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Participating Business – Simplifying Nuances for an Equity Analyst

Guide :

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Case Study



Case Study

- You are the consulting actuary, supporting life insurance companies in different areas such as product development and pricing; as a peer reviewer; as an Independent Actuary on the With Profits Committee; certifying the embedded valuations of the companies etc.
- A new equity analyst has started analysing the published disclosures of life insurance companies and has been at a loss as to why the financials of these companies, especially pertaining to their participating funds, are very different from each other in the following areas:
 - Implied tax rate applicable to the participating fund;
 - Ratio of the Funds for Future Appropriations (FFA) to the total reserves in the participating fund;
 - Expense ratios (i.e. total expenses to total premiums) in the participating fund.

Case Study Questions



- Regulatory Framework in the areas of fund structure, reserving and solvency, surplus distribution, investments and governance framework.
- Considerations for Taxation
 - Why implied tax rates could be different across companies?
- Funds for Future Appropriation(FFA)
 - Reasons for FFA to arise
 - What does high and low FFA indicate?
 - Why ratio of FFA to reserves could be different across companies
- Expense Ratios
 - Why different companies could have different expense ratios?
 - How can companies ensure policyholder protection despite having different expense ratios?

Regulatory Framework



Regulations & Professional Standards

- IRDAI(Actuarial, Finance and Investment Functions of Insurers) Regulations, 2024
- IRDAI (Insurance Products) Regulations, 2024
- IRDAI (Protection of Policyholder's Interests, Operations and Allied Matters of Insurance) Regulations, 2024
- IRDAI (Expenses of Management) Regulations, 2024
- IRDAI (Corporate Governance) Regulations, 2024
- Guidance Note 6-Management of participating life insurance business with reference to distribution of surplus
- APS 7- Calculation of MAD
- Income Tax Act, 1961
- Insurance Act, 1938

Fund Structure

- Segregation of funds
 - Separate funds for par and non-par business.
- Surplus Distribution
 - 90:10 between policyholders and shareholders
- Bonus Distribution
 - Fair and equitable to all policyholders.
 - Based on Asset Shares
- Investment Mix

Reserving

- Based on IRDAI(Actuarial, Finance and Investment) Regulations 2024
- Gross Premium valuation Method
 - Include all policy cashflows
 - Factor in options and guarantees
 - Allow for vested, future and terminal bonus
- Assumptions
 - Prudent assumptions, allowing for MAD with reference to APS7
 - Important assumptions
 - Mortality and Morbidity
 - Lapses
 - Valuation interest rate
 - Policy maintenance expenses

Reserving

- Treatment of Negative Reserves
 - For sec 35 of the insurance act negative returns are allowed
 - For other purposes, the reserves should be floored to 0 or the surrender value
- Additional Provisions
 - Exchange Rates
 - Pandemic Risks
 - Revival of lapsed policies

Solvency

- Based on IRDAI(Actuarial, Finance and Investment) Regulations 2024
- Solvency is demonstrated at the company level
- The solvency ratio is defined as Available Solvency Margin (ASM) / Required Solvency Margin (RSM).
- Factor based approach is used for calculating RSM
- FFA can be used for calculation of ASM
- Control Level of solvency is 150%
 - The company is required to provide a business plan to the authority if solvency falls below control level

Investments

➤ Based on IRDAI(Actuarial, Finance and Investment) Regulations 2024

No	Type of Investment	Percentage of funds
1	Central Government Securities	At least 25%
2	Central Government, State Government or other approved securities	At least 50% including point 1 above
3	Approved investments as per sec 27 of the act and	Not >50%
4	Investment in housing and infrastructure	At least 15%
5	Other investments specified in insurance act	Not more than 15%

Governance Framework

- With Profit Committee
- Benefit Illustrations
- Board approved bonus philosophy
- Mis selling/ Misleading Advertisements
- Other Committees as mandated by IRDAI
 - Policyholder Protection Committee
 - Audit Committee
 - Investment Committee
 - Audit Committee
 - Risk Management Committee
 - Nomination and Remuneration Committee
 - Corporate Social Responsibility Committee

Tax Considerations



Tax Considerations

- Tax gives way to interpretation - disagreements leading to appeals with the Income Tax Appellate Tribunal
- Life Insurance companies are protected by separate provisions under the Income Tax Act 1961, governed by rules stated under IRDA Act 1999 and Insurance Act 1938
- Based on the results of the appeals, a broadly common understanding has been developed
- Tax rules applicable specifically to Life Insurance companies
 - Income Tax Act 1961, Section 44, read with First Schedule
 - Income Tax Act 1961, Section 10(23AAB)ii
 - Income Tax Act 1961, Section 115-O
 - Income Tax Act 1961, Section 10(34)
 - Income Tax Act 1961, Section 115B

Tax Considerations

- Implication of the mentioned tax rules for a Life Insurance Company:
- Taxation based on surplus, disclosed by the actuarial valuation done as per Insurance Act 1938
 - All surplus is taxed at 12.5%
 - In addition to the 12.5% tax rate, there is a 4% Education Cess, and a Surcharge depending on the total income level:

Total income	Domestic Company	Foreign Branch
Less than Rs. 1 cr	0%	0%
More than Rs. 1 cr, less than Rs. 10 cr	7%	2%
More than Rs. 10 cr	12%	5%

- Income from micro insurance is exempt from tax
- Income on fund set up for pension products is exempt from tax

Tax Considerations

- Domestic companies are taxed on total surplus, with tax credit for tax paid outside
- Foreign branches in India are taxed on business transacted in India
- Income earned from dividends received is exempt from tax
- Bonuses declared for policyholders and additions made to FFA are exempt from tax
- Credit is given for losses made during the year. Any unutilized credit from losses can be carried forward for 8 consecutive years from when the losses first occur
- Credit is given for any tax deducted at source during the year e.g., on interest on securities, sale of investments, etc.

Tax Considerations

Example

- Company 1 - total income (revenue) less than Rs. 1 cr
- Company 2 - total income (revenue) less than Rs. 10 cr
- Company 3 - total income (revenue) above Rs. 10 cr
- Company 4 - total income (revenue) above Rs. 10 cr, including pension income Rs. 65 lac
- Company 5 - total income (revenue) above Rs. 10 cr, plus losses carried forward Rs. 20 lac

Tax Considerations

	Company 1	Company 2	Company 3	Company 4	Company 5
Surplus for FY 24-25	20,00,000	2,00,00,000	15,00,00,000	15,00,00,000	15,00,00,000
Tax Rate	12.50%	12.50%	12.50%	12.50%	12.50%
Education Cess	4%	4%	4%	4%	4%
Surcharge	0%	7%	12%	12%	12%
Pension income	-	-	-	65,00,000	-
Tax Credit on pension income	-	-	-	-9,46,400	-
Losses Carried Forward	-	-	-	-	20,00,000
Tax Credit on prior losses	-	-	-	-	-2,91,200
Tax payable without credit	2,60,000	27,82,000	2,18,40,000	2,18,40,000	2,18,40,000
Tax paid with credit	2,60,000	27,82,000	2,18,40,000	2,08,93,600	2,15,48,800
Implied tax rate (% of surplus)	13.00%	13.91%	14.56%	13.93%	14.37%

Fund for Future Appropriation(FFA)



Reasons for FFA to arise



- FFA arises due to surplus not distributed in the year it had arisen.

The key factors why FFA arises are:

- Smoothing policy of the company
- The company's policy on split between regular and terminal bonus
- Whether surplus from lapses is shared with policyholders
- The product may have low guarantee.
- Asset share-based reserving impacts FFA.
- Unallocated rider/reinsurance profits increase FFA.
- Expense profits increase FFA.

Reasons for FFA being different across companies

- Age of company.
- Bonus distribution philosophy.
- Smoothing philosophy.
- The company's policy with respect to how much FFA they want to hold at any point in time.
- New business volume.
- Company have recently utilized the FFA for bonus distribution.
- Operating efficiency of the company - operating surplus.

What does a low FFA ratio indicate?

- Distributing majority of the surplus arises in the same year to the PH
- The amount set for smoothing is low
- The company may be in their early stage of operation
- The company may be incurring losses in various components like lapse, mortality, expense, etc.
- The company is still injecting capital to pay regular bonus

What does a high FFA ratio indicate?

- The company is deferring the bonus distribution
- The amount set for smoothing is high
- The product has low guarantee
- The company may be keeping the FFA deliberately high for strategic reasons

Expense Ratio

Expense Ratios

- The expense ratio measures the operational costs incurred by the company in managing the participating fund, expressed as a percentage of total premium income.
- Different type of expenses in the participating fund:
 - Acquisition costs
 - Maintenance costs
 - Overheads
- The IRDAI sets the expense limits for the life insurance companies based on:
 - Type of insurance product.
 - Company's premium income
- For participating funds, expenses must be allocated appropriately to ensure fairness between policyholders and shareholders.

Why different companies could have different expense ratios?

➤ Product Portfolio & Complexity

- Different products have unique features and complexities
- Complex products might have higher costs for administration, development and servicing

➤ Distribution Strategies

- Expense ratio may vary by choice of channel
- Agents incur higher commissions and servicing costs.
- Digital/Direct Channel incurs lower distribution costs but may need higher marketing spend
- The mix of channels impacts the overall expense ratio.

Why different companies could have different expense ratios?

➤ Economies of Scale

- Larger insurers spread fixed costs over a bigger premium base, lowering per-unit expenses.
- Smaller insurers face higher expense ratios due to limited scalability.

How companies demonstrate policyholder interests?

- Compliance with the Expense of Management Regulations
 - Expense Sources include administration, investment expenses, underwriting, claims management, and commissions.
 - IRDAI Regulations (2024) mandate insurers must allocate expenses fairly and transparently.
 - Expense Apportionment must follow insurer's policy, ensuring equitable distribution across business segments.

How companies demonstrate policyholder interests?

- Board-Approved Expense Allocation Policy:
 - Strategies to enhance cost-effectiveness and minimize expenses.
 - Methods for sharing cost savings with policyholders.
 - Guidelines for distributing expenses across business sectors.
- The responsibility of implementation is on the AA and CFO
- With Profits Committee (WPC):
 - Insurers must establish a WPC as per IRDAI (Insurance Products) Regulations, 2024.

The WPC is responsible for:

 - Approving the methodology of asset shares calculation.
 - Appropriateness of the expenses debited to the with profit fund
 - A note on how Policyholders' reasonable expectation(PRE) is met

How companies demonstrate policyholder interests?

- Policyholder Protection Committee
 - Mandated committee to protect policyholder interests.
 - Sets standards for fair customer treatment.
 - Develops systems for complaints and grievance resolution.
 - Ensures compliance with legal policyholder protections.
- Role of the Appointed Actuary
 - Ensures asset share expenses align with illustrated bonuses
 - Some flexibility in renewal expenses if aligned with expectations.
 - Acquisition expenses must reflect benefit illustrations.
 - Any deviations must be documented.
 - Promotes fair surplus distribution despite varying expense ratios.

Thank You

