken as inadmissible assets.

5. Definition of Universal Life product has been dropped as the relevant business is the VIP business.

6. Other methods of valuation as relevant to specific liability segments would not require a check that such estimation would not be less than if done on Gross Premium Valuation method.

7. Provision for expense over run specifically included.

8. Specific requirement for valuation of short term business added.

9. Inclusion of VIP product in the Linked Liability estimation as the methodology is considered similar.

10. The option or guarantee may be provided for explicitly or implicitly subject to suitable justification by the Appointed Actuary based on considerations including those of materiality.

11. Additional Section included in the section relating to the determination of solvency margins to include 'Minimum Capital' and 'Control Level of Solvency' as required under the Act and an underpin relating to Risk based Capital at the level of control level of solvency as an underpin.

    - ✓ Minimum Solvency level is the higher of 50% of minimum capital (Rs. 50 Cr) or 100% of RSM
    - ✓ Control level of solvency at 150% of RSM or a measure based on Risk Based Capital norm to be prescribed, whichever is higher.

ARA & Liability Reporting:

12. Classification of products into participating / non- participating at the apex level and then further classification by the structure of the products into Linked, Non-Linked and Variable Insurance.

13. Details relating to reserves specific to VIP products and short term products such as One Year Group Term Assurance have been included.

14. Modified reporting timeline to 6 months from the end of the Financial Year from the current 9 months.

15. Appointed Actuary certificate has been amended to include
    - ✓ Product features appropriately set up in the valuation system
    - ✓ Compliance with the Act, Regulations, Guidance Notes and generally accepted actuarial principles
    - ✓ Appropriate steps taken to validate data
    - ✓ That Reserves are adequate under various circumstances

16. Principal Officer's certificate has been modified to allow for possible data deficiency and mitigation.

17. Only four summary statements formats included in the ARA Regulations; Statement of Assets, Statement of Liability, Valuation Balance Sheet and Solvency Statement.

18. Other statements of liability, Solvency estimation and Solvency Factors have been moved to a circular to be issued by IRDAI as when required. This will give the Authority the flexibility for introducing new formats or modifying existing formats for new or specific product classes or ask for further details as and when necessary.

19. The liability reporting format classification into classification, type, category, division and sub-classes. We thus have two layers –

- ✓ Classification, for Indian business and overseas business; total business only for the Statement of Solvency margin.
- ✓ Product Segments by type, category, division and sub-class.

20. Further classification of products for Solvency purposes (products with similar solvency margins being put together) into 6 classes to be reported in the KT1 form. KT1 format has been reworked to reflect this.

21. The liability reporting formats
    - ✓ LB / NLB are tailored for the specific requirements of the business segments.
    - ✓ LB3/LB4/NLB2 can be dispensed with; they are either further aggregations of earlier forms or have information which is contained elsewhere.
    - ✓ Similarly the committee feels that DD and DDD can be dispensed with.

22. New products launched during the reporting year are only to be listed with their UIN numbers, the committee felt that details of these are not required.

23. A section introduced where the Appointed Actuary comments on the quality and integrity of data.

24. The committee recommends grouping of data for valuation purposes, a departure from the earlier policy by policy reserve estimation, subject to suitable justification.

25. A method for taking reinsurance into consideration for the estimation of reserves net of reinsurance is to be stated by the Appointed Actuary.

26. Margins for adverse deviation to be stated in the ARA along with the valuation assumptions used.

27. I Form modified for greater clarity.

28. For form AA, asset value to be drawn from the balance Sheet, suitable adjustment for inadmissible assets and fair value change to be shown.

AAAR:

29. Committee feels that most of the content in the current AAAR is not required as they are either just presentation of information available elsewhere and relating to other than actuarial area of work. Hence they have not been retained.
30. Consequently the AAAR form has been dropped with the residual formats being taken in the ARA as additional information / annexure.

31. The draft circular contains the details of the residual information.

    - ✓ Analysis of experience and justification of the valuation assumptions
    - ✓ Analysis of surplus
    - ✓ Report of the With Profits committee (was also annexed with the ARA earlier)

- ✓ Financial Condition Report would contain current and future financial condition, Risk Management and Economic Capital estimation, Asset Liability management Report etc.

Chapter VI. Other matters referred to the Committee:

The following two issues of critical importance have also been referred to the committee as part of its scope.

- ✓ Should Solvency Ratio be used as a means to control the performance of the Life Insurance companies on various key parameters?
- ✓ Can an IRR structure, similar to ULIP products, be introduced in Participating Business to control cost / charges, improve transparency and provide greater customer protection?

The committee's note on the two issues has been annexed to this report.

Chapter VII. Summary and Conclusions:

Part of the committee's effort has been towards simplifying the regulation and the reporting formats and recommending a more qualitative, investigative and technical basis of reporting than one overly focused on factual data reporting.

The minimum capital and the control level of solvency would provide the framework for early and timely regulatory intervention so as to rectify the situation.

The concurrent use of a risk based solvency framework alongside the current prudential norm would allow a transition time frame that would result in a smooth transition to the new framework. This would minimize disruption that would accompany any sudden shift to RBC norms as well as afford the industry the time required to develop and implement such a framework.

In the meantime, the industry would need to formalize the details of the risk based capital norms and calibrated stress levels to be used, by setting up a working committee with members drawn from the industry, the actuarial profession and the regulator's office. Quantitative impact studies would need to be carried out across various life insurance companies before such norms could be adopted and implemented.

The Solvency Factors recommended to replace the existing factors, also need to be tested for sufficiency.

Annexure A

THE GAZETTE OF INDIA: EXTRAORDINARY [PART III ---SEC. 4]

INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA
NOTIFICATION

Insurance Regulatory and Development Authority of India (Assets, Liabilities, and Solvency Margin of Life Insurance Business) Regulations, 2015

F.No.IRDAI/ / /.—

In exercise of the powers conferred by clauses (y), (z) and (za) of sub-section (2) of section 114A of the Insurance Act, 1938, (4 of 1938), read with section 26 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), the Authority, in consultation with the Insurance Advisory Committee, hereby makes the following regulations, namely:-

1. Short title and commencement.----(1) These regulations may be called the Insurance Regulatory and Development Authority of India (Assets, Liabilities, and Solvency Margin of Life Insurance Business) Regulations, 2015.

(2) They shall come into force from the date of their publication in the Official Gazette.

(3) These regulations shall apply to all Life Insurance Business written by any Company licensed to do so by the Insurance Regulatory and Development and Regulatory Authority of India.

2. Definitions.—(1) In these regulations, unless the context otherwise requires ----
(a) "*Act*" means the Insurance Act, 1938 (4 of 1938);
(b) "*Authority*" means the Insurance Regulatory and Development Authority of India established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);
(c) "Materiality" Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of statements containing such information.

(2) All words and expressions used herein and not defined but defined in the Insurance Act, 1938 (4 of 1938), or in the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), or in any Rules or Regulations made there under, shall have the meanings respectively assigned to them in those Acts or Rules or Regulations.

3. Valuation of Assets.--Every insurer shall prepare a statement of the value of assets in accordance with Schedule I in respect of life insurance business.

4. Determination of Amount of Liabilities.--Every insurer shall prepare a statement of the amount of liabilities in accordance with Schedule II in respect of life insurance business**.**

5. Determination of Solvency Margin.--Every insurer shall prepare a statement of solvency margin in accordance with Schedule III, in respect of life insurance business.

6. Business outside India.-- Where the insurer transacts insurance business in a country outside India, and submits statements or returns or any such particulars to a public authority of that country, the liability valuation and solvency norms of that country shall apply. In such a case, the insurer shall enclose the same along with the Forms specified in accordance with these Regulations and the Insurance Regulatory and Development Authority of India (Actuarial Report and Abstract) Regulations, 2015.

Provided that if the appointed actuary is of the opinion that it is necessary to set additional reserves over and above the reserves shown in the statements or returns or any such particulars submitted to the public authority of a country outside India, he may set such additional reserves.

7. Furnishing of Forms.--- The Forms specified in accordance with these Regulations and the Insurance Regulatory and Development Authority of India (Actuarial Report and Abstract) Regulations, 2015, shall be furnished separately for Life Insurance Business within India and Life Insurance Business outside India transacted by the insurer.

8. Personal visit of appointed actuary to the Authority.-- The Authority may, if considered necessary and expedient, ask the appointed actuary to make a personal visit to the office of the Authority to elicit from him any further information.

Schedule I

VALUATION OF ASSETS

(see Regulation 3)

(I) **Values of Assets.—**(1) The following assets should be placed with value zero,--

(1) Intermediary's balances and outstanding premiums in India, to the extent they are not realised within a period of thirty days;
(2) Intangible assets of the company
(3) Agents' balances and outstanding premiums outside India, to the extent they are not realisable ;
(4) Sundry debts, to the extent they are not realisable;
(5) Advances and receivables, other than investment assets, of an unrealisable character;
(6) Furniture, fixtures, dead stock and stationery;
(7) Deferred expenses;
(8) Profit and loss appropriation account balance and any fictitious assets other than pre-paid expenses;
(9) Reinsurer's balances outstanding for more than three months;
(10) Preliminary expenses in the formation of the company;
(11) Any other asset, which in the view of the regulator should be considered inadmissible

(2) All other assets of an insurer have to be valued in accordance with the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

Schedule II

Valuation of Liabilities - Life Insurance

(See Regulation 4)

1. Interpretation.--In this Schedule, --

(a) "valuation date", in relation to an actuarial investigation, means the date to which the investigation relates.

(b) "segregated funds" means funds earmarked in respect of linked business.

2. Method of Determination of Mathematical Reserves —

(1) Mathematical Reserves shall be determined for each contract by a prospective method of valuation in accordance with sub-paras (2) to (4)

(2) The valuation method shall take into account all prospective contingencies under which any premiums (by the policyholder) or benefits (to the policyholder/beneficiary) may be payable under the policy, as determined by the policy conditions. The level of benefits shall take into account the reasonable expectations of policyholders (with regard to bonuses, including terminal bonuses, if any) and any established practices of an insurer for payment of benefits.

(3) The valuation method shall take into account the cost of any options and guarantees that may be available to the policyholder under the terms of the contract.

(4) The determination of the amount of liability shall be based on prudent assumptions of all relevant parameters. The value of each such parameter shall be based on the insurer's expected experience and shall include an appropriate margin for adverse deviations (hereinafter referred to as MAD) that may result in an increase in the amount of mathematical reserves.

(5) (i) The amount of mathematical reserve in respect of a policy, determined in accordance with sub-para (4), may be negative (called "negative reserves") or less than the guaranteed surrender value available (called "guaranteed surrender value deficiency reserves") at the valuation date.

(ii) The appointed actuary shall, for the purpose of section 35 of the Act, use the amount of such mathematical reserves without any modification;

(iii) The appointed actuary shall, for the purpose of sections 13, 49, 64V and 64VA of the Act, set the amount of such mathematical reserve to zero, in case of such negative

reserve, or to the guaranteed surrender value, in case of such guaranteed surrender value deficiency reserves, as the case may be.

(6) The valuation method shall be called "Gross Premium Valuation" .

If in the opinion of the appointed actuary, a method of valuation other than the Gross Premium Method of valuation is to be adopted, then, other methods may be used, provided that the appointed actuary can justify the suitability of such method including the materiality of such liability in relation to the overall liability.

(7) Reserves for short term business i.e. business with a term of less than three years shall allow for Unexpired risk, Premium deficiency and Incurred but not reported claims.

(8) The method of calculation of the amount of liabilities and the assumptions for the valuation parameters shall not be subject to arbitrary discontinuities from one year to the next.

3. Policy Cash Flows.--- The gross premium method of valuation shall discount the following future policy cash flows at an appropriate rate of interest,---

(a) premiums payable, if any, benefits payable, if any, on death; benefits payable, if any, on survival; benefits payable, if any, on voluntary termination of contract, and the following, if any, :-

- (i) basic benefits,
- (ii) rider benefits,
- (iii) bonuses that have already been vested as at the valuation date,
- (iv) bonuses as a result of the valuation at the valuation date, and
- (v) future bonuses (one year after valuation date) including terminal bonuses (consistent with the valuation rate of interest);

(b) commission and remuneration payable, if any, in respect of a policy
(c) policy maintenance expenses, if any, in respect of a policy, as provided under sub-para (4) of para 5;

(d) allocation of profit to shareholders, if any, where there is a specified relationship between profits attributable to shareholders and the bonus rates declared for policyholders.

Provided that allowance must be made for tax, if any.

4. Policy Options and Guarantees. –Where a policy provides built-in options that may be exercised by the policyholder, such as conversion or addition of coverage at future

date(s) without any evidence of good health, or guarantees, such as annuity rate guarantees at maturity of contract, investment guarantees etc., the costs of such options or guarantees, depending on materiality, shall be estimated and be provided for explicitly or may be allowed for implicitly in the mathematical reserves.

5. **Valuation Parameters**.—(1) The valuation parameters shall constitute the bases on which the future policy cash flows shall be computed and discounted. Each parameter shall have to be appropriate to the block of business to be valued. An appointed actuary shall take into consideration the following,--

(a) The value(s) of the parameter shall be based on the insurer's experience study, where available. If reliable experience study is not available, the value(s) can be based on the industry study, if available and appropriate. If neither is available, the values may be based on the bases used for pricing the product. In establishing the expected level of any parameter, any likely deterioration in the experience shall be taken into account;

(b) The expected level, as determined in clause (a) of this sub-para, shall be adjusted by an appropriate Margin for Adverse Deviations (MAD), the level of MAD being dependent on the degree of confidence in the expected level, and such MAD in each parameter shall be based on the Actuarial Practice Standards / Guidance Notes issued by the Institute of Actuaries of India, with the concurrence of the Authority

(c) The values used for the various valuation parameters should be consistent among themselves.

(2) **Mortality rates** to be used shall be by reference to a published table, unless the insurer has constructed a separate table based on its own experience:

Provided that such published table shall be made available to the insurance industry by the Institute of Actuaries of India, with the concurrence of the Authority.

(3) **Morbidity rates** to be used shall be by reference to a published table, unless the insurer has constructed a separate table based on its own experience:

Provided that such published table shall be made available to the insurance industry by the Institute of Actuaries of India, with the concurrence of the Authority:

(4) **Policy maintenance expenses** shall have regard to the actual expense experience of the insurer. Appropriate additional provisions shall be made if such actual experience has not been considered for the valuation. All expenses shall be increased in future years for inflation; the rate of inflation assumed should be consistent with the valuation rate of interest.

(5) **Valuation rates of interest**, to be used by appointed actuary -

(a) for the calculation of the present value of policy cash flows referred to in para 3, shall not be higher than the rates of interest, determined from prudent assessment of the yields from existing assets attributable to blocks of life insurance business, and the yields which the insurer is expected to obtain from the sums to be invested in the future, and such assessment shall take into account ---

(i) the composition of assets supporting the liabilities, expected cash flows from the investments on hand, the cash flows from the block of policies to be valued, the likely future investment conditions and the reinvestment and disinvestment strategy to be employed in dealing with the future net cash flows;

(ii) the risks associated with investment in regard to receipt of income on such investment or repayment of principal;

(b) shall not be higher than, for the calculation of present value of policy cash flows in respect of a particular category of contracts, the yields on assets maintained for the purpose of such category of contacts;

(c) in respect of non-participating business, shall recognize the risk of decline in the future interest rates;

(d) in respect of participating business , shall be based on the assumption (with regard to future investment conditions), that the scale of future bonuses used in the valuation is consistent with the valuation rate of interest, and

(6) **Lapse rate** considered for valuation should be a prudent assumption based on past experience of the product or similar product; shall have regard to the expected future experience based on the nature of the products, target market, distribution channel etc.

Other parameters may be taken into account, depending on the type of policy. In establishing the values of such parameters, the considerations set out in this Schedule shall be taken into account.

6. **Applicability to Reinsurance.—**(1) This Schedule shall also apply to the valuation of business in the books of reinsurers.

(2) As regards the business ceded by insurers, this Schedule shall be applicable to the net sums at risk retained by the insurer.

7. **Additional Requirements for Linked Business and Variable Insurance Products.**—(1) Reserve in respect of linked business and Variable Insurance Products shall consist of two components, namely, unit / account value reserves and general fund reserves.

(2) Unit / account value reserves shall be calculated in respect of the units / account value allocated to the policies in force at the valuation date using unit values if applicable, at the valuation date.

(3) General fund reserves (non-unit reserves) shall be determined using a prospective valuation method set out in this Schedule, which shall take into account of the following, namely:-

(a) premiums, if any, payable in future;
(b) death benefits, if any, provided by the general fund (over and above the value of units);
(c) management charges paid to the general fund;
(d) guarantees, if any, relating to surrender values or minimum death and maturity benefits;
(e) Fund growth rates and management charges. (The values of these parameters, along with others, shall be determined in accordance with para 5);

Any future negative cash flow shall be appropriately provided for by setting up reserves; and negative reserve if any, may be set to zero.

8. Additional Requirements for Provisions.--- The appointed actuary shall make aggregate provisions in respect of the following, where it is not possible to calculate mathematical reserves for each policy, in the determination of mathematical reserves:-

(a) Policies in respect of which extra premiums have been charged on account of underwriting of under-average lives that are subject to extra risks;
(b) Lapsed policies not included in the valuation but under which a liability exists or may arise;
(c) The rates of exchange at which benefits in respect of policies issued in foreign currencies have been converted into Indian Rupees and what provision has been made for possible increase of mathematical reserves arising from future variations in rates of exchange;
(d) Other, if any.

9. Statement of Liabilities-- An insurer shall furnish a statement of liabilities in accordance with the Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2015.

Schedule III

(See Regulation 5)

DETERMINATION OF SOLVENCY MARGINS—LIFE INSURANCE BUSINESS

1. Interpretation.-- In this Schedule–

(a) 'Available Solvency Margin' means the excess of value of assets (furnished in IRDAI form AA or any other form) over the value of life insurance liabilities (furnished in such forms as specified by the Authority) and other liabilities of policyholders' fund and shareholders' funds;

(b) Every insurer at all time shall maintain its Available Solvency Margin at a level which is not less than the higher of the amount of minimum capital as defined in Sec 64 V of the Act and a level equal to the required solvency margin as given below. Failing this, the Authority shall act in accordance with the provisions of the Insurance Act in this regard.

(c) "Solvency Ratio" means the ratio of the amount of Available Solvency Margin to the amount of Required Solvency Margin as furnished in IRDAI form K or any other form.

(d) "Control level of Solvency" shall mean the level of Solvency level below which the Authority shall act in accordance with the provisions of the Insurance Act in this regard. Such a breach would be where,

   i. the Solvency Ratio falls below 150% Or
   ii. Solvency ratio or measure falls below a specific level on any other methodology and measure as determined by the Authority

2. Determination of Required Solvency Margin.--Every insurer shall determine the required solvency margin, the available solvency margin, and the solvency ratio in such forms K or any other form as specified by the Authority.

Annexure B

Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Draft Regulations, 2015

In exercise of the powers conferred by clause (g) of sub-section (2) of section 114A of the Insurance laws (Amendment) Act, 2015, (4 of 2015), the Authority, in consultation with the Insurance Advisory Committee, hereby makes the following regulations, namely:-

1. **Short title and commencement.----**(1) These regulations may be called the Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2015.

(2) They shall come into force from the date of their publication in the Official Gazette.

2. **Definitions**. --In these regulations, unless the context otherwise requires ----

(a) "Act" means the Insurance laws (Amendment) Act, 2015(4 of 2015);

(b) "Authority" means the Insurance Regulatory and Development Authority established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);

(c) "extra premium' means a charge for any risk not provided for in the minimum contract premium;

(d) "group business" means those insurance contracts which are group policies as mentioned under sub-section (2) of section 4 of the Act;

(e) "guarantees" means the terms in regard to benefits or premiums or charges, which may not be altered during the currency of the policy;

(f) "individual business" means individual insurance contracts issued on single/joint lives;

(g) "inter valuation period" means, as respects any valuation, the period to the valuation date of that valuation from the valuation date of the preceding valuation in connection with which an abstract was prepared under the Act or under the enactments repealed by the Act, or, in a case where no such valuation has been made in respect of the class of business in question, from the date on which the insurer began to carry on that class of business;

(h) "maturity date" means a fixed date on which benefit may become payable either absolutely or contingently;

(i) "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;

(j) "office yearly premium" means regular premium (excluding extra premiums which are required to be shown separately) payable by the policyholder to secure the basic benefits under the policy in a policy year ;

(k) "options" means the rights available to a policyholder under a policy;

(l) "par policies" or "policies with participation in profits" means polices which are not non-par policies as defined under clause (i);

(m) VIP product – par and non-par separately means products as defined in the Non-Linked and Linked Insurance Products Regulations, 2013.

(n) "policies with deferred participation in profits" means polices entitled for participation in profits after a certain period from the date of commencement of the policy,

(o) "premium term" means the period during which premiums are payable;

(p) "riders” or “rider benefits" means add-on benefits, which are in addition to basic benefits under a policy;

(q) "valuation date" means as respects any valuation the date as at which the valuation is made;

(r) All words and expressions used herein and not defined but defined in the Insurance Act, 1938(4 of 1938), or in the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), or in any Rules or Regulations made there under shall have the meanings respectively assigned to them in those Acts or Rules or Regulations.

3. Procedure for Preparation of Actuarial Report and Abstract. — (1) The Abstract and Statements must be so arranged that the number and letters of the paragraphs correspond with Regulation 4.

(2) The Abstracts and Statements shall be furnished to the Authority, within six months from the end of the period to which they refer to, in accordance with sub-section (1) of section 15 of the Act.

(3) There shall be appended to every such Abstract and Statement –

a. Certificate signed by the Principal Officer that full and accurate particulars of every policy under which there is a liability, either actual or contingent, has been furnished to the appointed actuary for the investigation; however, exceptions if any may be brought out along with action being taken to rectify the deficiency in the valuation data.

b. Certificate signed by the Appointed Actuary with his remarks, if any, to the effect that:-

i. The data furnished by the Principal Officer has been included in conducting the valuation of liabilities for the purpose of the investigation.

ii. All relevant features of product are correctly and appropriately set up in the valuation system..

iii. Liabilities have been estimated in compliance with the Provisions of the Act, Regulations issued by IRDAI, Actuarial Practice Standards issued by IAI and other Generally Accepted Actuarial Practices of valuation of liabilities.

iv. Such tests have been applied as considered reasonable to be satisfied about the accuracy and completeness of the data.

v. In estimating mathematical reserves, appropriate actuarial methods, reasonable and prudent assumptions have been taken so that mathematical reserves are adequate

to meet future commitments in reasonably foreseeable circumstances and meet PRE[13].

4. Requirements Applicable to Abstract and Statements.—(1) Abstracts and statements shall be prepared separately in respect of ---

(a) Participating;
(b) Non Participating business

(2) An insurer shall prepare the following statements which shall be annexed to the abstract prepared in accordance with these regulations, namely:-

(i) Statements of liability – for each line of business
(ii) Summary statements:

1. Statement of Assets - Form AA
2. Statement of Liabilities – Form H
3. Valuation balance Sheet – Form I
4. Statement of Available Solvency Margin and Solvency Ratio – Form K
5. Composition and Distribution of Surplus – Form S

(iii) In addition, any forms as prescribed by IRDAI from time to time

(3) Each Abstract shall show---

(a) The **Valuation Date**.--The date on which valuation (investigation) is done;

(b) **New Products**.---A list of new products introduced during the inter-valuation period giving the UIN;

(c) **Foreign Operations- A** brief description of the foreign operations of the insurer, during the inter-valuation period;

(d) Valuation data- The Appointed Actuary shall

(i) Comment on the steps taken to verify consistency, completeness and accuracy of data provided by the Principal Officer, as per Annexure data.
(ii) Comment on the steps taken to ensure accuracy of valuation systems / models including those to verify consistency with the product features.

(iii) Whether there have been any adjustments or approximations in using the data or modelling the features in the valuation systems that may have material impact on the liabilities; such adjustments on the grounds of prudence including additional reserves required to be set aside and mention the steps taken to rectify these for future valuations.

[13] Policyholder reasonable expectation

(iv) Mention whether policy by policy valuation has been carried out or data has been grouped in some manner, if grouped, in what manner data has been grouped; adequately substantiate that the reserves would not have deviated significantly if a policy by policy valuation was done.

(e) **Valuation Method.--** A brief description of ----

(i) the methods adopted in the determination of mathematical reserves in respect of insurance products;

(ii) the method by which age at entry, premium term, maturity date, valuation age, period from the valuation date to the maturity date, have been treated for the purpose of valuation;

(iii) the manner in which reinsurance has been taken into account in arriving at the valuation reserves net of reinsurance

(iv) the method of allowing for-

(I) incidence of premium income: and

(II) premiums payable otherwise than annually;

(v) valuation methodology for various options and guarantees where it is material:

(a) Provide the details of various options that are provided under various products included in investigation.

(b) Summarize the methods used to make suitable provisions for these options, wherever explicitly provided.

(c) Provide the details of various guarantees that are offered under various products included in investigation.

(d) Summarize the methods used to make provisions for these guarantees, wherever explicitly provided.

(e) The impact of these options or guarantees may or may not be material and if so Appointed Actuary may use discretion whether to allow explicitly or implicitly or use a simplified approach or not consider this on the basis of materiality. In cases where it is provided implicitly or a simplified approach has been used, the Appointed Actuary may specify how the provisions for options and guarantees are made.

(vi) Include other Adjustments (Provisions), where material. The methods by which provisions, if any, have been made for the following matters, along with a statement of bases as part of Valuation bases, wherever necessary,-

(f) Policies in respect of which extra premiums have been charged on account of underwriting of under-average lives that are subject to extra risks such as

occupation hazard, over-weight, under-weight, smoking history, health, climatic or geographical conditions;

(g) Lapsed policies not included in the valuation but under which a liability exists or may arise;

(h) The rates of exchange at which benefits in respect of policies issued in foreign currencies have been converted into Indian Rupees and what provision has been made for possible increase of mathematical reserves arising from future variations in rates of exchange;

(e) **Valuation bases.--** (i) Valuation parameters used in the valuation shall be furnished in the manner as specified in the table hereunder:-

Description	Mortality basis Used	Morbidity basis used	Inflation rate	Interest Rate	Expenses	Future bonuses if any	Lapse / Surrender	Others please specify	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
(a) Insurance Product:									
i) Regular Premium									
ii) Single premium and Fully paid up									
iii) Reduced Paid up									
(b) Insurance Product:									
i) Regular Premium									
ii) Single premium and Fully paid up									
iii) Reduced Paid up									

(i) Summarize the Margins for Adverse Deviations for these parameters.

(ii) For key parameters, the basis for arriving at the parameter along with experience, if any shall be provided

(iii) Summarize and justify any material changes made to the assumptions during the inter-valuation period along with the impact.

(iv) Expenses related to premiums, sum assured, annuity, etc., and per policy shall be specified separately under Column (6) of the table;

(v) Items such as terminal bonus, in case of with profit contracts, management charges, etc., in respect of linked business, shall be specified under Column (7) of the table;

(vi) Items related to Other Provisions can be included as part of Column (9)

5. **Negative Reserves and Guaranteed Surrender Value Deficiency Reserves.---** A brief description of treatment adopted for negative reserves and guaranteed surrender value deficiency reserves shall be furnished.

6. **Distribution of surplus. --** The basis adopted in the distribution of surplus as between the shareholders and the policyholders, and whether such distribution was determined by the instruments constituting the company, or by its regulations or by-laws or how otherwise shall be mentioned.

7. **Principles adopted in distribution of profits.---** The general principles adopted in distribution of profits among policyholders, including statements on following points, shall be furnished:-

   (i) Whether the principles were determined by instruments constituting the insurer, or by its regulations or by-laws or how otherwise;

   (ii) The number of years premium to be paid, period to elapse and other conditions to be fulfilled before a bonus is allotted;

   (iii) Whether the bonus is allocated in respect of each year's premium paid, or in respect of each calendar year or year of assurance or how otherwise; and

   (iv) Whether the bonus vests immediately on allocation, or, if not, conditions of vesting.

8. **Statement of composition of surplus and distribution of surplus in respect of policyholders' funds.—**(1) A statement, showing total amount of surplus arising during the inter-valuation period, and the allocation of such surplus, shall be furnished separately for participating business and for non-participating business, with the particulars as mentioned below:-

Composition of Surplus:

(a) Surplus emerging during the year:
(b) Interim Bonuses paid during the inter-valuation period:;
(c) Terminal Bonuses paid during the inter-valuation period:
(d) Loyalty Additions or other forms of bonuses, if any, paid during the inter-valuation period;
(e) Sum transferred from shareholders' funds during the inter-valuation period:;
(f) Amount of surplus, from policyholders' funds, brought forward from preceding valuation:
(g) Total Surplus (total of the items (a) to (f)):

Distribution of Surplus:

Policyholders' Fund:

(a) To Interim Bonuses paid;
(b) To Terminal Bonuses
(c) To Loyalty Additions or any other forms of bonuses, if any;

(d) Among policyholders with immediate participation giving the number of polices which participated and the sums assured there under (excluding bonuses);
(e) Among policyholders with deferred participation, giving the number of polices which participated and the sums assured there under (excluding bonuses);
(f) Among policyholders in the discounted bonus class giving the number of polices which participated and the sums assured there under (excluding bonuses);
(g) To every reserve fund or other fund or account (any such sums passed through the accounts during the inter valuation period to be separately stated);
(h) As carried forward un-appropriated.

Shareholders' Fund:
(i) To the shareholders' funds(any such sums passed through the accounts during the inter valuation period to be separately stated);

Totals:
(j) Total Surplus allocated: (total of the items (a) to (i))

(2) Specimen of Bonuses allotted to policies for one thousand rupees together with the amounts apportioned under the various manners in which the bonus is receivable, for each type of participating product, shall be furnished.

FORM AA (Statement of Assets) ***(See Regulation 4)***

Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations,

Business Within India / Outside India

Form AA			
Particulars (Amount in 000's)	**Policyholders A/C**	**Shareholders A/C**	**Total**
Investments			
Investments Shareholder' (Schedule 8)			-
Policyholders' (Schedule-8A)			-
Assets held to cover linked liabilities (Schdule-8B)			-
Assets held to cover discontinued funds			-
Total Investments as per BS ---------------- (A)			-
Inadmissible Investments ------------------ (B)			-
			-
Fixed assets			
Fixed assets as per BS ----------------------- (C)			-
Inadmissible Fixed assets ------------------ (D)			-
Current Assets			
Cash & Bank Balances as per BS --------------- (E)			-
Current assets as per BS ----------------------- (F)			-
Total Current Assets as per BS ------------- (G) = (E) + (F)			-
Inadmissible Current assets --------------- (H)			-

Current Liabilities & Provisions			
Current Liabilities as per BS ---------------------- (I)			-
Provisions as per BS ------------------------------ (J)			-
Total Current Liabilities & Provisions ----- (K) = (I) + (J)			-
Policy Loans			
Policy Loans as per BS --------------------------- (L)			-
Fair Value Change Account			
Max (FVCA,0)---------------------------(P)			
Total Assets as per BS ---------------------- (N) = (A) + (C) + (G) + (L)	-	-	-
Total Inadmissible assets ----------------------- (O) = (B) + (D) + (H) + (P)	-	-	-
Total Admissible assets for Solvency ---- (N) - (O)	-	-	-

FORM H (Statement of Liabilities)
(See Regulation 4)
Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2015

SUMMARY OF VALUATION AS AT 31ST March, 20____.

Business Within / Outside India

Form Code: [ ][ ][ ][ ][ ][ ][ ][ ]		
Name of Insurer: _____________	Registration Number:	Date of registration:

Item No.	Category of business	Mathematical Reserves (inclusive of cost of bonuses allocated)
(1)	(2)	(3)
01	Participating	
02	Non Participating	
03	**TOTAL**	

Note to Form H -

1. All figures should be in thousands.
2. Mathematical reserves in Col (3) shall be furnished inclusive of cost of bonuses allocated

FORM I (Valuation balance sheet)

(See Regulation 4)

Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2015.

VALUATION RESULTS AS AT 31st March, 20___

Business Within India / Outside India

Form Code: [ ][ ][ ][ ][ ][ ][ ][ ]

Name of Insurer: _____________ Registration Number: Date of registration:

Item No	DESCRIPTION	Balance of Fund shown in Balance Sheet	Mathematical reserves (excluding cost of bonuses allocated)	Surplus
(1)	(2)	(3)	(4)	(5)
01	Par Polices			
02	Non-par Polices			
03	**Total**			

Note to Form I -

1. All figures should be in thousands.
2. Col (5) = Col (3) - Col (4).
3. The figures shown in column (3) includes surplus in the policyholder fund; it is the Balance Sheet position of assets prior to any transfer having being made out to the shareholder fund.
4. The figures shown in (3) and the Surplus shown in (5) also includes shareholder transfer to the policyholder fund in order to meet the deficits in some segments.
5. The figures shown in column (3) for Par business does not include the amount of interim and terminal bonus paid to the policyholder during the inter valuation period amounting Rs. X.

Form K - TABLE III- AVAILABLE SOLVENCY MARGIN AND SOLVENCY RATIO.

Form Code: [ ][ ][ ][ ][ ][ ][ ][ ]

Name of Insurer: Registration Number: Date of registration: _____________

Classification: Business Within India/ Outside India / Total Business
Classification Code:[ ]

Item	Description	Notes No...	Adjusted Value
(1)	(2)	(3)	(4)
01	Available Assets in Policyholders' Fund:		
	Deduct:		
02	Mathematical Reserves		
03	Other Liabilities		
04	**Excess in Policyholders' funds (01-02-03)**		
05	Available Assets in Shareholders Fund:		
	Deduct:		
06	Other Liabilities of shareholders' fund		
07	**Excess in Shareholders' funds (05-06)**		
08	Total ASM (04)+(07)		
09	Total RSM		
10	**Solvency Ratio (ASM/RSM)**		

Certification:

I, , the Appointed Actuary, certify that the above statements have been prepared in accordance with the section 64VA of the Insurance Act, 1938, and the amounts mentioned therein are true and fair to the best of my knowledge.

Place Name and Signature of Appointed Actuary

Date:

Notes

1. Item No. 01 shall be the amount of the Adjusted Value of Assets as mentioned in Form IRDA-Assets- AA;
2. Item No. 02 shall be the amount of Mathematical Reserves as mentioned in Form H;
3. Item Nos. 03 and 06 shall be the amount of other liabilities as mentioned in the Balance Sheet;
4. Items No. 05 shall be the amount of the Total Assets as mentioned in Form IRDA-Assets- AA;

Annexure C

CIRCULAR NO: IRDA/ACTL/CIR/XXX/XXX /XX/XXXX/XXXXXXXXXX

1. Applicability: For the use of Appointed Actuaries for the Preparation of "Actuarial Report and Abstract for the year ended March 31, 2017".
2. The content as required under this circular shall be annexed to the ARA that is to be submitted as per the ARA Regulations.

Chapter 1.

(1) Insurer shall prepare in accordance with Sec 4 (2) (i) of the ARA Regulations, the statements of liability in the formats as annexed to this circular, for the following lines of business. Each form shall have the following description -

Categorization	Description	Code
Type	Participating	PAR
Type	Non-Participating	NPAR
Category	Non-Linked	NL
Category	Unit Linked	UL
Category	VIP	VIP
Division	Individual	I
Division	Group	G
Sub-Class	Life	L
Sub-Class	Pension	P
Sub-Class	Annuity	A
Sub-Class	Health	H

(2) The statements of Liability formats are separately available for Linked (LB), Non-Linked (NLB) and VIP (VIP) business. For Linked business, the statement of Net Asset Value by Segregated Funds (LB2) is also to be prepared for applicable lines of business.

(3) The insurer shall also prepare data statements in formats DDD as annexed to this circular for the same lines of business; these statements shall be annexed to the abstract prepared in accordance with the ARA, Regulations. The formats available are DDD (NL) for Non-Linked business and DDD (UL & VIP) for Linked and VIP business.

(4) The statements mentioned above and all forms (AA,H,I and S) mentioned under Sec 4 (2) (ii) of ARA Regulations 2015 shall be provided based on two classifications with classification codes 1 and 2, for business within India and Business outside India respectively.

(5) Form K in addition to the above shall also be provided for total business with a classification code 3.

Chapter 2.

The Required Solvency Margin will be estimated in the following manner.

Form KT1, shall be prepared for business types and business categories, but further grouped by Solvency Grouping Codes as stated below.

1) Where investment risk borne by the issuer is Full / Limited/ Less or None [Solvency Grouping Codes: GI, LGI and NGI respectively]

2) Where insurance risk is guaranteed for long term (>3 years) or guaranteed for short term (equal to or less than 3 years) [Solvency Grouping Codes: GP and NGP respectively]

There shall be two factors (x%, y%): x% is applicable on Mathematical reserves after Reinsurance and y% is applicable on sum at risk after reinsurance. The factors are applicable on the basis of the underlying risk borne by the company for different classes of business.

- ✓ Full Investment risk borne (for e.g., non-par endowment etc., UL guaranteed)
- ✓ Limited Investment risk borne (for e.g., traditional participating, VIP, Group Fund Based Business)
- ✓ Less or nil Investment risk borne (e.g., term assurance, UL no guarantee)
- ✓ Insurance risk guaranteed for more than 3 years
- ✓ Insurance risk guaranteed for 3 years or less (either renewable mortality / morbidity rate/premium, reviewable charges)

(X%, Y%)		Investment Risk		
		Full	Limited	Less or None
Insurance risk	>3 years	(3%, 0.2%)/ GIGP	(2%, 0.2%) / LGIGP	(0.5%, 0.2%)/ NGIGP
	<=3 years	(3%, 0.1%) / GINGP	(2%, 0.1%) /LGINGP	(0.5%, 0.1%) / NGINGP

The above factors are applicable for all Life Insurance business including the riders; the riders which are categorized as Health Insurance Business will follow the factors applicable for such business.

When two or more insurance benefits are aggregated and a single reserve is kept for all (e.g. accelerated benefits), such benefit should be treated as guaranteed if one of them carries a guarantee of more than 3 years.

Mathematical Reserve after reinsurance or Sum At Risk after reinsurance, are after application of the relevant K1 and K2 factors.

The Solvency factors for ULIP business apply at the product and not fund level. If one of the funds carries a guarantee, the entire product will be treated as 'Investment Risk borne in full'.

Chapter 3.

Analysis of Experience:

This section covers the analysis of experience that as at December 31st 2016 that forms the basis for setting the assumptions as required under Sub-regulation XX of ARA, Regulations. The experience relates to yield on investment, expense, lapse and mortality / morbidity etc.

The yield on investment for the purpose of the valuation rate of interest would be the investment income as a percentage of the mean fund over the period, on assets attributable to blocks of business / segments etc. The value of the fund or backing assets would be assessed on a purchased cost or amortized cost basis for this purpose.

The above may be determined and disclosed, with and without taking realized gains for each fund maintained by the insurance company. The investment income and gains taken into consideration would be that shown in the revenue account.

A brief description of the methodology used for doing so should be stated.

The policy maintenance expenses shown would be fixed or variable, shown in relation to premium, sum assured or fund or as a per policy expense.

Mortality and Morbidity experience would be shown in relation to standard tables where applicable.

Chapter 4.

Analysis of Surplus:

This section covers the analysis of surplus carried out based on the consideration of the generally accepted actuarial practice.

Chapter 5.

Report of With-profits Committee:

Chapter 6.

Financial Condition Report – The insurer shall submit a report on Financial Condition prepared in line with the Guidance as provided by the Institute of Actuaries of India from time to time to cover the following sections at minimum.

- **a.** Current Financial Condition
- **b.** Future Financial Condition
- **c.** Risk Management and Control, to include Economic Capital Report.
- **d.** Asset Liability Management

Annexure D

Liability / Data Reporting Formats

The following forms to be used for the purpose as mentioned below, are in the attached excel worksheet.

1. Statements of Liability
   - ✓ Form NLB
   - ✓ Form LB
   - ✓ Form VIP
   - ✓ Form LB2
   - ✓ Form IA (NP)
   - ✓ Form IA (Par)
2. Data Forms
   - ✓ DDD (NL)
   - ✓ DDD (ULIP & VIP)
3. Solvency Form
   - ✓ Statement of Solvency Form KT1

Annexure E

Introduction of higher Solvency Margin/Ratio for Companies defaulting on certain parameters – Comments of the Committee on Life Insurance

The following parameters can be thought of as key indicators of the Life Company's administrative efficiency, governance in place and financial health which would impact policyholder in terms of value generated by his policies as well in terms security of his investments.

- ✓ Expense Ratio
- ✓ Claims rejection / Repudiation Ratio
- ✓ No of misspelling Complaints

The above list is not exhaustive.

There is a school of thought that one of the ways in which the Regulator could monitor and apply restraint on the companies with respect to their performance on the parameters would be to prescribe that they keep additional Solvency Margins if they breach certain minimum (or maximum on these parameters)

The rationale is to (a) penalize the company for not maintaining their performance in certain key areas within acceptable norms (b) incentivize them to improve

Committee's view on the matter is as follows –

1. Some of the above (e.g. high expense) would in any case lead to higher reserving in terms of a high expense basis unless perceived to be a temporary or transient occurrence and expected to improve over a certain period of time. In case of the latter there is a requirement for the company to provide additional reserve in terms of an expense overrun reserve which would lead to some financial stress.

   Additional solvency capital on top of the additional reserving requirement would be a double whammy which would make the situation worse particularly if the company is new and/or is expanding.

2. The expense overrun or high expense ratio situation may also be emerging out of the continued stagnation of New Business volumes and hence the under utilization of distribution network and other fixed capacities and not entirely as a case of unfettered spending per se by the Life companies. Frequent regulatory changes

resulting in product/process modifications may also have contributed to the increase in operating expense.

Additional Solvency capital would make the situation worse, as to get over the situation the company would aim at larger New Business volumes which unfortunately would require higher capital in any case.

3. High Repudiation Ratios or mis-selling are administrative and governance issues which the Regulator would need to tackle at that level rather through the requirement of higher solvency. In such a situation it would not be appropriate for the Regulator to gloss over the company's underwriting standards and the claim settlement norms and impose the punishment of additional solvency hoping that the company by its own would take measures to improve matters.
4. Such norms would be difficult to implement in practice. The appropriateness of expense ratios are different for different companies by maturity (e.g. New/old), companies writing different businesses (savings / protection) etc. Similarly the appropriate repudiation ratios may be very different for mortality and Critical Illness/Health business. Hence setting appropriate levels at which a breach would be reckoned on a particular parameter is at best difficult and is likely to be controversial.

To conclude, the committee would feel that the right way to Regulate the companies would be to monitor the parameters and intervene in terms of administrative and technical oversight as and when breaches are about to happen rather than to impose additional solvency requirement on the happening on the breach which would worsen the financial state of the company and in no way help them in taking some corrective course of action.

The committee also feels that with the larger of the companies due to go in for IPOs and public listing, the internal governance structures and practices would improve; owing to their responsibility to the investing public and moreover, the concern around the possible adverse impact that the disclosure of a sensitive performance parameter would have on their share price.

Annexure F

Reduction in yield equivalent for Traditional Par Products: View of the Committee

The demonstration of reduction in yield (RIY) is currently part of the disclosure in the Benefit Illustration of the Unit Linked Products. The RIY which is estimated excluding the mortality charge serves three distinctly important functions in terms of product transparency and customer protection.

1. It discloses to the prospective customer the effect of charges on the overall yield of the product; thereby a customer is effectively able to derive a net yield that would be achieved on the product.

2. It provides a tool in the hands of the Regulator to enforce a cap of the expense charges by regulating the maximum reduction in yield at various durations of the product, also effectively capping high upfront charges.

3. It provides a means to the customer to compare the products across companies in terms of their overall charges, hence helps to an extent the customer to make an informed choice amongst many similar products.

The committee is required to suggest if a similar methodology can be adopted for the traditional With Profits products, thereby increasing transparency and enabling the IRDA to ensure that charges that may be applied on the product stay within prescribed limits.

Difference in Product Structure:

1. The ULIP products are considered as unbundled as every component of the cash flow is distinct, segregated and visible; whereas the traditional Par products are considered as bundled products where all cash flows are pooled and all benefits are paid from the pool. The components, hence are not distinct, e.g. the year on year mortality charge is not visible to the customer. The unbundling however happens at the back end in terms of the asset share where all cash flows are separately tracked if the asset share is carried out at the contract level.

2. There is no discretion that is to be applied in terms of benefits that is to be passed on to the policyholder as the actual returns earned are provided to the customer by way of a unitized structure and the charges under the product are disclosed upfront. While in the participating products, the benefits both in terms of investment return, expense are subject to discretion of the company management. Additional discretion comes in the form of smoothing methodology applied at the time of maturity or earlier surrender. There is little visibility for the customer in terms of the discretion being applied in determining his final benefits.

3. Pooling / smoothing is not only applied on the with profits benefits explicitly at the exit of the policy but implicitly by declaring bonuses once a year only or declaring bonuses for policies grouped by types of policies, terms etc.

4. ULIP and VIP products have features of 'Readily identifiable current benefits' in the sense that the benefits payable on such products are transparently visible to the customer while traditional par products give no inkling whatsoever of currently available benefits except as made available at a point of exit.

We presume here that the VIP Par products are unbundled, charges in such products are disclosed transparently upfront, and satisfy the readily identifiable current benefit criteria. Such products are hence amenable to regulation in terms of a capping of charges, some discretion is however available in terms of the crediting interest rates or the smoothing applied on such rates but to a lesser extent because of the transparency of the policy fund value and the manner of crediting rates applicable which essentially mimics a bank deposit account.

The surplus distribution in a VIP par product can be of two types; one which is similar to the traditional par product where all surpluses are shared and the other where any surplus / deficit on account of expense and mortality is excluded from the distribution.

Hereinafter, we do not deal with the VIP Participating products; however certain aspects of disclosure e.g. smoothing etc. is applicable to such products as well.

Difficulty in Regulating RIY in Traditional Par products:

A draft circular of IRDA was issued which required that a traditional Par product at the pricing stage be tested to return at maturity at least the premiums paid (Internal Rate of Return of zero if the fund earned 4% rate of return). Companies have generally found it difficult to implement, they have coped with this prescription in one of the following ways -

1. Companies have restricted the maximum age at which the products were offered in order to minimize the impact of the mortality cost. This is because of significantly higher mortality cost at higher ages reduces the yield substantially.

2. By being overly optimistic on future expenses, higher future bonus earnings could be estimated thereby inflating the maturity payouts

The imposition of the above condition on the management of the business implies effectively a cap on the total expense and mortality loadings, the implication being that if 4% return on the fund was achieved, the maturity value would at least be equal the premiums paid.

The imposition of RIY at a certain level would also effective impose a similar kind of constraint, except that if the RIY was framed excluding the mortality, the mortality loadings would not be restrained.

There are inherent difficulties in this regulatory approach -

There is no apparent way to enforce this at the point of maturity. This is because there is currently no visibility on the returns earned by the fund over the term of the contract. Even if in some way the returns earned on the fund over the term is disclosed, it by no means entails that the same return would be been paid to the policyholder because of smoothing considerations or even a percentage of the asset share may be retained to build the estate.

Secondly, the traditional participating policyholders are like equity shareholders and they participate in the overall profit and loss of the with profit fund. Providing a guarantee would take away the essence of participation which lies at the core of the With Profits business and the participation would be asymmetric, the downside not being taken by the policyholder. Currently however, there exists an explicit guarantee in the form of the sum assured but at a fairly low level.

<u>Proposed Solution/Direction:</u>

The specific features, structure of participation and complexity of the with profits products has over the years led to particular concern over the extent to which consumers understand the nature of their investments and the risk attached to it.

- ✓ Features such as bonuses, smoothing, and guarantees are little understood.
- ✓ There is little understanding of what investment returns are being delivered in the product.
- ✓ The factors that affect the returns are also not appreciated, including the effect of mortality loading and expenses. 'Price' of such products is the effect on the policy, of charges and expenses. The absence of fully transparent charges as is in the case in the traditional with profits product, means that the consumer has little information about the 'price' of the product before buying it.

A further concern of the current traditional with profits products is the high degree of discretion retained by the insurer and how that discretion is applied in particular, in smoothing of benefits, bonuses, and surrender charges etc. Currently, there is little restraint on this discretion by way of principles, practices or any governance structure or disclosure in place.

Overall, the concern is around the customers not being treated fairly; even if they are, there is very little in the information provided that establishes such fairness.

The solution in our view lies in a combination of (a) better governance of the with profits business, (b) appropriate documentation and (c) transparent disclosure to the policyholder at point of sale, post point of sale and periodic (annual) statements rather than an artificial imposition of RIY which would be difficult to implement in practice.

Governance:

1. Every company writing With Profits business would have a Board Approved With Profits Governance Policy / Bonus Policy which would be in the lines of the Principles & Practices of Financial Management (PPFM) of the UK.

2. The Bonus Policy would provide information on the following matters (Principle & Practice) -

   - ✓ Nature of the business; General Principles and key financial objectives of the business
   - ✓ Nature and types of bonuses.
   - ✓ How bonuses are decided including a review of the asset share methodology and assumptions
   - ✓ Asset share range targeted for benefit payout on surrender and maturity
   - ✓ Description of the smoothing methodology adopted
   - ✓ Investment philosophy and asset allocation strategy
   - ✓ Apportionment and allocation of charges/expenses to the with profits business
   - ✓ Key Risk areas of the business

3. The With Profits Committee would be a committee of the Board which would review the company's adherence to the Bonus Policy, asset share methodology and the actual asset share calculation. It would also provide an opinion on the fact that the discretion retained by the insurer is applied in a manner which is fair to the policyholders.

   The WPC would also review the ongoing expense of the company, the expense being charged currently to the asset share and ensure that it is fair in relation to the ongoing expense experience. The WPC would specifically ensure that the initial expenses being charged to the asset share is in line with what is shown in the Benefit Illustration provided to the prospective customer.

   The company would engage a 'With Profits Actuary' who would be responsible for the governance of the with profits business, estimating appropriate bonus and ensuring adherence to the Bonus policy. The WPA would be a member of the WPC and be accountable to it. The WPA would be a statutory position. If IRDAI wishes to take this idea forward, the role and responsibility of the WPA could be incorporated into the Appointed Actuary Regulations. From our side, we would suggest that WPA and Appointed Actuary would be two different actuaries for companies with significant with profits fund, else a single actuary would perform both the roles.

Disclosure - Achieving transparency and greater customer understanding:

The various disclosures pre/post sales or provided on an annual basis would help customer have a greater understanding of the product, benefits paid and the key risk factors that would affect the overall return. The information should result in the following -

- ✓ The customer would understand the concept of with profits business and its long term nature. He would understand the factors which would affect risk, performance and return on investment.
- ✓ The information provided should address the concern around the suitability of the product.
- ✓ The customer should have a sense of the uncertain nature of the investment return and would be able to appreciate the stability or otherwise of the return vis-a-vis other investment products.
- ✓ The consumer should understand those parts of the benefits that are guaranteed and that future bonuses are not guaranteed.
- ✓ How bonuses are decided, concept of asset share, nature of smoothing and how it affects returns.
- ✓ The customer should be informed of the consequence of not paying further premiums, surrender value available and the rationale for imposition of surrender penalty in the early years.
- ✓ The customer would, at various points have an indication of the likely maturity / surrender value of his policy.
- ✓ The customer should be informed as to how his investment is progressing, investment returns being earned on his fund.

Kinds of Disclosure:

At the Point of Sale:

1. A 'key feature document' to be handed over at the point of sale would be in two parts - Generic KFD and a client specific KFD, the latter would also be called the Benefit Illustration.

The generic KFD would have the following information to the prospective customer who is in the process of buying a with profit policy.

- ✓ Objective/s of the product (investments/savings/protection etc)
- ✓ Nature and extent of participation in profits, exposure to investment risk, business risk
- ✓ Extent of Life Insurance that is available in the product
- ✓ Long Term nature of the product, possible consequences of stoppage of premium payment, surrender values available
- ✓ Nature of benefits, types of bonuses and how they are decided, that bonus rates may not be equated with the rate of return on the product
- ✓ Factors that would possibly affect returns achieved
- ✓ Any benefit that is guaranteed or will be guaranteed
- ✓ Explanation of taxation both from the policyholder and company viewpoint
- ✓ Details of other information that would be available either at the point of sale or as annual statements etc.

2. Benefit Illustrations would be the client specific part of the KFD which will be provided at the point of sale. The BI would provide a projection of the death, surrender and maturity benefit to be paid over the duration of the policy at two different rates of investment returns earned. The BI would have a structure which would include the future best estimate expenses and mortality outgoes at all years and a reduction in yield on account of expenses. The benefit illustration would give rise to PRE which would be required to be met.

3. An extract of the Bonus Policy will be made available to the customer/prospective customer if he requests for such information or the same may be made available in the company's website and a suitable reference be made in the KFD about this information being available. The extract of the bonus policy would include the following information

a) Objectives of the business, General Principles

b) Bonus policy and nature of guarantees:
- ✓ Definition and nature of annual and terminal bonus,
- ✓ When and how bonuses are determined and applied,
- ✓ Discretionary nature of the bonuses,
- ✓ When the bonus additions become guaranteed, why future bonuses are not guaranteed,
- ✓ The principle and key considerations taken into account while setting the bonus rates including the concept and use of asset share etc.

c) Investment objective / philosophy:
- ✓ What kind of assets will form the investments, investment objectives of the with profits fund,
- ✓ How asset allocation or equity backing ratio is decided,
- ✓ What factors may affect the investment strategy,
- ✓ Proportion of the premium used for providing protection on an average.

d) Factors which will affect the return that may be achieved:
- ✓ Nature of participation, Exposure to investment & business risks,
- ✓ Profits / losses arising from the company's with profit business such as - the investment from assets being higher or lower than anticipated, the expenses of sales and administration being higher or lower than anticipated, the mortality and morbidity levels being higher or lower than anticipated,
- ✓ Profits from other sources such as surrenders or from business other than with profits, cost of guarantees and charges made for such guarantees etc.

e) Smoothing:
- ✓ Definition of smoothing,
- ✓ Description of the present smoothing policy being operated and principle that will be applied in the future,
- ✓ Disclosure on limits of smoothing applicable, that smoothing may not defy the effect of sustained investment decline.

f) Surrender:

- ✓ Charges that apply on surrender in the early years of the policy to cover costs, including marketing costs, commission etc,
- ✓ Description of the surrender penalty over various duration and rationale for determining the surrender values.

Post Sale and by way of Annual Statements:

- ✓ Current/last year's annual bonus, bonus earned to date
- ✓ Current Surrender Value
- ✓ Amount that will now be paid on death
- ✓ Returns achieved by the with profits fund: The investment return achieved from the fund in which the customer's policy is invested.
- ✓ Projection of how much the customer is expected to receive on his policy at maturity and on earlier surrender over the rest of the policy duration.

Summary & Recommendation:

A RIY equivalent prescription in a traditional participating product is not a feasible proposition as it is difficult to implement both from the company or regulatory stand point.

The general perception is that there is a lack of transparency coupled with the complexity of the business which is a critical drawback of this product class.

The solution to the problem needs to be sought in terms of better governance, documentation of the principles and the core practices, compliance and adherence to which is monitored independently and a series of pre, post and periodic disclosures on the various aspects of the business and its performance.

The adherence to the Bonus Policy will be reviewed by the WPC, the WPC will also ensure that the discretion retained by the company with regards to benefit payments is exercised in a manner which is fair to the policy holder. The expense of the with profits business would be reviewed by the WPC; the committee would also ensure that the expenses charged to the asset share is appropriate and the initial expense is in line with what was shown in the benefit illustration.

We also recommend that the creation of a With Profits Actuary role in the companies where with profits business is substantial; the WPA being a statutory position, his role and responsibility will be incorporated into the Appointed Actuary Regulation. The WPA would be accountable to the WPC.

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