

43rd India Fellowship Seminar

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Increasing Capital Requirement

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Case study

- Company has been traditionally writing significant portion of Non-par endowment assurance business.
- Due to competition, the margins are low and company wants to increase surrender values in the initial years as per their customer first strategy.
- AA and CFO are worried that given the current interest rate situation, the capital requirement may increase and may not be available in the immediate future.
- They are discussing on options such as - release or reduction in reserves, reduction in profit margins etc., available to continue writing same portions of business.

Case study

- Requirement
 - Please discuss the options available from the perspective of AA and give your recommendations to the AA for a follow up discussion with CFO.
 - Also in a situation where you are reporting to CFO where CFO asks you to come up with options that he can put to AA. How different your approach would be and what would be the options?

Agenda

❖ Options available

- Reduction in reserve
- Re-pricing of products
- Sources of funds
- Change in profit margin
- Change in Commission Structure
- Reduction in Expenses
- Other considerations

❖ Recommendation

❖ Q&A

Reduction in Reserves

- Reserves are one of the key responsibilities of the AA
- Reserves should be sufficient to meet policyholder outgoes
- Reduction of reserves will lead to increase in available capital
- But reduction in reserves should not be done at the cost of policyholder protection
- Reserves must be in compliance with the relevant IRDAI regulations and APS

IRDAI (Actuarial, Finance and Investment Functions of Insurers) Reg 2024

APS 1 - Appointed Actuary and Life Insurance Business

APS 2 - Additional Guidance for AA and other Actuaries involved in Life Insurance

APS 7 - AA and Principles for determining MADs in Life Insurance liabilities

Reduction in Reserves

Following can be evaluated for **both existing business and new business**

Review of the valuation assumptions

- Is there a buffer in the BE assumptions?
- If so, is the buffer required to be held or can it be released?
- Is the MAD more than the minimum MAD guided in APS7?
- If the additional MAD is required to be held or if it can be reduced?

Reduction in Reserves

Key Assumptions:

- Valuation Rate of interest (VROI)
- Persistency
- Expenses
- Mortality



more
significant

IRDAI (Actuarial, Finance and Investment Functions of Insurers) Reg 2024

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Reduction in Reserves

Valuation Rate of Interest (VROI)

❖ Review the parameters used in derivation of VROI

- Review the investment return of underlying assets and outlook, along with the investments team
- If Company already invests in derivatives, then it may be considered while deriving VROI, if not already considered
- If the asset liabilities are well-matched, review if Illiquidity premium shall be considered on the yields of corporate bonds

IRDAI (Actuarial, Finance and Investment Functions of Insurers) Reg 2024

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Reduction in Reserves

Valuation Rate of Interest (VROI)

❖ Change in Strategic Asset Allocation (SAA)

Asset Allocation can be shifted to increase the VROI

- from government securities to corporate securities
- from short-term securities to long-term securities

Key considerations:

- Compliance with relevant IRDAI regulations on limits
- Asset-Liability matching while deciding duration of securities

Reduction in Reserves

Valuation Rate of Interest (VROI)

❖ Reduce risk of decline in future interest rates

- Invest in Interest rate derivatives permissible under IRDAI regulations
- Focus on shorter premium payment term and policy term policies

Key considerations:

- Compliance with relevant IRDAI regulations on investments
- Discussions with the investments and finance team
- Other risks introduced by the interest rate derivatives

IRDAI (Actuarial, Finance and Investment Functions of Insurers) Reg 2024
IRDAI Guidelines on Interest Rate Derivatives, 2014

Reduction in Reserves

Persistency Assumptions

Higher surrender values in initial years might lead to lower persistency. Company can take various initiatives to increase persistency especially in the initial years

- Introduce initial commission clawback
- Persistency related incentives for the agents
- Initiatives to reduce mis-selling
- Introduction of policy loans for policyholders
- Increased engagement with the policyholders

Reduction in Reserves

Persistency Assumptions for New Business

- Modification of product design / benefits
 - Introduction of shorter premium payment term and policy term
 - Introduce survival benefit such as monthly income or milestone benefits at regular intervals
 - Introducing rebates for higher premiums to increase sales towards high income policyholders

Repricing of products

Products can be re-priced such that the impact of increase in surrender value is offset by:

- Reduction in policyholder IRR
- Reduction in profit margin and policyholder IRR

Key considerations from AA perspective

- ❖ Customer centric
 - Meet customer needs
 - Increased flexibility and liquidity

Repricing of products

- ❖ Fair pricing
 - Premium rates are fair, provide value for money
 - Self sustainable
 - Not discriminatory
- ❖ Market benchmarking
 - Surrender value provided by competitor
 - IRR provided by competitor
- ❖ Compliance with regulations
 - Principles of pricing
 - Surrender value factors and calculation

*APS 1 - Appointed Actuary and Life Insurance Business
IRDAI (Insurance products) Regulations, 2024
Master Circular on Life Insurance Products, 2024*

Repricing of products

- ❖ Persistence
 - May expect higher surrenders in initial years
 - Allowed appropriately to reduce strain on available capital in future
- ❖ Profit testing and sensitivity analysis
 - Identify key risks
 - Identify model points which are loss making / have high new business strain
- ❖ Financial soundness
 - Minimal change in capital requirement and profit margin
 - Lower impact of interest rate volatility

Repricing of products

Key considerations from CFO perspective

- ❖ Financial stability
 - Minimal change in new business strain
 - Availability of free assets
- ❖ Business volume
 - Increase due to differential product
 - Decrease due to lower IRR
- ❖ Per policy expense
 - Decrease due to higher volume
 - Increase due to lower sales / higher withdrawals

Sources of funds

Key considerations from AA perspective are:

- ❖ Reserves and solvency margin requirement met from capital within the shareholder's fund
- ❖ Indicate limits on volume of sales
- ❖ Marketing plan and projected volume of new business
- ❖ Reassurance from the Board of Directors that the required level of capital will be available and not earmarked for other purposes.

Sources of funds

Key considerations from CFO perspective are:

❖ Addition to Issued capital

- If Issued capital is lower than the Authorized capital

❖ Other forms of capital

- Preference share capital
- Subordinate debt

❖ Financial Reinsurance

IRDAI (Other Forms of Capital) Regulation, 2022

IRDAI (Re-Insurance) Regulation, 2018

Change in Commission Structure

Altering the commission structure can help in optimizing financial resources and achieving better capital efficiency.

This includes:

- Shift from upfront commissions to trail commissions
- Performance based commission and commission clawback
- More focus on selling through low commission distribution channel (Digital Selling)
- Reduction in commission level

Change in Commission Structure

Key considerations from AA perspective:

❖ Regulatory Compliance

- IRDAI Guidelines
- Solvency Requirements
- Policyholder Protection

❖ Profitability Analysis

- Impact on Profitability
- Impact on Expense Ratios

IRDAI (EOM including Commission) Regulations, 2024

IRDAI (Actuarial, Finance and Investment Functions of Insurers) Reg 2024

IRDAI (Protection of Policyholder's Interests, operations and allied matters of insurers) Regulations, 2024 (

Change in Commission Structure

❖ Risk Management

- Reduction in Persistency Risk
- Operational Risk - Need to update IT systems to for trail commission tracking
- Reputational Risk - dissatisfaction among intermediaries

❖ Stakeholder Communication

- Agents and Intermediaries
 - work with the sales and distribution teams to communicate changes to agents and intermediaries
- Regulators
 - reporting how changes impact the insurer's financial position and compliance with regulatory requirements

Change in Commission Structure

❖ Scenario Analysis and Stress Testing

- Scenario analysis to evaluate the impact of different commission structures under various economic and market condition
- Stress test to assess how changes to commission structures perform under adverse conditions such as a sudden increase in lapse

❖ Long Term Sustainability

- Alignment with business strategy

❖ Competition

- What commission structure competition is following

Change in Commission Structure

Key considerations from CFO perspective:

❖ Financial Impact Assessment

- Cash Flow management
- Profitability Analysis

❖ Budgeting and Forecasting

- Adjust expense forecasts, revenue projections and capital allocation plans

❖ Technology and System Integration

- IT Systems
- Automation

Change in Commission Structure



❖ Alignment with Strategic Goals

- Ensure that the changes to commission structure align with the company's strategic goals, such as improving capital efficiency, expanding market share etc.

❖ Competitive Positioning

- Assess company's competitive positioning in the market.
- Reducing commissions may make the company's products more attractive to customers but less appealing to agents

Reduction in Expenses

Reduction in expenses can help in improving profitability, increasing cash flow, strengthening free reserves and hence better capital position. This can be achieved by:

- **Operational Efficiency**
- **Outsourcing**
- **Controlling Administrative Expenses**
 - Negotiate Vendor Contracts
 - Reduce Overheads
- **Workforce Management**
 - Eliminate Redundant Roles and Processes
 - Cross-Training Employees

Reduction in Expenses

Key considerations from AA perspective:

❖ Regulatory Compliance

- IRDAI Guidelines
- Solvency Requirement

❖ Policyholder Interest

- Customer Service
- Claims Settlement

IRDAI (EOM including Commission) Regulations, 2024

IRDAI (Actuarial, Finance and Investment Functions of Insurers) Reg 2024

IRDAI (Protection of Policyholder's Interests, operations and allied matters of insurers) Regulations, 2024 (

Reduction in Expenses

❖ Operational Feasibility

- Potential challenges and the time required to realize savings
- Risk Management
 - Operational Risks
 - Increased fraud due to reduced oversight or errors due to understaffing

Reduction in Expenses

Key considerations from CFO perspective:

❖ Impact on Profitability

- Reducing expenses improves net income, which enhances retained earnings and strengthens the capital base

❖ Cost Benefit Analysis

- Potential savings vs the impact on operations and services

❖ Strategic Cost Reduction

- Avoid short term cost-cutting measures that could harm long term growth or operational stability.

Reduction in Expenses

❖ Employee Morale

- Impact of cost-cutting measures on employee morale and productivity
- E.g. layoffs or reduced benefits could lead to lower employee engagement

❖ Talent Retention and Acquisition

- Ensure critical talent is retained
- Market perception of cost-cutting environment may create problem in good talent acquisition

Reduction in Expenses

❖ Short Term vs Long Term Impact

- Balancing short-term expense reductions with the long-term strategic goals of the company
- Ensuring that measures taken do not compromise future growth and stability

❖ Competitive Advantage

- Lower expenses can provide pricing flexibility, allowing the insurer to offer competitive premiums while maintaining profitability

Change in Profit Margin

A reduction in profit margin as currently being considered will not address the growing capital requirements on non-par endowment products.

Further, a lower profit margin can lead to a gradual decline in an insurer's Indian embedded value:

- ❖ With the increase in proportion of new business within the in-force portfolio
- ❖ No contribution of early surrenders to future profits

Reduction in Profit Margin

Adverse impacts from AA perspective

❖ Financial Stability Concerns:

- Increased Capital Strain
- Solvency Challenges

❖ Risk Management Issues:

- Limited Financial cushion for adverse deviation (AvE)
- Higher lapse risk

❖ Product Sustainability

- Challenge in funding future policyholder benefits

Reduction in Profit Margin

Adverse impacts from CFO perspective

❖ Financial Performance Impact:

- Erosion of profitability
- Pressure on earnings

❖ Capital Allocation Challenges:

- Resource Constraints
- Increased cost of capital

❖ Market Competitiveness:

- Pricing Limitations
- Brand Perception

Increase in Profit Margin

CFO's approach for Proposed Increase

❖ Financial Analysis:

- Profitability Assessment

❖ Market Analysis:

- Competitive Benchmarking
- Customer Sensitivity Analysis

❖ Regulatory Compliance:

- IRDAI Guidelines

IRDAI (EOM including Commission) Regulations, 2024

Increase in Profit Margin

❖ Stakeholder Communication:

- Board Approval

❖ Scenario Planning:

- Contingency Planning

❖ Implementation Strategy:

- Phased Approach
- Monitoring Framework

Increase in Profit Margin

While increase in profit margin address the growing capital requirements, it can affect the company adversely through:

- ❖ Reduced market competitiveness

- ❖ Higher surrenders

Therefore, a more balanced approach towards setting profit margin is crucial for managing capital requirements effectively.

Other considerations

❖ Business Mix Change

- Allocate capital to higher margin products

❖ Channel Mix Change

- Target to sell more through channels with lower acquisition cost
- Persistency monitoring at channel level

❖ Product Differentiation

- Differentiate on value, not solely on price
- E.g. High standards of service, Faster claim settlement

Other considerations

❖ Monitor Surrender Experience closely

- Higher surrender values should not lead to selection against the company by either policyholders or agents
- Agents can buy policies and surrender after 12 months if
 $\text{Initial commission} + \text{Surrender Payout} > \text{First year premium}$

❖ Review current investments to increase the level of admissible assets

Recommendations

- ❖ AA and CFO should carry out thorough investigation with respect to options available
- ❖ The AA and CFO can work together to implement a strategy that balances the need for competitive, customer-centric products with the financial stability and long-term success of the company
- ❖ Both of them should be satisfied as to the resilience of the financial position in all reasonable circumstances
- ❖ The outcome of such investigation should be presented to Board of Directors and the way forward should be accordingly implemented



Thank you!