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Regulatory Impact Assessment in Insurance Sector in India

Facilitating Investments and Enabling Access

CUTS International

Regulatory Impact Assessment in Insurance Sector in India:
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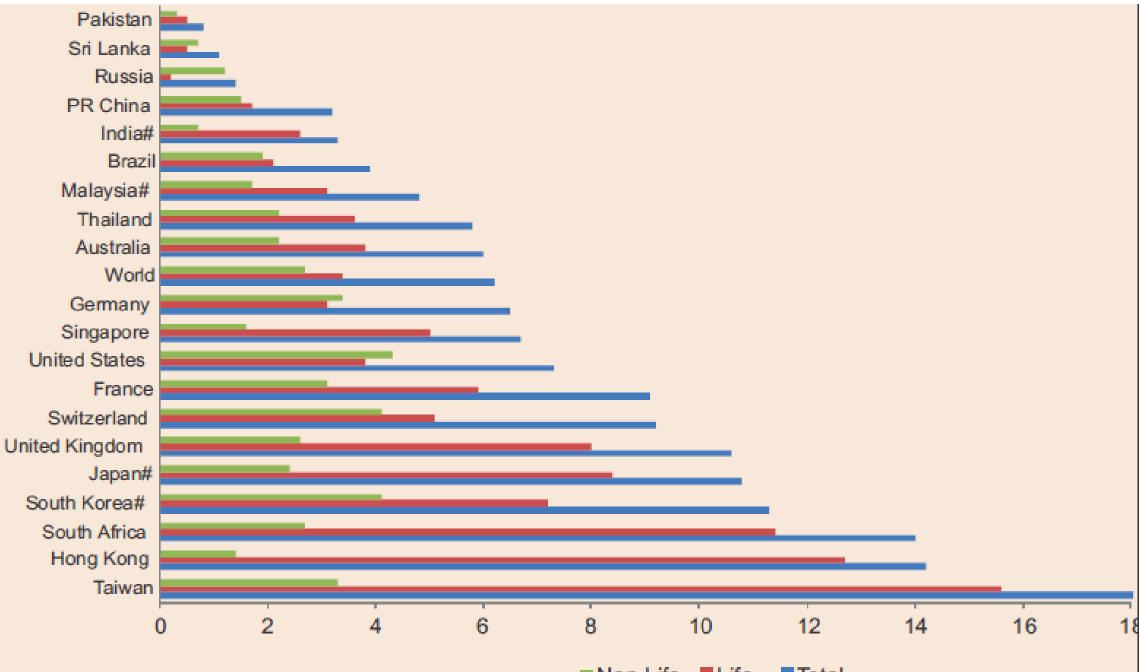
Chapter 1
State of Insurance Sector

Insurance is a public good and access to basic insurance services is necessary for dealing with contingencies and emergency situations. Insurance becomes much more essential in country like India with significant poor population, facing income and health uncertainties.

India currently accounts for less than 1.5 percent of the world's total insurance premiums and about 2 percent of the world's life insurance premiums despite being the second most populous nation.[1] Access to basic financial services is essential to enable poor deal with uncertainties and contingencies. The insurance sector is very similar to the banking sector in that both are vehicles and instrumentalities for encouraging savings amongst the people in the country.

Figure 1.1: Insurance Penetration in Select Countries (2014)[2]



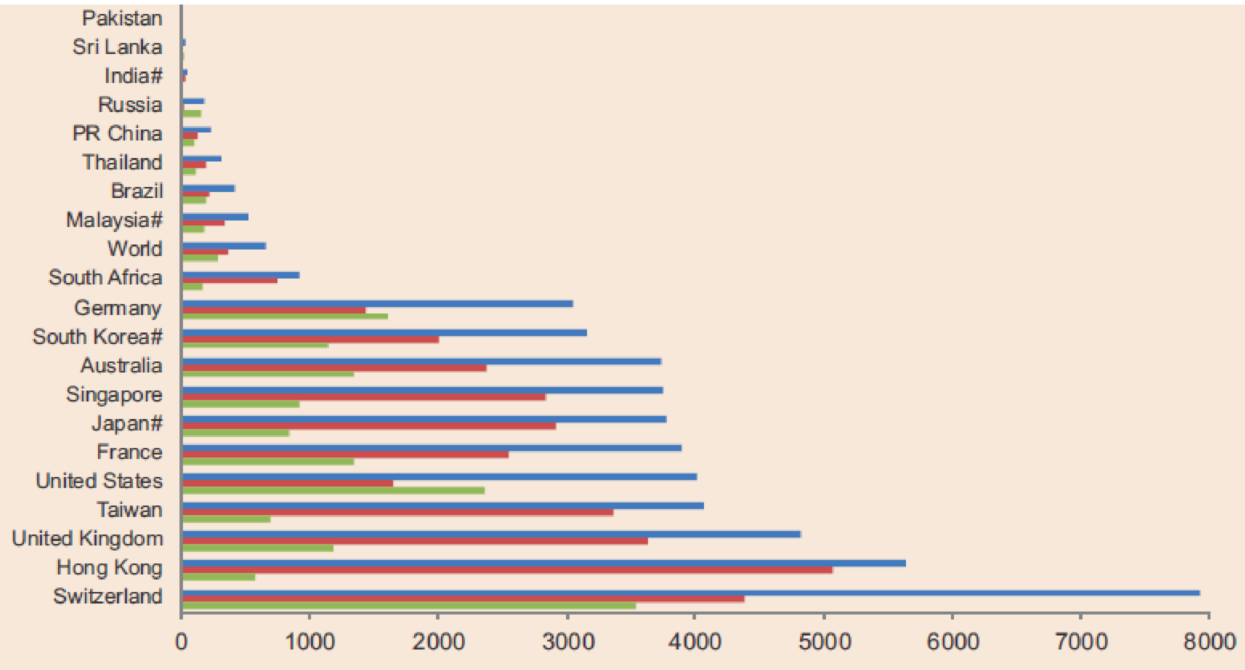
Source: Swiss Re, Sigma No. 4/2015. Data is in percent.
Data relates to Financial Year

Access to insurance is measured by indicators like insurance penetration and insurance density. Insurance penetration is the ratio of premium collected in a given year to the gross domestic product (GDP) and density is ratio of premium collected in a given year to the total population. The measure of insurance penetration and density reflects the level of development of insurance sector in a country. India is witnessing a consistent drop in insurance penetration and density. During the first decade of insurance sector liberalisation, the sector has reported consistent increase in insurance penetration from

[1] India Brand Equity Foundation, *Insurance Sector in India*, December 2015, http://www.ibef.org/industry/insurance-sector-india.aspx, accessed on 19 January 2016
[2] Figure taken from IRDA Annual Report 2014-15

2.71 per cent in 2001 to 5.20 percent in 2009. However, since then, the level of penetration has been declining reaching 3.3 percent in 2014. This has been the lowest since 2005-06, when the penetration was at 3.14 percent. Globally, the average insurance penetration stands at 6.2 percent. A similar trend was observed in the level of insurance density which reached the maximum of USD 64.4 in the year 2010 from the level of USD 11.5 in 2001. During 2014, the insurance density was USD 55.0. Without adequate insurance penetration and density, the poor would remain excluded from the benefits of formal financial system and depend on costly informal sources to deal with uncertainties, thus remaining trapped in the vicious cycle of poverty.

Figure 1.2: Insurance Density in Select Countries (2014)



Source: Swiss Re, Sigma No. 4/2015. Data is in USD
data relates to financial year

Deprivation from life insurance

India's share in global life insurance market was merely 2.08 percent during 2014. The life insurance premium in India increased only by 1.0 percent (inflation adjusted) when global life insurance premium increased by 4.3 percent.[3] While the insurance density of life insurance business had gone up from USD 9.1 in 2001 to reach the peak at USD 55.7 in 2010, it declined to a mere USD 44 by 2014. The global life insurance density is around USD 400 and countries such as Switzerland and Japan recorded a life insurance density of more than USD 4,000 in recent years.

Similarly, the life insurance penetration in the country had surged from 2.15 percent in 2001 to 4.60 percent in 2009. Since then, it has exhibited a declining trend reaching 2.6

[3] IDRA Annual Report 2014-15, January 2016

percent in 2014.[4] Countries such as Taiwan, South Africa and Japan have consistently recorded a life insurance penetration of more than 10 percent.[5] During 2014-15, the life insurance industry witnessed a 36.61 percent decline (7.50 percent decline in 2013-14), in the number of new policies issued.[6]

Given the importance of life insurance in one's life, and performance of this segment in the country, greater push is required to increase penetration and density of life insurance. The insurance industry of India consists of 53 insurance companies of which 24 are in life insurance business and 28 are non-life insurers.[7] During the decade from fiscal 2004 to fiscal 2014, the life insurance premium market in India expanded at a Compounded Annual Growth Rate (CAGR) of 15.3 percent, from USD 14.5 billion in FY04 to USD 60.3 billion in FY14. The non-life insurance premium market rose at a CAGR of 16.3 percent, from USD 3.4 billion in FY04 to USD11.7 billion in FY14.[8] However, this growth rate fades on comparison with peers. The total real premium growth rate in 2013 in emerging economies was 7.4 percent but India recorded a negative growth of -0.4 percent. In life insurance segment the emerging market growth rate was 6.4 percent, whereas India recorded a negative growth of -1.1 percent.[9] As a result, access to insurance, and specifically life insurance, is still a luxury to many in the country. The need to increase insurance penetration is often discussed in the Parliament, with a suggestion to introduce regulatory and taxation reforms with this objective.[10]

Reasons for insufficient access

Majumdar (2015) suggests that insurance penetration has remained low in rural and informal sectors of the country on account of several reasons, including: low quality/ skill of agents in rural areas; inadequate use of alternate channels of distribution (such as banks) by insurers in rural areas; lack of customised products for rural and informal sector; sub-optimal marketing of low cost group insurance products, etc. It has been suggested that agents need to be better trained and properly motivated to tap rural and informal market; banks need to increase their involvement in rural and informal sector; and customised products needs to be designed for increasing insurance reach to rural areas.[11]

Problems like poor infrastructure in rural areas, high agent procurement cost, need of significant efforts to gain trust and confidence of rural inhabitants, low awareness level,

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[4] M. Saraswathy, *Insurance penetration at 10-year low,* Business Standard, 25 June 2015 , and IDRA Annual Report 2014-15, January 2016

[5] Pradeep S Mehta (ed.), *Competition, Regulation and Consumer Protection in Indian Financial Sector*, State of Competition and Regulation in India, CUTS International, 2013

[6] IDRA Annual Report 2014-15, January 2016

[7] IRDAI, *Insurance market,* IRDAI Consumer Education Website, http://www.policyholder.gov.in/indian_insurance_market.aspx, accessed on 09 January 2016

[8] India Brand Equity Foundation, *Insurance,* August 2015

[9] Swiss Re, Sigma 3/2014, as cited in IRDA Annual Report 2013-14, January 2015

[10] Rajya Sabha unstarred question no 2230, answered on 13 December 2012, as "*consultations have been held with the insurance industry and steps have been identified for action, to give fillip to the sector and expand insurance penetration. These include regulatory issues as well as tax related measures including direct tax and service tax benefits*."

[11] Nirjhar Majumdar, *There is a business opportunity at the bottom of the pyramid,* IRDAI Journal: Next Stop for Insurance – Rural Insurance, June 2015

need to travel long distances, high illiteracy levels, high cost of operations, etc. have been repeatedly identified as a reason for low insurance penetration and density.[12]

A recent joint study by CRISIL and ASSOCHAM noted that insurance has been hitherto largely sold as a tax-saving instrument rather than as a safety cushion for contingencies. There is a considerable amount of misinformation about insurance in the mind of the average Indian investor and hence a crying need to change people's perception and outlook on insurance. It stressed that in order to increase insurance penetration, steps required include, making premium more affordable; creating insurance awareness; simplifying products for the masses; designing tailor-made products for different target audience.[13] The study highlights that the key to enhancing insurance penetration is investing in distribution.

Problems in expanding reach of life insurance

A 2013 study by Insurance Information Bureau highlighted that more than 55 crore people in the country have very limited access to life insurance. The bottom 120 districts in terms of life insurance penetration had an average agency penetration[14] of 0.77 during 2012-13, compared with an all-India average of 3.15, and the agency penetration in top 50 districts being more than 7. The report highlights the causes for low agency penetration, and consequently, low life insurance penetration and density amongst low income segments as, *inter alia*, low appetite for insurance; non availability of qualified agents in these locations; low ticket sizes; high cost of operation and viability for life insurers.[15] Other challenges that life insurers face, as highlighted by Hegde (2015), include the geographical spread of rural branches across the length and breadth of the country making it difficult to ensure the presence of a life insurance expert at these branches; non-availability of technology backbone similar to what is available in urban branches; and high cost of doing business in these locations vis-à-vis the business generated.[16]

The inability of insurance industry to expand its reach has been exacerbated by high agent attrition rate. Reports suggest that 24 life insurers collectively lost nearly nine lakh agents in just five years to other sectors[17], and the Life Insurance Council suggests that there was a decline of more than 24,000 in the agency force in the first nine months of fiscal 2016.[18]

[12] R. Venugopal, *Reaping the rural revolution,* IRDAI Journal: Next Stop for Insurance – Rural Insurance, June 2015

[13] ASSOCHAM India and CRISIL Research, *Inclusion + Intermediation + Technology = Inflection, The next game in Insurance*, October 2015

[14] The report defined agency penetration as the number of valid life insurance agency licenses per thousand population.

[15] Insurance Information Bureau, *Spread of life insurance agents across locations in India*', November 2013

[16] Ashay Ravi Hegde, *Increasing insurance penetration to rural and informal sector of the economy,* IRDAI Journal: Next Stop for Insurance – Rural Insurance, June 2015

[17] *Policy of Quitting Claims 9 Lakh Insurance Agents in Five Years*, The New Indian Express, 15 December 2015. It notes, "Youngsters do not want to become insurance agents. Selling insurance is a tough job — the youth find it difficult to understand and communicate. Despite training, we are unable to retain them," V Manickam, Secretary, Life Insurance Council told Express. Insurers have been losing about 30,000-40,000 agents every month and the number now stands at 20,37,007 agents as on November, 2015 down from 28,98,653 in FY10. "These 20 lakh agents reached out to just 25 crore people and still 75 crore are yet to be addressed," Manickam said."

[18] Deepa Nair, *Agent attrition continues to haunt life insurers,* The Hindu Business Line, 18 January 2016

The Insurance Information Bureau estimated that increase in number of agency licenses by close to 2,00,000 licenses in under exploited states in the country has the potential to generate additional new business premium of more than Rs. 3,000 crore.[19] However, increasing agency network is expected to require significant investments in recruitment, training and retaining agents.

While insurance industry as a whole is facing problems to increase access, life insurance segment in particular is grappling with severe constraints. These limitations need to be urgently addressed to increase the life insurance penetration and density in India.

Need to increase investments

The level of insurance access depends on a large number of factors like level of economic development of the economy, the extent of the savings in financial instruments and the size and reach of the insurance sector.[20] Insurance penetration and density cannot increase without more investments,[21] and significant increase in the number of investors and players going deeper into the countryside. Insurance has been a historically significant product for investors and its popularity is likely to grow exponentially as more investors realise its importance. Insurance penetration and investments in the sector are pro-cyclical in nature. This means that low penetration limits revenue generation and consequently the bottom line of insurers, thus attracting fewer investments. Inadequate investments in the sector limit the opportunity of insurers to expand the operations and increase penetration. There is an urgent requirement to break this cycle for industry to grow.

It has been expected that the insurance industry will require INR500 billion (US$7.5 billion) to INR600 billion (US$8.9 billion) in capital to improve insurance penetration in the country from around 3 percent of gross domestic product at present to 6 percent, the world average.[22] Investments will be required for increasing last mile access, creating effective agency structures, identification of alternative network channels, etc.[23] According to Swiss Re (2015), technology and the digital data revolution is expected fundamentally change the business of insurance. To grow their business, insurers will need to review their investments in technology, rethink talent strategy and adapt their business models.[24] Consequently, the industry needs to invest in innovation and technology to come up with low cost products, automate various processes and cut costs without affecting service delivery.[25]

[19] Insurance Information Bureau, *Spread of life insurance agents across locations in India*', November 2013
[20] Rajya Sabha unstarred question no 1375, answered on 10 March 2015
[21]PTI, *FDI hike in insurance will help deepen penetration: Vijayan*, 10 December 2015
[22] Asia Insurance Review, *India: Insurers need USD 9 billion to reach global average penetration*, 16 December 2015. In March 2015, Minister of State for Finance Jayant Sinha said: "What we estimated is, if we have to increase insurance penetration from 3 percent currently to 6 percent, then we will require capital somewhere in the range of INR400-500 billion, of which of course 49 percent will have to come from FDI. "So we are talking about (foreign) investment in the range of INR250 billion in the insurance sector to really ensure that we get to 6% penetration in the medium term."
[23] K. Kumar, *Need for increasing insurance penetration in India*, Bimabazaar, March 2014
[24] Swiss Re, Life insurance in the digital age: fundamental transformation ahead, Sigma No 6/2015. It notes, "*While new technology presents opportunities, but also gives rise to new challenges that life insurers need to address. One is regulation, with lack of clarity and consistency around data protection and privacy.*"
[25] India Brand Equity Foundation, *Insurance,* August 2015

Investments required in life insurance

Life insurance industry is capital intensive, and insurers are required to infuse capital at regular intervals to fund both the new business strain and to expand their infrastructure base including expenses on initial operations, training costs for development of the distribution channels, creating niche markets and achieving reasonable levels of persistency. The experience of the insurance markets globally indicates that companies in the life sector take seven to ten years to break-even.[26] Many private players in the life insurance sector have incurred losses due to lack of scale and the long term and capital intensive nature of business. Moderate- to-heavy losses and slow premium growth have led several foreign joint ventures to exit the Indian life insurance market.[27] Consequently, there is a need to review investment scenario in life insurance sector, and address prevailing challenges.

Potential to increase returns for industry

Improvement in insurance access is not merely important from society's point of view, but is also significant for industry's growth. As per the existing growth rate of the industry, the premium collected and the commissions in the life insurance is expected to grow by Compound Annual Growth Rate (CAGR) of 15 percent each, by 2020 to Rs. 7.22 lakh crore ($115.44 bn) and Rs. 48,000 crores ($7,674 mn), respectively. The premium and commission under non-life segment are expected to grow by CAGR of 12 percent each- to Rs.0.98 lakh crore ($15.67 bn) and Rs.6,400 crores ($1,023 mn), respectively. However, with increase in investments and penetration, the premium collected and the commissions in the life insurance segment is expected to grow by CAGR of 19 percent each, by 2020 to Rs. 8.74 lakh crore ($139.74 bn) and Rs. 58,000 crores ($9,273 mn), respectively. The premium and commission under non-life segment is expected to grow by CAGR of 17 percent each to Rs.1.31 lakh crore ($20.94 bn) and Rs.8,500 crores ($1,359 mn), respectively.[28]

The country is fifteenth largest insurance market in the world in terms of premium volume, and has the potential to grow exponentially in the coming years. India's insurable population is anticipated to touch 750 million in 2020, with life expectancy reaching 74 years. Furthermore, life insurance is projected to comprise 35 percent of total savings by the end of this decade, as against 26 percent in 2009-10. Demographic factors such as growing middle class, young insurable population and growing awareness of the need for protection and retirement planning are expected to support the growth of Indian life insurance.[29] India's insurance market is expected to quadruple in size over the next 10 years from its current size of US$ 60 billion. During this period, the life insurance market is slated to cross US$ 160 billion. The general insurance business in India is currently at

[26] IRDA Annual Report 2013-14, January 2015

[27] India Briefing, *Investing in India's Insurance Sector,* 16 June 2015, http://www.india-briefing.com/news/investing-indias-insurance-industry-10856.html/, accessed on 09 January 2016

[28] Financial Intermediaries Association of India and CRISIL Research, *Indian Financial Distribution Industry at the cusp: Vision 2020,* March 2015

[29] India Brand Equity Foundation, *Insurance sector in India,* December 2015, http://www.ibef.org/industry/insurance-sector-india.aspx, accessed on 09 January 2016

Rs 78,000 crore (US$ 11.7 billion) premium per annum industry and is growing at a healthy rate of 17 per cent.[30]

As per the FIAI-CRISIL report on India's financial distribution industry, assuming penetration levels remain the same as today, the insurance industry is estimated to log a none-too-inspiring growth rate. In case of life insurance, total premium is expected to increase from Rs 3.14 lakh to Rs 7.41 lakh crore by 2020, while in the non-life segment premiums could grow to around Rs 1.38 lakh crore from Rs 0.71 lakh crore. However, should penetration increase, as a result of increased investment, the total premium in the life insurance segment is estimated to nearly treble from Rs 3.14 lakh crore in 2014 to Rs. 8.98 lakh crore in 2020, even as the non-life insurance segment goes from Rs 0.71 lakh crore to Rs 1.83 lakh crore.[31] The large population in India that is currently underinsured or uninsured presents a huge opportunity for the life insurance industry. As more youngsters enter the workforce, there will be a burgeoning need for financial security and life insurance will play a crucial role in providing this. Consequently, it is crucial for the industry to enhance penetration so as to be able to reach out to the farthest corner of the country.[32]

Increase in investment is also necessary to meet customer expectations. The World Insurance Report 2015 highlights that customer experience declined globally in 2014 indicating that insurers are not keeping pace with rising expectations. India was amongst the bottom 10 countries recording a drop of 7.6 percent in customer experience. The report notes that digital channels are dragging down customer experience levels around the world, and insurers of the future will need to fully blend agent-guided, high value engagements with digital transactions via mobile and social media, to meet customer expectations.[33]

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[30] India Brand Equity Foundation, *Insurance,* August 2015

[31] Financial Intermediaries Association of India and CRISIL Research, *Indian Financial Distribution Industry at the cusp: Vision 2020,* March 2015

[32] Jimmy John, *India: Life is Positive,* Asia Insurance Review, January 2016

[33] Capgemini and Efma, *World Insurance Report, 2015,* available at https://www.worldinsurancereport.com/

Chapter 2
Need for Regulatory Impact Assessment in Life Insurance Sector

Regulations affect behaviour of any stakeholder in any sector and unsurprisingly, they play a major role in investment related decisions in the life insurance sector. While an enabling and predictable regulatory regime provides confidence to investor to investment capital and skill in any sector, an uncertain regulatory and policy regime could force existing and potential investors to review their decisions and hold back further investments.

The World Investment Report (2015) notes the global foreign direct investment inflows fell by 16 percent in 2014 to USD 1.23 trillion, down from USD 1.47 trillion in 2013. This decline was influenced mainly by the fragility of the global economy, policy uncertainty for investors and elevated geopolitical risks. Handley and Limao (2012) provided evidence that policy uncertainty can significantly affect firm level investment and entry decisions in the context of international trade. Gulen and Ion (2013) discovered that policy-related uncertainty is negatively related to firm and industry level investment, and the economic magnitude of the effect is substantial. Anand and Tulin (2014) established that heightened uncertainty and deteriorating business confidence in India have played a key role in investment slowdown. Similarly, Bernanke (1983) pointed out that high uncertainty gives firms an incentive to delay investment and hiring, when investment projects are expensive to cancel or workers are costly to hire and fire. Dixit (1989) showed that uncertainty about future prices creates an option value of waiting, so firms will delay investments in entry or exit until they receive more information. Also, Dixit and Pindyck (1994) found that in the presence of uncertainty and given the irreversibility of investment decisions, investors may choose to forego or delay investment to avoid bearing the cost of investing in the wrong activity.[34]

Consequently, there is a need to review the regulatory scenario in insurance sector, in order to assess if it is restricting investments or is not providing appropriate incentives to promote investments.

Regulatory impact assessment is a globally recognised tool to assess impact of regulatory proposals by estimating costs and benefits of such regulations on different stakeholders, including economy, society and environment. It has been adopted by several advanced economies, including United States, United Kingdom and Australia. The US President recently issued an executive order directing use of behaviour science to design government policies. The order states, "*the Federal Government should design its policies and programs to reflect our best understanding of how people engage with, participate in, use, and respond to those policies and programs.*" The order was part of a series of orders

[34] CUTS International et al, *Background note: Reducing Policy Uncertainty to Revive Investment*, October 2014, available at http://goo.gl/glS4PR

issued from time to time to improve regulation and reduce regulatory burdens, using evidence based policy making.[35]

The EU also recently updated its better regulation toolbox, of which impact assessment is a salient feature. The Red Tape Challenge in UK has resulted in £300 million in annual savings to 100,000 small businesses from increased flexibility on audit requirements, and around £132 million estimated savings to business from cleaner guidance about contaminated land use. The One-In Two-Out rule in UK essentially requires estimation of burden of existing and proposed regulations to enable removal of £2 of existing regulatory burden, for introduction of every £1 of regulatory burden. RIA has been recommended for India by several expert committees like Financial Sector Legislative Reforms Committee, Damodaran Committee, and Tax Administration and Reforms Committee.

Consequently, in order to determine efficiency of prevailing regulations, and assessing if these are promoting or hindering investments, RIA in insurance sector would be necessary.

Regulatory architecture in insurance sector

The regulatory architecture of insurance sector in the country is very wide and complex. The Insurance Act, 1938 is the principal legislation in the insurance sector. It was enacted to consolidate and amend the law relating to insurance in the sector. It requires insurers to obtain a certificate of registration from IRDA for carrying on insurance business, and insurance agents to obtain a license. It also sets out minimum limits of annuities and other benefits secured by policies of life insurance, capital requirements, voting rights in insurance companies etc. The Insurance Act also requires insurer to make specific investments, and specifies restrictions on granting loans on insurers. It empowers IRDA to restrict payment of excessive commission, conduct investigation and inspection, and change management. It also sets limitation of different expenses which could be made by insurers. The Insurance Act is perhaps the only primary law which has the foreign investment limit prescribed in the statute. At present, Indian owned and controlled insurance companies are permitted to have foreign investment up to 49 percent of their paid up share capital. This recent increase in the maximum allowable ownership of insurers from 26 percent to 49 percent is likely to stimulate additional investment in the market sector, which is in great need of capital and product and service innovation.[36] Such investments will take their own time, and can happen only when regulatory certainty and predictability is the order of the day.

The IRDA Act, 1999 was enacted to establish IRDA to protect the interests of holders of insurance policies, and to regulate, promote and ensure orderly growth of the insurance industry. It provides for composition and membership of IRDA, its duties, powers and functions, powers of central government to issue directions to IRDA etc. In addition, IRDA and Ministry of Finance issues several circulars, regulations, guidelines, press notes, rules etc to regulate the industry.

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[35] US Executive Order, *Using Behavioral Science Insights to Better Serve the American People*, 15 September 2015, available at https://goo.gl/gQ5RMw

[36]E&Y, *2015 Global Insurance Outlook*

Focus on life insurance

The regulatory instruments issued by different regulatory agencies cover diverse segments of the insurance industry, such as life, general, health, and reinsurance. They also cover insurance intermediaries like agents, brokers, surveyors, web aggregators, repositories and marketing firms.

However, as indicated earlier, life insurance is one of the most critical segments of insurance sector. Access to life insurance is extremely low in the country and the efforts to reach out to the masses have not resulted in desired results. Moreover, life insurance being capital intensive business, it has substantial investment requirements.

Limiting the scope of this report is also essential taking into account the time availability and capacity constraints. Consequently, this report conducts RIA in life insurance sector. This approach has been approved by the experts comprising national reference group for the project.

Chapter 3
Description of key regulations

The primary and secondary regulations in life insurance sector cover various aspects of this business. This include regulations on investors in insurance companies, investment which insurers are permitted to make, the extent of expenses and commissions allowed to be paid, design of non-linked and linked products etc. The regulations also cover registration requirements for brokers, agents and conditions for banks acting as agents, disclosure requirements in advertisements, grievance redress mechanisms etc. With the advent of Insurance (Amendment) Act, 2015, the regulator is reviewing many of these regulations, and has been putting revised drafts in public domain for consultation.[37]

In order to identify critical legislations that influence investment decisions in the insurance sector, primary and secondary research was conducted. This involved desk research and review of existing regulations in life insurance, identifying their relation with investments in the sector, identification of information gaps, developing of stakeholder interaction tools, discussion with stakeholders for plugging the information gaps and validating findings of secondary research, and finalisation of regulations for RIA.

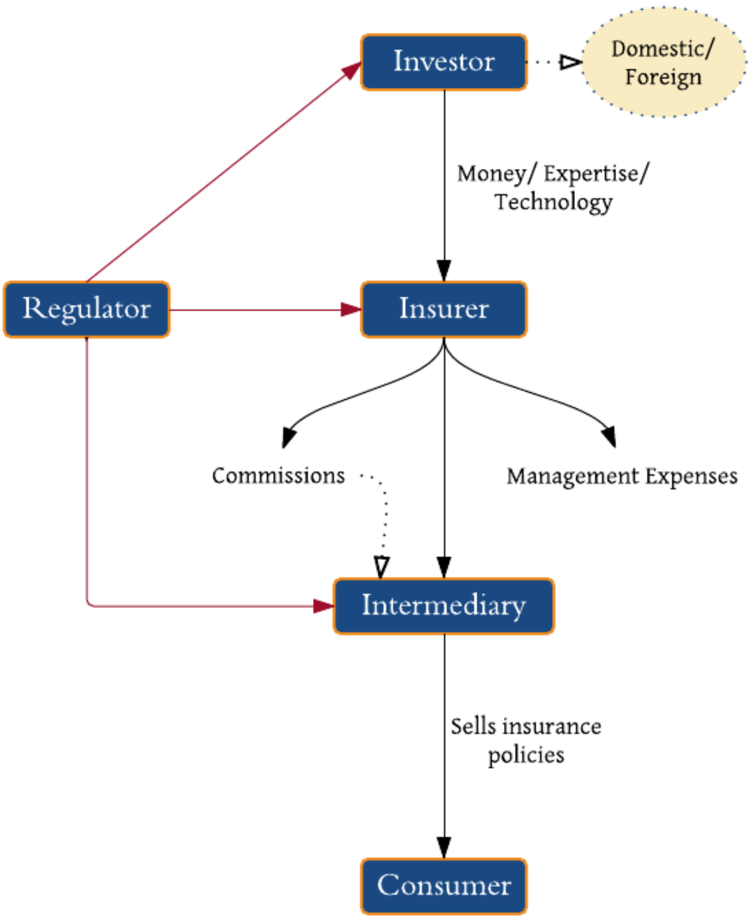
Key stakeholder categories in life insurance sector are investors, insurers, intermediaries and consumers. The sector regulator attempts to nudge behaviour of these stakeholders towards consumers' interests. Investments in the sector are guided by the burden that regulations impose on these stakeholders.

Initial literature review and stakeholder interaction revealed that regulations dictate behaviour of investors with the respect to the amount and the related rights which could accrue to investors. There are regulations around operating expenses of insurers, commissions of intermediaries, and the products which the insurers are supposed to push.

All this impacts the expenses of management and operating costs of insurers and their consequent need for investments. Regulations around remuneration and retention of consumers by intermediaries and insurers guide the interaction between insurers/ intermediaries and consumers. Treatment of consumers by market players impacts revenues for insurers and consequently determines attractiveness of insurers for investors.

[37] Exposure drafts issued by IRDA are available at https://goo.gl/xSJeud

Figure 3.1: Relationship between different stakeholders in the insurance sector



In light of above, regulations governing following areas in life insurance sector were selected to conduct RIA:

1. Investment in insurance companies
2. Expenditure by insurance companies
3. Retention of consumers

Consequently, this study attempts to study regulations, which directly influence investors, insurers and intermediaries, without losing sight of consumers' interest and regulator's role in the sector.

Regulation of investment in insurance companies

A private insurance company can raise capital from domestic as well as foreign sources, and there are regulations on both.

Foreign investment:

The Insurance Act, 1938, is perhaps the only national legislation in which the foreign investment cap features.[38] At present, foreign investment is permitted up to 49 percent of paid up equity capital of Indian insurance companies[39], which are Indian owned and controlled. While earlier the increase in foreign ownership beyond 26 percent was under the government route and required permission from the Foreign Investment Promotion Board the same is now permissible under the automatic route.[40]

The Insurance Act previously allowed foreign investment up to 26 percent of paid up equity capital in Indian insurance companies, which was amended with effect from December 2014, to 49 percent with permissions[41] and subsequently in March, 2016 to its current position.[42] The condition of Indian insurance companies being Indian owned and controlled, did not exist previously. The Ministry of Finance clarified the scope of Indian ownership and control pursuant to rules made in February 2015.[43]

The issue of need to increase foreign investment in insurance sector was first raised in 2002[44] and it took more than a decade for the change to happen. This draft legislation has gone through several amendments, including review by Parliamentary Standing Committee on Finance, and the Select Committee on Insurance Bill.

The IRDA has also initiated the process of amending its regulations to ensure compliance with the provisions of the Insurance (Laws) Amendment Act, 2015, including in relation to increase in the foreign investment limit. In October 2015, it issued guidelines on 'Indian owned and controlled', with the objective of bringing clarity for compliance with the manner of 'Indian owned and controlled'[45]. To ensure compliance with the said condition

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[38] Section 2(7A) of the Insurance Act

[39] Insurance companies incorporated in India

[40] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10316&Mode=0, Last accessed on 4th April, 2016

[41] The Insurance Laws (Amendment) Act, 2015

[42] Foreign Direct Investment (FDI) in India – Review of FDI policy –Insurance sector, Notification, Reserve Bank of India, 31st March, 2016

[43] The Indian Insurance Companies (Foreign Investment) Rules, 2015, clarified that 'Indian Ownership' of an Indian Insurance Company means more than 50 percent of the equity capital in it is beneficially owned by resident Indian citizens or Indian companies, which are owned and controlled by resident Indian citizens. 'Indian Control of an Indian Insurance Company' was defined to mean control of such Indian Insurance Company by resident Indian citizens or Indian companies, which are owned and controlled by resident Indian citizens.

[44] In April 2002, the IRDA requested the Law Commission of India (Law Commission) to review the provisions of Insurance Act and IRDA Act. The 190th report of the Law Commission (2004) noted, "*One issue that repeatedly surfaced during discussions with the industry was whether the law should be amended to permit greater foreign equity participation than the present limit of 26%. There were also questions raised about permitting insurance companies to have branches outside of India and to conduct business outside India. The Law Commission does not have the benefit of the views of the Government or the IRDA on these matters. In the Law Commission's perception these are matters on which a policy decision will have to be taken by the Government in consultation with the industry and the IRDA. The Law Commission is not making any research in this matter.*"

[45] No draft of such guidelines was issued in public domain for comment. The guidelines were issued under the powers conferred to IRDA under the IRDA Act, and. The guidelines are not only applicable to Indian insurance companies which may come into existence after Insurance Laws (Amendment) Act, 2015 comes into force or where Indian insurance companies propose to hike their foreign investment from the existing

the Indian insurance companies are required to ensure that majority of directors (excluding independent directors) are nominated by Indian promoter(s)/ Indian investor(s). The appointment of key management person including Chief Executive Officer / Managing Director /Principal officer should be through the board of directors or by the Indian promoter (s) / Indian investor(s). In addition, where the chair of the Board has a casting vote, such person is required to be nominated by Indian promoter(s). The quorum for board meeting will be considered met if the majority of directors present are nominated by Indian investors, and even if no participation from foreign investors' represented directors happens. Existing Indian insurance companies are required to comply with the guidelines within a prescribed timeframe.[46]

Raising capital from domestic sources:

Previously, insurance companies were allowed to have capital only in form of ordinary shares. The Insurance Laws (Amendment) Act changed this situation and allowed insurance companies to have capital in such other forms, as may be specified by regulations by IRDA. Consequently, in November 2015, IRDA issued regulations allowing insurance companies to have capital in form of preference shares and subordinate debt, in accordance set out under the regulations.[47]

In addition, IRDA has recently has issued regulations regarding issuance of capital by Indian life insurance companies.[48] These regulations are in supersession of regulations made in 2011, which allowed insurance companies to raise share capital through public issue only on completion of 10 years from the date of commencement of business, or any other period prescribed by the central government. This was on account of erstwhile provision in the Insurance Act requiring dilution of promoter equity in excess of 26 percent of paid up equity capital of the insurer company after a period of 10 years.[49] This provision has been repealed by the Insurance Laws (Amendment) Act.

Indian insurance companies transacting in life insurance business are required to take prior written approval from the IRDA before approaching SEBI for public issue of shares and further issue under SEBI (Issue of Capital and Disclosure Requirements) Regulations.

IRDA has also issued regulations on transfer of equity shares of Insurance companies.[50] The regulations provide for prior approval of IRDA in case of transfer of shares likely to result in holding of transferee exceeding 5 percent of paid up equity capital of the company. The foreign investors are required to hold shares in insurance companies in accordance with Indian Insurance Companies (Foreign Investment) Rules, 2015.

level, but also to those existing Indian insurance companies which do not intend to increase their current foreign stake from the existing level.

[46] The Indian insurance companies are required to submit an undertaking signed by Chief Executive Officer and Chief Compliance Officer, conforming the compliance of 'Indian owned and controlled' conditions. The undertaking is required to be accompanied by a board resolution to this effect, and an amended copy of agreement/ JV venture agreements, wherever applicable.

[47] IRDA (Other Forms of Capital Regulations) 2015

[48] IRDA (Issuance of Capital by Indian Insurance Companies transacting Life Insurance business) Regulations, 2015, issued in December 2015

[49] Section 6AA (now repealed) of the Insurance Act

[50] IRDA (Transfer of Equity Shares of Insurance Companies) Regulations, 2015, issued in April 2015

Expenditure by insurance companies

Two critical components of expenditure by insurance companies are commission payable to intermediaries and the expenses which management is allowed to make respect to different insurance product segments. Insurance regulations govern both these aspects of expenditures by insurance companies.

Commission paid to intermediaries

Key intermediaries in insurance sector include individual agents, corporate agents, brokers, and insurance marketing firms. The Insurance Act empowers the IRDA to restrict the payment of excessive remuneration to any person, by way of regulations issued in this regard.[51] Prior to the Insurance Laws (Amendment) Act, section 40A of the Insurance Act capped commission/ remuneration in any form in life insurance business, according to the type of insurance, term, and year of premium.[52] Section 40A was omitted by the 2014 amendment. The amendment, however, provides that IRDA shall take into account the nature and tenure of the policy and in particular the interest of the agents and other intermediaries concerned, while making regulations with respect to remuneration of intermediaries.[53]

At present, IRDA has linked commissions to premium collected on the relevant insurance products. Life insurance companies can offer participatory[54] or non participatory[55] products. Participatory products can be offered only under non-linked[56] platforms, while non-participatory products may be offered either under linked[57] or non-linked platforms.

Thus, three main product segments in the sector (relevant to study) are participatory non linked policies (such as endowment plans), non participatory non linked policies (such as term insurance policies), and non participatory linked policies (such as unit linked insurance policies).

[51] Section 31B

[52] Section 40A of the Insurance Act provided:

1. Where the policy grants an immediate annuity or a deferred annuity in consideration of a single premium, or where only one premium is payable on the policy, two per cent of that premium,
2. Where the policy grants a deferred annuity in consideration or more than one premium, 7.5 of the first year's premium, and two per cent of each renewal premium payable on the policy, and
3. In any other case, 35 percent of the first year's premium, 7.5 percent of the second and third year's renewal premium, and thereafter 5 percent of each renewal premium payable on the policy. However, during the first ten years of business, an insurer can pay insurance agent up to 40 percent of first year premium payable.

[53] Section 40 of the Insurance Laws (Amendment) Act

[54] Policies with participation in profits, i.e. which are entitled for share in surplus (profits) during the term of the policy

[55] Policies without participation in profits, i.e. which are not entitled for any share in surplus (profits) during the term of the policy

[56] Non linked products are those where benefits assured are payable on the occurrence of specified event which is explicitly stated at the outset and not linked to any index or benchmark

[57] Linked products are those where benefits are partially or wholly dependent on the performance of underlying assets or approved external index/ benchmark, which is linked to the products

The IRDA regulations provide that in case of other than single premium products, the first year commission/ remuneration can range from 15-35 percent of the premium, and for subsequent years it could range from 5-7.5 percent of premium (See Table 3.1 for details).

As per relevant IRDA regulations, commission or remuneration in any form for the procurement of all individual policies in respect of all distribution channels except the direct marketing shall not exceed 2 percent of the single premium, in case of single premium products. In case of other than single premium products, the commission/ remuneration are capped as follows:

Table 3.1: Cap on premium/ remuneration

Premium paying terms	Maximum Commission or remuneration in any form as % of premium		
	1st year	2 & 3year	Subsequent years
5	15	7.5/5(*)	5
6	18	7.5/5(*)	5
7	21	7.5/5(*)	5
8	24	7.5/5(*)	5
9	27	7.5/5(*)	5
10	30	7.5/5(*)	5
11	33/30(*)	7.5/5(*)	5
12 years or more	35/30(*)	7.5/5(*)	5

* The maximum commission or remuneration:
(a) For brokers shall be
i) 30% in the first year for policies with premium paying term 10 and above; and
ii) 5% in the subsequent years for all premium paying terms
(b) During the first ten years of a life insurer's business for all intermediaries, except for brokers, shall be 40% in the first year for policies with premium paying term 12 and above

In addition, with respect to unit linked insurance products, IRDA has mandated distribution of overall charges in an even fashion during the lock-in period. The objective was to avoid front loading of expenses, and consequent high first year premiums.[58]

Management expenses

Like commission/ remuneration to intermediaries, insurance regulations links management expenses to premium collected through different product segments by the insurer. Rule 17D of the Insurance Rules, 1939 describes the caps on management expenses that any life insurance company can incur from the premium income. Expenses of management refer to all charges incurred either directly or indirectly and include commission payments of all kinds, operating expenses and expenditure capitalised. The rule takes into account the size, age of the insurance company as well as the type of business segment, for limiting the expenses.

There are also certain exemptions provided, for instance accounting for the high initial set-up costs that would be incurred, private insurance companies are exempt for a period of

[58] IRDA circular on Unit Linked Insurance Products dated 28 June 2010, available at https://www.irdai.gov.in/ADMINCMS/cms/Uploadedfiles/CIRCULAR_ULIP%2028062010.pdf. Accessed on 11 February 2016

five years from the commencement of business operations, from compliance of the mentioned rules.[59]

Retention of consumers

Life insurance is a long term product and would translate into value for all stakeholders if it completes its full term through regular payment of premium. Customer retention is critical to this industry and persistency is the term used to describe the ability to renew policies till it reaches maturity. It is the percentage of business retained which can be calculated as the proportion of policies remaining at the end of the period out of the total policies in force at the beginning of the period.[60] Retention of customers is also important to project adequate revenue growth and attract investments.[61]

The regulatory scenario around retention/ persistency has been subject to change in recent past. The IRDA guidelines on individual agents for persistency of life insurance policies[62] recognise the negative impacts of low persistency on the sector as a whole as well as the role that can be played by intermediaries to correct this scenario by putting in place minimum standards of performance. The guidelines states that agents should (i) avoid soliciting unsuitable products, (ii) ensure greater transparency by providing correct and complete details of the product and (iii) consider the needs of the policyholders.

The important aspects such as persistency rate, orphan policy and deferred commission have been defined. The guidelines originally provided that all renewals made prior to financial year 2014-15, the average persistency rate for each agent for the years 2011-12, 2012-13 and 2013-14 needs to be at least 50 percent in terms of number of policies as well as premium procured. Further, from financial year 2014-15, the same was required to be at least 75 percent for such agent. The renewal of the agent license was based on meeting these above conditions. The agents were required to maintain a record of the policies sold as well as their persistency on a year to year basis and the insurer was required to endorse by the same was at the end of the year.

Within two months on their coming into force, the guidelines were revised in September 2011. The revision set uniform average persistency rate as 50 percent which was to be reckoned on only on number of policies, thus excluding procurement of premium from the calculation of persistency. The revision also clarified that while arriving at the persistency rate, policies with ‘auto cover’ feature embedded as per File & Use approval may be

[59] Insurance Rules are available at http://financialservices.gov.in/Insurance/Acts/Insurance%20Rules%201939.pdf. Accessed on 11 February 2016

[60] http://www.lifeinscouncil.org/component/content/article/106-whats-new/478-exposure-draft-persistency-of-life-insurance-policies, Accessed on 4th February, 2016

[61] “There is a distinct link between persistency and profitability… . Any valuation should reflect the persistency track record of an insurer..”, Deepti Bhaskaran, *Need more transparency in participating insurance plans,* 23 December 2015, Livemint, at http://www.livemint.com/Money/utjj10D73Hcx1z29Xy4qGK/Need-more-transparency-in-participating-insurance-plans.html. Accessed on 11 February 2016

[62] The guidelines were originally issued on 11 February 2011 (and came into effect on 01 July 2011) and are available at https://www.irdai.gov.in/ADMINCMS/cms/Circulars_Layout.aspx?page=PageNo1065&flag=1. Accessed on 11 February 2016

treated as in force during the said ‘auto cover period’. Further all the policy exits by way of death, maturity and in-force surrenders may also be exempted in determining the exposure to persistency calculation. The persistency rate requirements were made effective for all agency renewals that were due from 01st July, 2014.[63] Admittedly, the revisions were made on the basis of representations made by the industry.

Further modifications were made in the guidelines within two months, in November 2011. The modifications removed the requirement for insurers to endorse the records. It also stated that these guidelines (except certain conditions) would also be applicable to corporate agents.[64]

In order to ensure uniform and systematic methodology in calculation of persistency rate in all regulatory reporting and internal assessments, IRDA issued relevant methodology and other requirements pursuant to a circular dated 23 January 2014. Insurers were required to submit a report on persistency along with appointed Actuary’s Annual Report. The persistency is required to be calculated in terms of premium amounts and number of policies.[65]

The guidelines were further modified in February 2014 to provide that renewal of individual agency license and corporate agency license will not be subject to meeting the persistency rates.
Further, all life insurers were required to have their own company specific persistency criterion for renewal of individual and corporate agency from 1st July 2014, thus removing the requirement of maintaining 50 percent persistency rate.[66]

In addition to guidelines related to persistency, IRDA requires life insurance companies to report conservation ratio on a periodic basis.[67] Conservation ratio is the ratio between renewal premium of current year and renewal and first year premium combined of the previous year.

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[63] The revision is available at https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_Layout.aspx?page=PageNo1528&flag=1. Accessed on 11 February 2016.

[64] The modifications are available at https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_Layout.aspx?page=PageNo1556&flag=1. Accessed on 11 February 2016

[65] The circular is available at https://www.irdai.gov.in/ADMINCMS/cms/Circulars_Layout.aspx?page=PageNo2184&flag=1. Accessed on 11 February 2016

[66] The revisions are available at https://www.irdai.gov.in/ADMINCMS/cms/frmGuidelines_Layout.aspx?page=PageNo2207&flag=1. Accessed on 11 February 2016

[67] IRDA Master Circular on preparation of financial statements and filing returns of life insurance business dated 11 December 2013, available at https://www.irdai.gov.in/ADMINCMS/cms/Circulars_Layout.aspx?page=PageNo2138&flag=1. Accessed on 11 February 2016

Chapter 4
Assessment of Baseline Scenario

A critical component of regulatory impact assessment involves understanding the existing scenario and assessing how the regulations are influencing behaviour of relevant stakeholders in sector to achieve what is prevalent. Assessment of baseline scenario is also necessary to design correct alternatives to achieve the desired scenario in the sector.

As indicated earlier, this study deals with three critical areas of regulations which influence investments in the sector, viz. regulations on: i) investors with respect to conditions on investing; ii) insurers about expenditure on operations and commission; and iii) retention of consumers. Following sections highlight existing scenario on these issues in the life insurance sector.

Investments in insurance companies

Foreign investment

The total paid up capital (excluding share premium and share application money) of the life insurance companies as on 31st March, 2015 was Rs. 26,244.14 crore, of which the total paid up capital of private sector was Rs. 26,144.14 crore. During 2014-15, an additional capital of Rs. 305.63 crore was brought into the industry by the private sector insurers.[68]

According to the public disclosures filed by life insurance companies, between September 2014 and September 2015, the total paid up capital (excluding share premium) increased by merely Rs. 23.57 crore. However, most of this was increase in non-promoter shareholding.[69]

It might be recalled that the cap on foreign investment in the sector was increased from 26 percent to 49 percent, with effect from December 2014. Absence of increase in shareholding of foreign investors within one year of allowing greater investment is contrary to experience of the industry in early 2000s, when private sector was allowed to operate in the sector, with foreign investment up to 26 percent. IRDA was incorporated in April 2000 and it started inviting applications for the registration in August 2000. Within first eight months, seven life insurance companies and three non-life insurance companies with foreign partners were granted registration.

As per the public disclosures of HDFC Standard Life Insurance Company Limited, Housing Development Finance Corporation Limited proposes to transfer 179,539,209 equity shares of HDFC Standard Life Insurance Company Limited to Standard Life (Mauritius Holdings) 2006 Limited pursuant to the Share Sale and Purchase Agreement

[68] IRDA Annual Report 2014-15
[69] Increase in non-promoter shareholding in ICICI Prudential Life Insurance was around Rs. 22.01 crore during the mentioned period. The public disclosures of life insurers are available at https://www.irdai.gov.in/ADMINCMS/cms/NormalData_Layout.aspx?page=PageNo764&mid=31.1

dated August 14, 2015. The proposed transfer is subject to regulatory approvals from relevant authorities.[70] This equals to around Rs. 180 crore of paid up share capital (excluding share premium).

Further, according to India Brand Equity Foundation, following investments are being planned in the life insurance sector:[71]

- Insurance firm AIA Group Ltd has decided to increase its stake in Tata AIA Life Insurance Co Ltd, a joint venture owned by Tata Sons Ltd and AIA Group from 26 per cent to 49 per cent.
- Canada based Sun Life Financial Inc plans to increase its stake from 26 per cent to 49 per cent in Birla Sun Life Insurance Co Ltd, a joint venture with Aditya Birla Nuvo Ltd, through buying of shares worth Rs 1,664 crore (US$ 249 million).
- Nippon Life Insurance has signed definitive agreements to invest Rs 2,265 crore (US$ 348 million) in order to increase its stake in Reliance Life Insurance from 26 per cent to 49 per cent.
- Bennett Coleman and Co. Ltd (BCCL) is set to buy Religare Enterprises Ltd's entire 44 per cent stake in life insurance joint venture Aegon Religare Life Insurance Co. Ltd. The foreign partner Aegon is set to increase its stake in the joint venture from 26 per cent to 49 per cent.
- State Bank of India has announced that BNP Paribas Cardif is keen to increase its stake in SBI Life Insurance from 26 per cent to 36 per cent. Once the foreign joint venture partner increases its stake to 36 per cent, SBI's stake in SBI Life will get diluted to 64 per cent.

However, as in case of HDFC Life Insurance, all these plans are subject to regulatory approvals and compliance with relevant regulatory conditions. While it appears that, after the passage of Insurance Laws (Amendment) Act, 2014, foreign investors are interested to invest in the sector, stringent regulatory restrictions and related conditions have forced them to hold back their plans.
As indicated earlier, these conditions include compliance with domestic owned and controlled condition within the required time frame by existing as well as new insurers, confusion created by multiple regulatory instruments issued by different regulators, and little time available with insurers to comply with regulatory changes issued as a result of changes in Insurance Act. Such regulatory complexities holding back the investments were validated through stakeholder interactions and available literature.[72]

And such complex regulatory requirements have been put in place after delay of close to a decade in increasing the investment limit the sector. According to report of Standing Committee on Finance (2009) on the Insurance Laws (Amendment) Bill, 2008, the

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[70] Form L9 filed by HDFC Standard Life Insurance Company Limited for quarter ended September 2015.
[71] India Brand Equity Foundation, *Insurance Sector in India: Investments,* December 2015
[72] George Mathew, *49% insurance FDI: 6 months later foreign firms still elusive,* Indian Express, 16 October 2015, at http://indianexpress.com/article/business/business-others/49-insurance-fdi-6-months-later-foreign-firms-still-elusive/, accessed on 19 October 2015, Subhomoy Bhattacharjee, *Why 49% FDI is still not good news for the insurance sector,* Indian Express, 17 July 2015, at http://indianexpress.com/article/india/india-others/why-49-fdi-is-still-not-good-news-for-the-insurance-sector/ accessed on 12 October 2015

government submitted that the increased foreign investment was required to maintain solvency margin and additional capital for growth of business. IRDA had estimated that the total capital requirement of the insurance sector was Rs. 61,200 crore over five years, which cannot be expected to be contributed from domestic promoters or domestic capital market. However, the Standing Committee was not convinced by the rationale submitted by government/ IRDA, and the latter's failure to consider alternative capital sources.

The Insurance Bill was thereafter referred to a Select Committee on Insurance Bill. The Central Government, through the Department of Financial Services explained that the rationale behind increasing the FDI limit was that the insurance companies were regulated by stringent solvency norms and continuously required additional capital for growth, which partly get invested in key sectors like infrastructure. IRDA has estimated that the additional capital requirement of the insurance sector would be Rs. 55,000 crore (Rs.44,500 crores for the life sector and Rs. 10,500 crores for the non-life sector) over the next five years, which may not be taken care of by the limited domestic sources.

In its report dated December 2014, the Select Committee recommended increase in the foreign investment cap to 49 percent. It noted:

"*There is a requirement of huge amount of capital as defined by the regulator for stipulated solvency levels to maintain the trust level of stake holders in life insurance companies through solvency under all circumstances. This enhanced foreign equity will not only help in expansion of insurance coverage, comprehensive and better portfolio management, enable growth of pension sector but also potentially enable transfer of technical knowhow and other better consumer services through improved practices and competitive pressures. The Committee observed that IPOs may not be the best route for raising capital in the insurance sector as FIIs face constraints due to sectoral foreign equity caps.*"

Consequently, the sub optimal regulatory scenario with respect to investments in life insurance sector is delaying potential investments to the tune of Rs. 50,000 crore, which is adversely affecting the growth potential of the industry and its ability to reach out to the masses and uninsured populace.

Domestic investment

As indicated earlier, insurance companies were previously allowed to have capital only in form of ordinary shares, situation which was changed pursuant to the Insurance Laws (Amendment) Act. As the result of reforms issued pursuant to the amendment act, the regulator has issued guidelines with respect to raising of capital by life insurance companies, and transfer of equity shares. It appears that the delay in passage of insurance amendment has resulted in opportunity cost for insurers to access domestic sources for raising capital.

It has been reported that earlier regulations on initial public offering by insurance companies, which required 10 years in operation, specific embedded value, restricted interested insurers from accessing domestic capital markets. With the passage of insurance amendment after a huge delay, the insurers are expected to seriously consider availing domestic sources of capital.[73] However, it has also been reported that the necessity of multiple approvals from IRDA and SEBI, as prescribed in the current regulations, has the potential to act as roadblocks in the capital raising process of the insurance companies.[74] Such regulatory complexities might have held back potential investors in the insurance sector and deprived life insurance companies of much needed investments.

Expenditure by insurance companies

As indicated in earlier, insurance regulations have linked commission/ remuneration to intermediaries and operating expenses to the premium collected by insurance intermediaries. For the financial year 2014-15, the average commission expense ratio[75] for first year with respect to private sector life insurers was 8.74 percent, while the renewal commission expense ratio was 2.42 percent. Further, the average operating expenses ratio[76] for private life insurers was 16.36 per cent in 2014-15.[77]

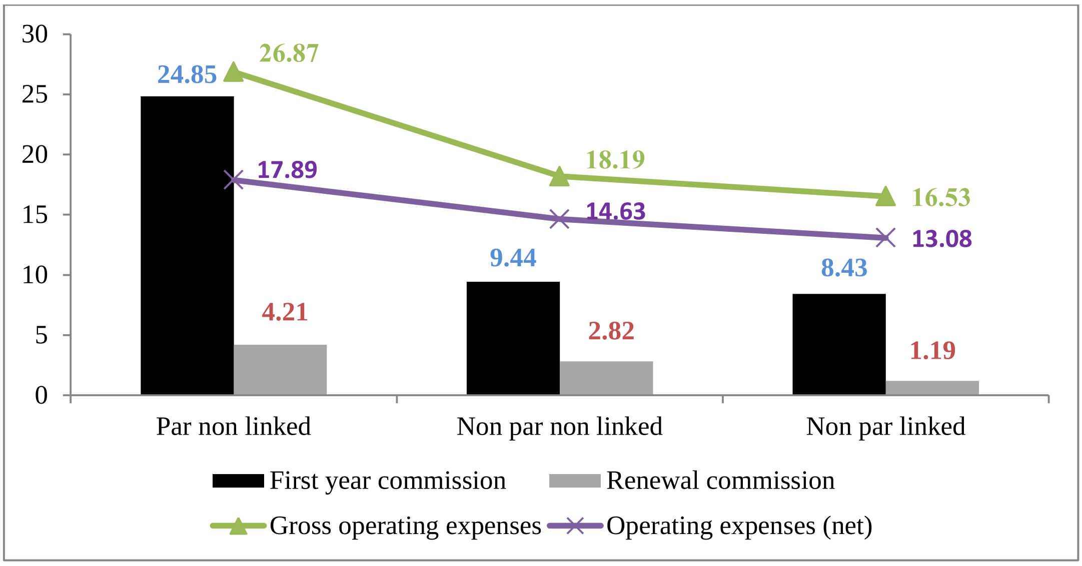
The commission expense ratio and operating expense ratio for non linked products in higher than linked products. This appears to be a result of higher cap on commission and management expenses for non-linked products than for linked products. This, understandably, was a result of high misselling and mid-course surrender of policies, experienced in unit linked insurance product segment. The commission and management expense cap for all products in non-linked segment appears to be similar.

Despite having similar caps, the average commission for participatory products appears to be more than twice that for the non participatory products, within the non linked product segment. The management expense in the former also appears to be significantly higher than the latter (see Figure 4.1 below and Annexure 1 for related discussion).

Perhaps, this is on account of attractiveness of participatory products when compared with non participatory products. Participatory products offer additional incentives like bonus at the discretion of insurer, and endowment plans offer survivor benefits. Such incentives are not available in case of non participatory products which are pure risk/ term products, and the insurance benefit is contingent upon happening of the event (death) within the coverage period. However, such non participatory non linked products are cheaper when compared with other product segments.

[73] John Loh, *India pushes on with IPOs from life insurance sector*, Global capital, 17 September 2015, at http://www.globalcapital.com/article/tcb0dcq4hspr/india-pushes-on-with-ipos-from-life-insurance-sector. accessed on 17 February 2016
[74] Saraswathy and Lele, *Insurance IPOs still 2-3 years away*, Business Standard, 04 August 2014, at http://www.business-standard.com/article/finance/insurance-ipos-still-2-3-years-away-114072901018_1.html, accessed on 01 February 2014
[75] Commission as a percentage of premium
[76] Operating expenses as a percent of gross premium
[77] IRDA Annual Report 2014-15

Figure 4.1: Comparison of commission and operating ratios



Source: Public disclosures by select life insurers for six month ending September 2015

In addition, the insurance regulations allow front loading of expenditure by permitting high first year commission. This naturally makes procurement of new business a focus for intermediaries. Consequently, during 2014-15, the first year premium commission expenses for private sector life insurers was Rs. 3,043.38 crore while renewal premium commission expenses was Rs. 1,299.16 crore. High upfront costs create barriers to entry, delayed break-even, and deferred expansion plans.

Further, as indicated earlier, rule 17D of the Insurance Rules, 1939 caps management expenses. It has been reported that for the financial year 2014-15, nine companies were not complying with said required, and action was initiated against such nine private sector life insurance companies.[78] In order to address the situation, life insurance companies will have to improve operational efficiency and commission ratio, for which they might have to rely on external expertise, technology and investments.

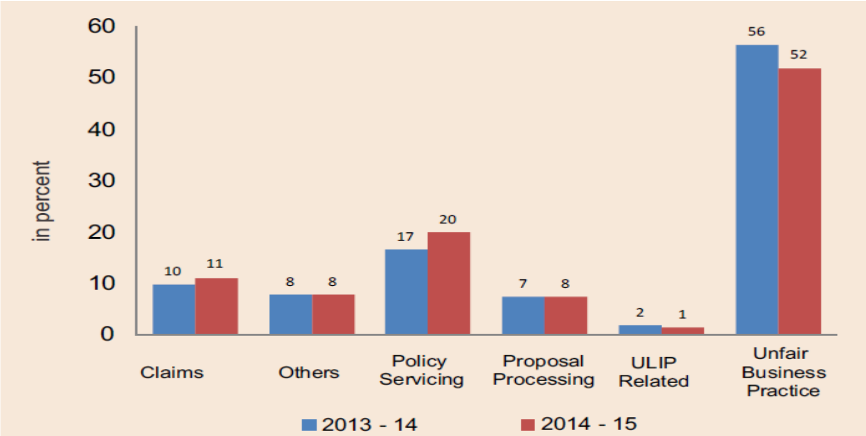
Owing to lower operating costs, while insurers are interested to push for non-participatory products, intermediaries are interested to push for participatory and linked products, which offer additional incentives over pure risk products, and consequently higher commission (close to respective regulatory caps). Regulatory push also appears towards pushing non linked products. However, management expenses (and commission payouts) for non-linked products are higher. Hence regulatory push for such policies, without availability of adequate capital with insurers, might not be sustainable in the long term. As a result, the regulations might need to be relooked to provide appropriate incentives (with respect to availability of capital) to insurers to sell non linked insurance policies for long term.

Also, the aforesaid conflict of interest between critical stakeholders groups has the potential to result in adverse consequences for the vulnerable consumers. Experts suggest that insurance agents overwhelmingly recommend products which provide high

[78] Annual Report 2014-15, Insurance Regulatory and Development Authority of India, November 2015

commissions to the agent and are unsuitable for the customers. This is greater for customers who appear to be less financially literate.[79] Consequently, the possibility of misselling non linked insurance products is high. The annual report of IRDA also suggests that complaints of unfair business practice comprise more than 50 percent of the total complaints received by life insurance companies (See figure 4.2).

Figure 4.2: Classification of Life Insurance Complaints during 2013-14 and 2014-15



Source: IRDA Annual Report 2014-15

Misselling can have several negative consequences for insurers. They might lose consumers who leave the policy mid-way upon realising the unsuitability of the policy. In addition, claims of misselling against insurance companies could increase their contingent liabilities, and adversely impact insurer's reputation. Expansion of business and customer onboarding might become more difficult which might drag down revenue expectations of the insurer. This is turn could adversely impact valuation of insurance companies, and their ability to attract investments.

Retention of consumers

As indicated earlier, to push for customer retention, IRDA has been requiring insurers to frame company specific criteria for calculation of persistency ratio, and report the relevant ratio in public domain on periodic basis.

A review of public disclosures of 18 life insurance companies for six months period ended September 2015 reveal that in close to 60 percent of disclosures, persistency rate is less than 50 percent (See Figure 4.3 below and Annexure 2 for related calculations). It might be recalled that IRDA had earlier required maintaining persistency ratios of at least 50 percent.

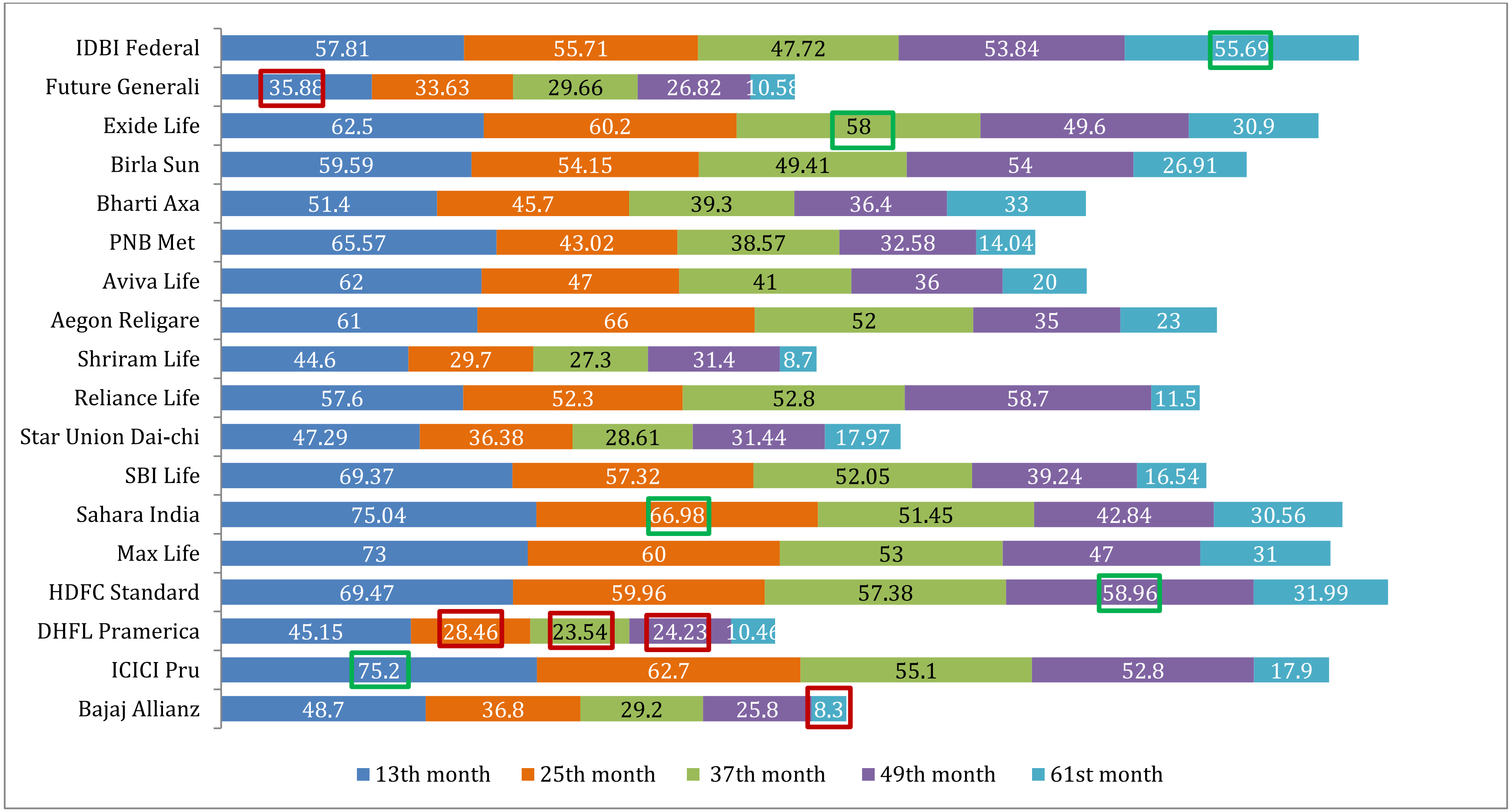
[79] Santosh Anagol, Shawn Cole, and Shayak Sarkar, *Understanding the Incentives of Commissions Motivated Agents: Theory and Evidence from the Indian Life Insurance Market*, Working Paper 12-055, Harvard Business School, Jan. 2012, cited from Sumit Bose et al, *Report of the Committee to recommend measures for curbing mis-selling and rationalising distribution incentives in financial products*, Ministry of Finance, Government of India, August 2015

It also appears that persistency spread between companies is significant and only high performer insurers come close to maintaining decent persistency levels. Unsurprisingly, these insurers are well capitalized, highlighting the relation between capital and persistency levels. Perhaps, this also indicates to a vicious cycle wherein capital is required to maintain persistency and investors (who can provide capital) are attracted towards those companies which have high persistency, an indicator of adequate revenue generation potential.

India fares poorly when compared with rest of the world on insurance persistency. Average 13th month persistency in India is around 58 percent while the average for OECD countries (Organisation for Economic Co-operation and Development) is close to 90 percent. The 61st month average for Indian insurance companies excluding LIC (44 percent) is close to 28 percent while the same for OECD countries is around 60-65 percent.[80] Consequently, urgent measures are required to address the situation and improving the persistency rates amongst private life insurers.

[80] http://www.livemint.com/Money/5fIh4IrUV4zsj9H5s5UJwI/Why-are-life-insurance-policies-abandoned-midway.html, Accessed on 5th February, 2016

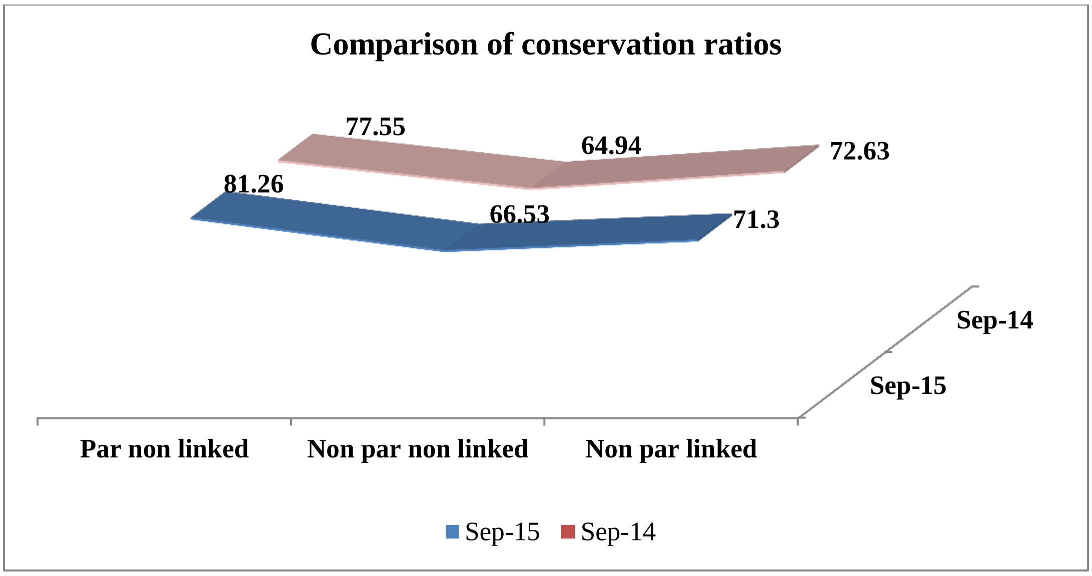
Figure 4.3: Comparison of persistency ratios of life insurers



Source: Public disclosures by select life insurers for six month ending September 2015

In addition to persistency, conservation ratio is one of the key indicators of insurers' ability to retain customers. It is an indicator of how much of business underwritten in the previous years is getting renewed each year.[81] It appears that the conservation ratio of non-participatory non linked policies has been consistently lower that other policy segments (See figure 4.4 and Annexure 3 for related calculations).

Figure 4.4: Comparison of conservation ratios



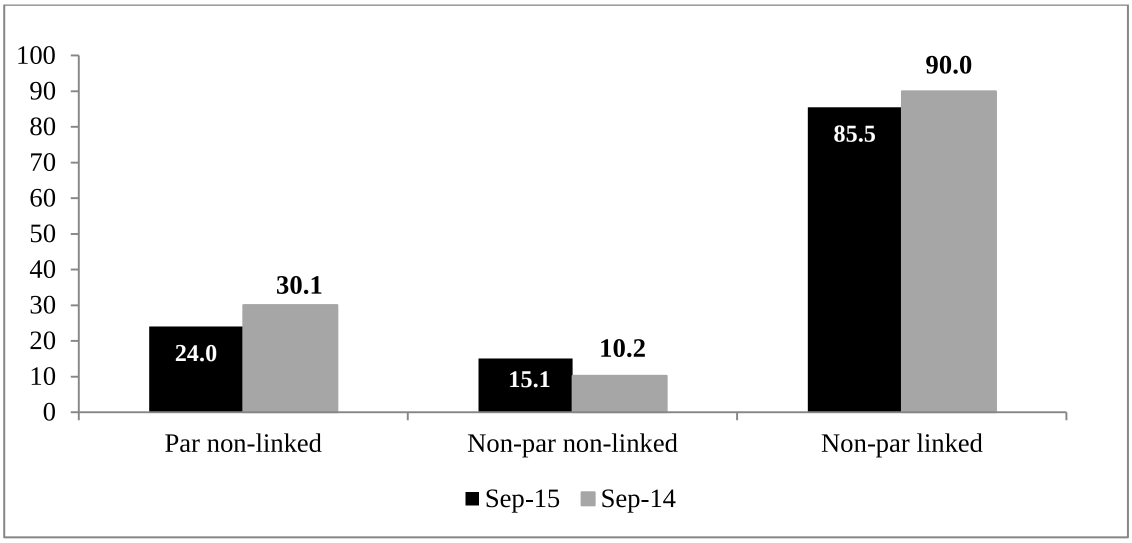
Source: Public disclosures of select insurers for six month ended September 2015

Low persistency and conservation can be interpreted as mid-course surrender of policies by consumers. Upon realising that the product sold is not suitable for them, consumers stop paying renewal premiums. In the process, they also lose significant portion of their initial investments made in procurement of policies.

During the six months ending September 2015, surrender payouts of traditional non linked policies (participatory and non participatory non linked policies) was Rs. 4.59 billion, for the nine life insurance companies for which data is available (See Annexure 4 for related calculations)

[81] Srikumar Bondyopadhyay, *Policy renewal a headache for private life insurers*, The Telegraph, 11 March 2009, at http://www.telegraphindia.com/1090311/jsp/business/story_10656114.jsp

Figure 4.5: Comparison of average surrender payout ratio



Source: Public disclosures by select insurers for the six month period ending September 2015

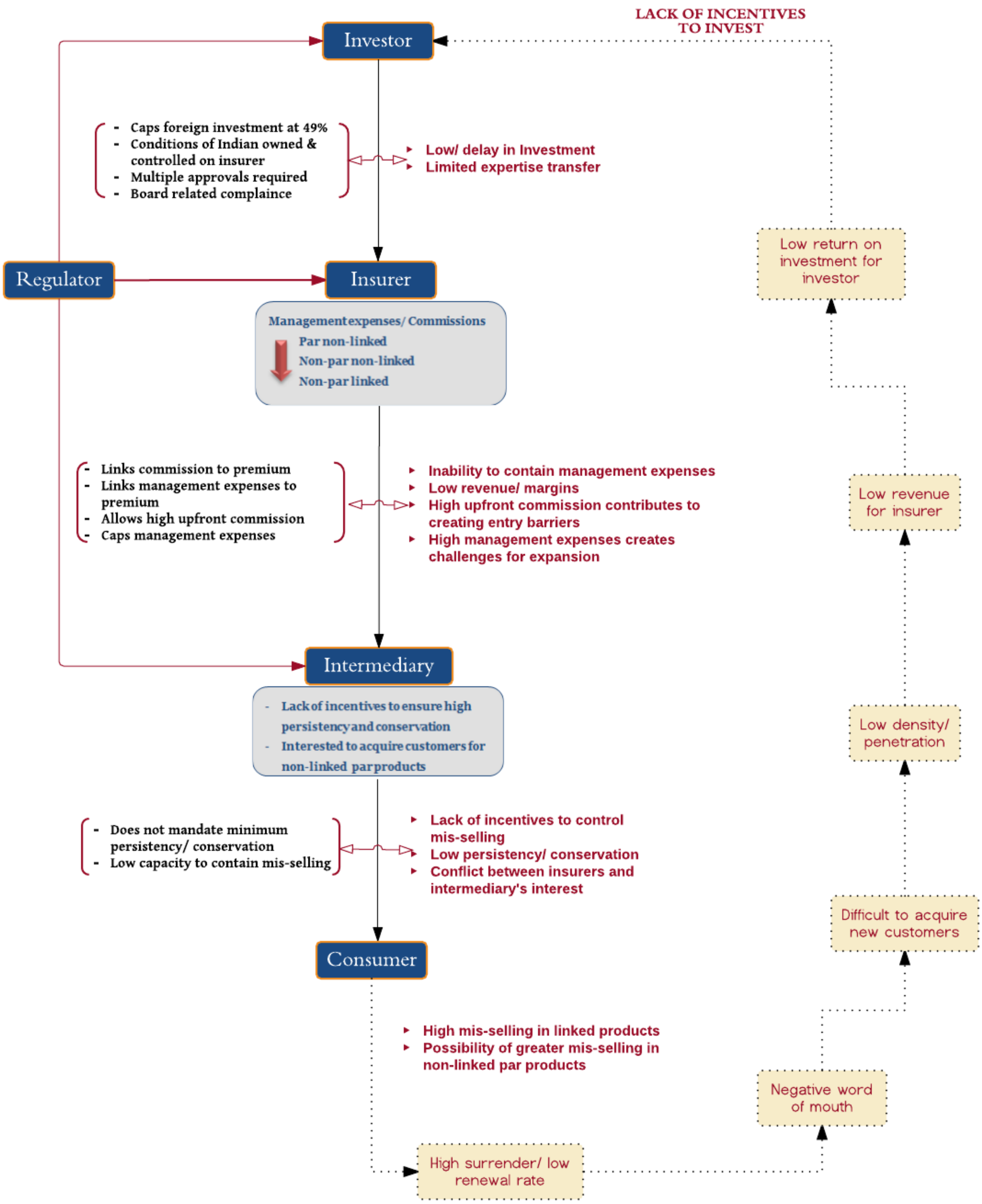
As indicated in Figure 4.5, surrender of non participatory non linked policies has increased during past year, with surrender payout increasing by Rs. 30.11 million. This is consistent with finding that conservation of such pure risk policies in lowest.

The surrender payouts for non participatory linked policies reduced substantially by Rs. 60.03 billion to Rs. 24.58 billion, however, the reduction in non-linked policies (on a consolidated basis) was merely Rs. 0.10 billion. This indicates to the lack of incentives to prevent/ reduce surrender of traditional non linked policies. High surrenders could be on account of actual return differing from promised returns, poor need gap assessment at the time of sale, negative experience with customer service and complaint management, new product options, financial crisis of policyholder, lack of knowledge of policyholder with respect to terms and conditions[82], mis-selling,[83] among others.

Surrender usually means movement of consumers away from the relevant product segments. This effectively results in lower revenue potential for insurers in the longer term, reducing attractiveness of the insurance company for potential investor. Consequently, if the incentives to stakeholders are not realigned to prevent surrender of non linked policies, insurance companies might not be able to attract requisite investments in the long term.

[82] The definitive guide to improving insurance persistency in India, Aureus Analytics
[83] Report of the Committee to recommend measures for curbing mis-selling and rationalizing distribution incentives in financial products, Ministry of Finance, Government of India, August 2015

Figure 4.6: Diagrammatic representation of baseline scenario



Source: Authors' analysis

Chapter 5
Designing regulatory alternatives

The prevailing regulatory architecture in life insurance sector has contributed to existing state of affairs, which has attracted less than adequate investments. Regulations around investors, insurers and intermediaries in the sector appeared to have inhibited growth of the sector. However, investments do not merely look at the text of regulations, but also the process of regulation making, which is an indicator of certainty and predictability of regulatory architecture.

Consequently, the following sections discuss possible regulatory alternatives to existing text of select regulations, along with the process of regulation making.

Reforming the design of regulations

Expenditure by insurance companies

Regulatory proposal: Increase in cap on commission and management expenses for participatory non linked policies

To regulate expenditure by insurance companies, IRDA has issued draft regulations on expenses of management[84] of life insurers and commissions/remuneration[85] payable by life insurers.

These draft regulations link expenses of management[86] as well remuneration/ commission to the premium collected. For instance, regulation on management expenses delves into different product segments and caps expenses between 12-25 percent of renewal premiums, depending on nature of product, with higher caps for pure risk products. Similarly, the regulation on commission/ remuneration provides different caps for different product segments, ranging from 35-50 percent in the first year, and 5-10 percent in renewal years, with higher caps for pure risk products.

The underlying objective to these draft regulations is to push for sale of non-participatory non linked policies. The presumption seems that allowing higher management expenses and commission/ remuneration for non-participatory non linked policies would increase uptake of such policies.

Existing regulations allow first year commissions up to 30 percent and renewal commission up to 7.5 percent. However, average commissions are not more than 10

[84] Exposure draft of the IRDA (Expenses of insurers transacting the business of life insurers) Regulations, 2015, issued on 22 December 2015
[85] Exposure draft of the IRDA (Payment of commission or remuneration or reward to insurance agents and insurance intermediaries) Regulations, 2016, issued on 13 January 2016
[86] Defined in the exposure draft as all expenses in the nature of operating expenses including commission, remuneration to the insurance agents, intermediaries and insurance intermediaries which are charged to Revenue Account.

percent and 3 percent, respectively, in case of non participatory non linked policies. Also, the gross operating expenses ratio for such pure risk products is merely 20 percent, much below allowed cap (See Figure 4.1, Annexure 1 and related discussion in Chapter 4).

On the other hand, the expenditure and commission on participatory policies are close to caps allowed in respective product segments. This indicates that while insurers are pushing for linked participatory products, owing to high margins, and intermediaries are pushing for non -linked participatory products, owing to highest commissions, the sale of non-participatory non linked policies is lagging. Consequently, it is difficult to establish causal link between the regulation of management expenses and commission and the objective of popularising non participatory non linked policies.

Expected impact:

On the basis of review of baseline scenario, it is unlikely that the regulatory proposal of allowing higher commission/ management expenses for non-participatory non linked policies will increase their sale.

On the contrary, the proposal caps management expenses at 25 percent of the premium. Evidence suggests that average gross operating expense ratio for participatory non linked policies is more than 25 percent (See Figure 4.1 and Annexure 1), and consequently the management expenses ratio is expected to be higher. A reduction in the allowable management expenses could have negative impact on sale of participatory non linked policies. Reduction in sale of endowment policies, hitherto most attractive segment, has the potential to lower the revenue projections and profitability,[87] reduction in rate of increase of insurance penetration and density and thereby lowering the attractiveness of sector for investor community.

Alternative 1: Comparative disclosure on costs to consumer

The inherent design of non participatory non linked products (no additional incentive over and above the agreed amount, as against possibility of bonus in participatory policies and benefit from increase in prices of linked products in linked policies) puts them at disadvantage against the other product segments.

Low cost is the only advantage which such policies have, over others, which needs to be leveraged if the sale of this product segment needs to be popularised. Consequently, disclosure on cost of comparable products in different product segments could be mandated to highlight the advantage of non participatory non linked policies. While the IRDA regulation on insurance advertisement requires clear disclosure on cost of insurance product, there is no requirement to provide costs of comparable products.[88] Expert

[87] Deepa Nair, *IRDAI crackdown on 'participatory products' may impact profitability*, Hindu Business Line, 18 February 2016, at http://www.thehindubusinessline.com/money-and-banking/irdai-crackdown-on-participating-products-may-impact-profitability/article8253684.ece, accessed on 21 February 2016

[88] IRDA Master Circular on Insurance Advertisement, August 2015, at https://www.irdai.gov.in/ADMINCMS/cms/Uploadedfiles/Master%20Circular%20on%20Advertisements%20of%20Aug%202015.PDF. Accessed on 18 February 2016

committees have also made similar recommendations regarding product cost comparisons.[89]

The current regulations also govern the illustration of benefits in insurance advertisement has been regulated. However, IRDA has observed non-compliance with relevant conditions.[90] Experts have also pointed out to violation of IRDA regulation on insurance advertisement by insurance companies.[91] Consequently, the insurance regulator needs to focus energies in enforcing regulations and ensuring compliance.

Expected impact:

Requirement of improved and comparative disclosure of costs of similar products across product segments is expected to consumers' bringing home the fact that non participatory non-linked policies are pure risk least expensive products. Such realisation is expected to increase the sale of such products and aid in attainment of regulatory objective. With increased consumers' interest in this product segment, the intermediaries are expected to focus on selling such products, which will consequently increase revenues for intermediaries and insurers from this product segment, and increase insurance penetration and density. Increased revenue potential for insurers is expected to increase attractiveness of industry for potential investors.

However, increase in disclosure is expected to marginally increase the costs for insurers. The monitoring, supervision and enforcement costs for insurers are also expected to increase moderately.

Upon comparison, the benefits of improved and effective disclosure regime to the economy are expected to outweigh the costs it will impose on stakeholders.

Alternative 2: Check surrender and misselling

As insurers and intermediaries have limited incentives to sell non participatory non linked policies, these policies tend to suffer neglect of these stakeholder groups. Evidence suggests that this could have resulted in increase in surrender (perhaps, as a result of misselling) of such policies, when all other policy segments are witnessing reduction in surrender (see Figure 4.4, Annexure 4 and related discussion in Chapter 4). Consequently, there is a requirement to shift regulatory energy from regulating commissions and operating expenses of different product segments to checking surrender and misselling of policies.

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[89] Sumit Bose Committee on Incentive Structure notes, "*For comparison, the cost of a pure life cover as in a term policy for a similar life and tenor should be disclosed alongside such that a customer is able to evaluate the true value of the product.*"

[90] IRDA Circular on Benefit Illustration in Advertisement of Life Insurance Products, 23 November 2015, at https://www.irdai.gov.in/ADMINCMS/cms/Uploadedfiles/Circular%20on%20benefit%20illustrations.PDF. Accessed on 18 February 2016

[91] Sumant Prashant and Renuka Sane, *Concerns about compliance with IRDAI regulations by insurance companies,* Ajay Shah Blog, 28 January 2016

At present, regulations exist with respect to calculation and amount of surrender pay-outs.[92] However, it appears that there is no regulation to investigate reasons for surrender. Similarly, regulation requires insurers to resolve consumer grievance regarding incorrect surrender value, delay in payment of surrender value within specified time period, and misselling[93], but there is no regulation on linking surrender to misselling. In addition, it appears that there is no requirement at present that requires stakeholders to check surrender and work towards reduction of surrender of policies (especially on account of misselling).

Expected impact:

Regulation to check surrender of policies due to misselling is expected to reduce surrender payouts and consumers moving away from insurance sector. This is expected to boost sales in non-participatory non linked product segment, which has been witnessing an increase in surrender ratio.

Reduction in surrender of pure risk traditional policies is expected to fulfil the regulatory objective of pushing such policies, without any regulation around expenditure by insurers. Reduction in surrender is also expected to improve the revenue projection for intermediaries and insurers in the sector, while improving insurance penetration and density. Improved revenue projections will improve valuation of the insurers and increase their attractiveness amongst investors.

However, checking surrender on account of misselling is expected to increase costs of regulation and enforcement for regulator. The cost of compliance for industry and intermediaries is also expected to increase.

Upon comparison, the benefit to economy on account of reduced surrender and misselling is expected to outweigh the related cost of regulation, enforcement and compliance.

Alternative 3: Disallow high upfront commissions

As discussed earlier, high upfront commissions act as barriers to entry and expansion for potential and existing investors. The break-even is delayed and so are any plans of insurers to tap the hitherto untapped markets.

Consequently, in order to ensure that market players focus on traditional pure risk segments, there is a need to increase competition and enable insurers to quickly recover costs and expand in less profitable segments like non participatory non linked policies.

Expected impact:

Disallowance of high upfront commissions and the requirement to spread out commissions across the insurance period is expected to reduce the requirement of upfront capital for insurers, and will allow insurers to strategically target hitherto untapped product segments, such as non participatory non linked insurance policies.

[92] IRDA (Non Linked Insurance Product) Regulations, 2013 and IRDA (Linked Insurance Product) Regulations, 2013

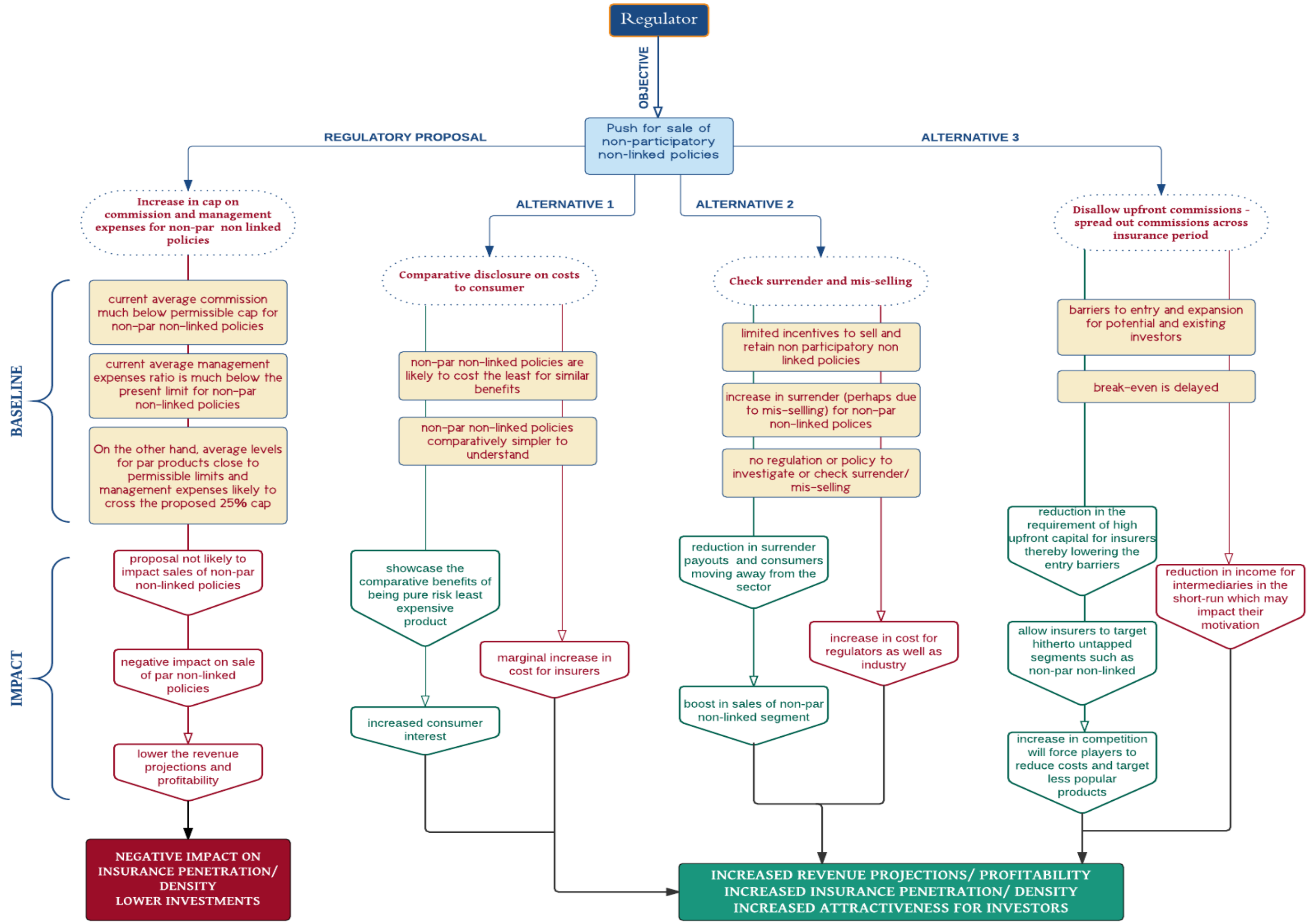
[93] Life insurance complaints classification issued by IRDA

Reduction in initial costs is also expected to lower the entry barriers in the sector, and making the sector attractive for potential insurers. Increase in competition is expected to force market players to reduce the costs of operations and target less crowded product segments like pure risk insurance products.

However, disallowance of high upfront commissions is expected to reduce the income through customer on-boarding for intermediaries and they might not remain highly motivated to acquire new customers. This negative consequence is expected to be set off by increase in competition and greater demand for intermediaries by insurers, however, in long term.

Upon comparison, the costs of reduced upfront commission are expected to be outweighed by its benefits to the economy.

Figure 5.1: Assessment of Alternatives: Expenditure by Insurance Companies



Retention of customers

As discussed earlier, insurers are required to regularly report persistency and conservation levels but there is no requirement to maintain minimum persistency. The persistency and conservation levels in Indian insurance sector are abysmally low, when compared with rest of the world average. Low persistency levels adversely impact growth potential of insurers and do not make them attractive for insurers. As a result, there is a need to improve persistency and conservation levels in the industry.

Alternative 1: Commission claw-backs

Literature suggests that low persistency and conservation levels are on account of misselling of policies. As soon as consumers realise that the policies has been mis-sold, they stop paying premium, which results in high persistency. This tendency is increasingly being noticed amongst non-participatory non linked policies.

In order to address the problem of low persistency rates, the regulator could prescribe for commission claw backs. Claw backs allow for upfront commissions to be recouped from the agent in case the consumer exits partially or fully from the product before a predefined tenure, and has been implemented in the mutual fund market by the securities market regulator, Securities and Exchange Board of India (SEBI).[94]

Claw backs are proposed to be introduced by financial sector regulators in other jurisdictions as well, like Australia[95] and UK.[96]

Claw-backs of variable pay of directors and key managerial personnel can be witnessed increasingly in financial sector globally, and has been recommended for India as well.[97] Further, literature suggests that IRDA had proposed claw backs of commission earlier.[98]

[94] Report of the Sumit Bose Committee, 2015

[95] *ASIC to handle commission and clawback legislation,* 11 November 2015, at http://www.lifehealthinsurancenews.com.au/regulatory-government/asic-to-handle-commission-and-clawback-legislation, accessed on 15 February 2016, notes, "*The Australian Securities and Investments Commission (ASIC) will have the final word on how commissions and the clawback proposal under the Life Insurance Framework are legislated…The Federal Government will introduce legislation to Parliament later this year giving ASIC power to cap commissions and implement the clawback under an amendment to the Corporations Act.*". Also, Expsoure Draft of the Corporations Amendment (Life Insurance Remuneration Arrangments) Bill, 2015 dated 24 November 2015, at http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Life%20Insurance%20Reform%20Legislation/Key%20Documents/PDF/Exposure%20Draft.ashx, accessed on 15 February 2016.

[96] "*Insurers are required to provide us with details of individual clawback amounts paid to intermediaries. This in turn should be reported by the intermediary as part of their return as a liability*", Financial Conduct Authority, UK, at http://www.fca.org.uk/firms/systems-reporting/gabriel/help/rma/helptexts/helptext-g, accessed pm 10 February 2016

[97] Report of the Financial Sector Legislative Reforms Commission, 2013

[98] *IRDA cracks whip on agents,* 05 March 2009, Economic Times, at http://articles.economictimes.indiatimes.com/2009-03-05/news/27654493_1_single-premium-insurance-agents-first-year-commission, accessed on 15 January 2016

Expected impact:

Efficiently designed claw back provisions are expected to reduce consumer churn and improve persistency and conservation of policies. The instances of misselling are expected to reduce and confidence of consumers on availing benefits of life insurance industry will increase. This is expected to increase consumer acquisition and retention. As a result, insurance penetration and density is expected to increase, and raising the revenue expectations for existing and potential insurers and consequently, the investors.

However, commission claw back provisions are expected to increase the burden on insurance intermediaries such as insurance agents and advisors. They will have to take greater care while selling the insurance policies and providing advice about the appropriate product. The consequent increase in risk for intermediaries might result in them moving away from insurance sector, which is already facing shortage of intermediaries. However, increased revenue potential of insurers might allow them to make payments to intermediaries, commensurate to their efforts in sale of insurance products.

Upon comparison, the expected benefits to the economy of designing and enforcement of commission claw-back provisions are expected to outweigh their related costs.

Alternative 2: Enforce suitability requirements

Consumers often drop out from insurance products because they realise that the product purchased was not suitable for them. Absence of regulations on insurers and intermediaries to assess suitability of products for the consumers often results in unsuitable advice and misselling, mostly for vulnerable retail consumers.

It has been pointed out that retail consumers may often be in a situation where they are not able to fully appreciate the features or implications of a financial product, even with full disclosure of information to them. This makes a strong case for a thorough suitability assessment of the products being sold to them. The Financial Sector Legislative Reforms Commission recommends that any person who advises a retail consumer in relation to the purchase of a financial product or service must obtain relevant information about the needs and circumstances of the consumer before making a recommendation to the consumer.[99]

The Sumit Bose Committee also recommends suitability requirements and notes that UK and Australia have moved away from a commissions based model of distribution, towards a fee-for-advice model. This has been accompanied by strong suitability requirements i.e. advisors have a duty to sell products that are suitable to customer requirements, making it imperative for them to understand customers situation and act in the interest of the customer.[100]

[99] Report of the Financial Sector Legislative Reforms Commission (2013)
[100] Report of Sumit Bose Committee (2015)

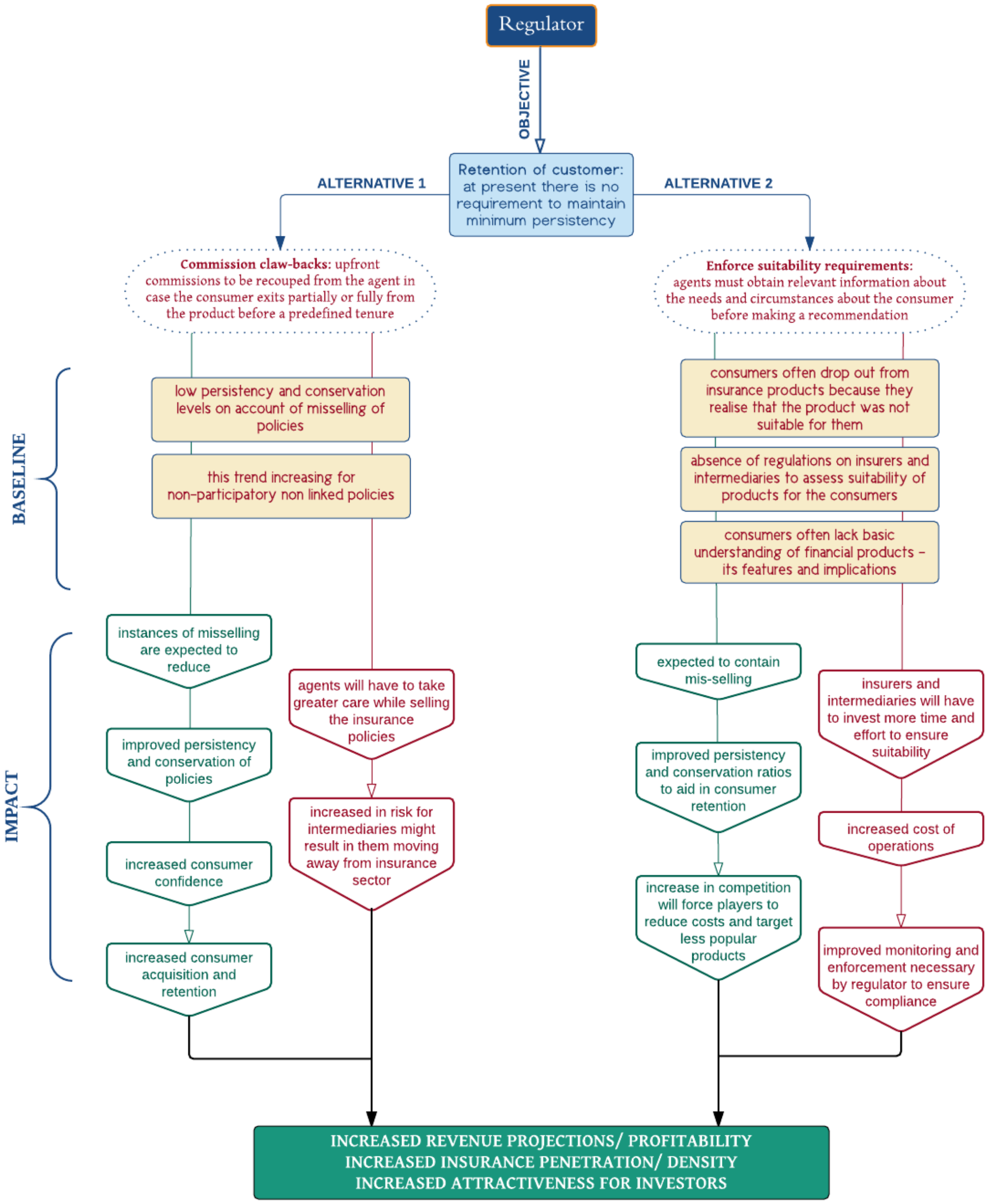
Expected impact:

Enforcement of suitability requirements is expected to contain misselling, consequently improving persistency and conservation ratios and aid in customer retention. Improved customer retention is expected to improve revenue projects of insurers, further insurance penetration and density and make the sector attractive for insurers.

However, the requirement to ensure suitability is expected to increase burden on insurers, intermediaries as well as regulators. While insurers and intermediaries will have to invest more time and effort to ensure suitability, thereby hiking their cost of operations, the regulator will have to improve monitoring and enforcement efforts to ensure compliance.

Upon comparison, the benefits of suitability, in terms of improved customer retention, increase in consumer penetration and density, and healthier revenue projections for insurers and intermediaries, are expected to outweigh its costs on stakeholders.

Figure 5.2: Assessment of Alternatives: Retention of Customers



Investments in insurance companies

The prevailing regulatory scenario around allowing domestic and foreign investment in insurance companies appears to be prescriptive rather than outcome driven. In process, they could increase cost of compliance and turn investors away from the sector.

Domestic investment:

The regulations on issuance of capital by Indian insurance companies require insurer to obtain prior approval from IRDA before approaching SEBI. While considering the application, IRDA is required to consider company's financial position, regulatory record, capital structure, objects of the issue, embedded value, record of policyholder protection etc. Most of these aspects are reviewed by the capital markets regulator, SEBI, as well, and the aforesaid requirements appear to create duplicity and loss of time for the insurer. Moreover, while granting approval, IRDA can prescribe the extent to which promoters/ shareholders could dilute their shareholding; maximum allotment possible to foreign investors; lock-in period; additional disclosures; etc.

Limited rationale is available to provide such sweeping powers to IRDA, through which it could override management's decision and SEBI regulations applicable for capital raising by companies. Also, the objective of the IRDA regulations was to open up the sector for domestic investors. However, in its present form, it is unlikely that the regulations would achieve their objective.

Alternative:

A single window clearance structure for regulatory approvals for capital raising could be much more efficient. SEBI, IRDA and any other regulator (such as the Competition Commission of India) should be in a position to access application and documents for public issue, have inter-se discussion, and share consolidated non-contradictory/ consistent comments with insurer. This would help the insurer to address regulatory comments in timely fashion, without unreasonably increasing the cost of compliance.

Foreign investment:

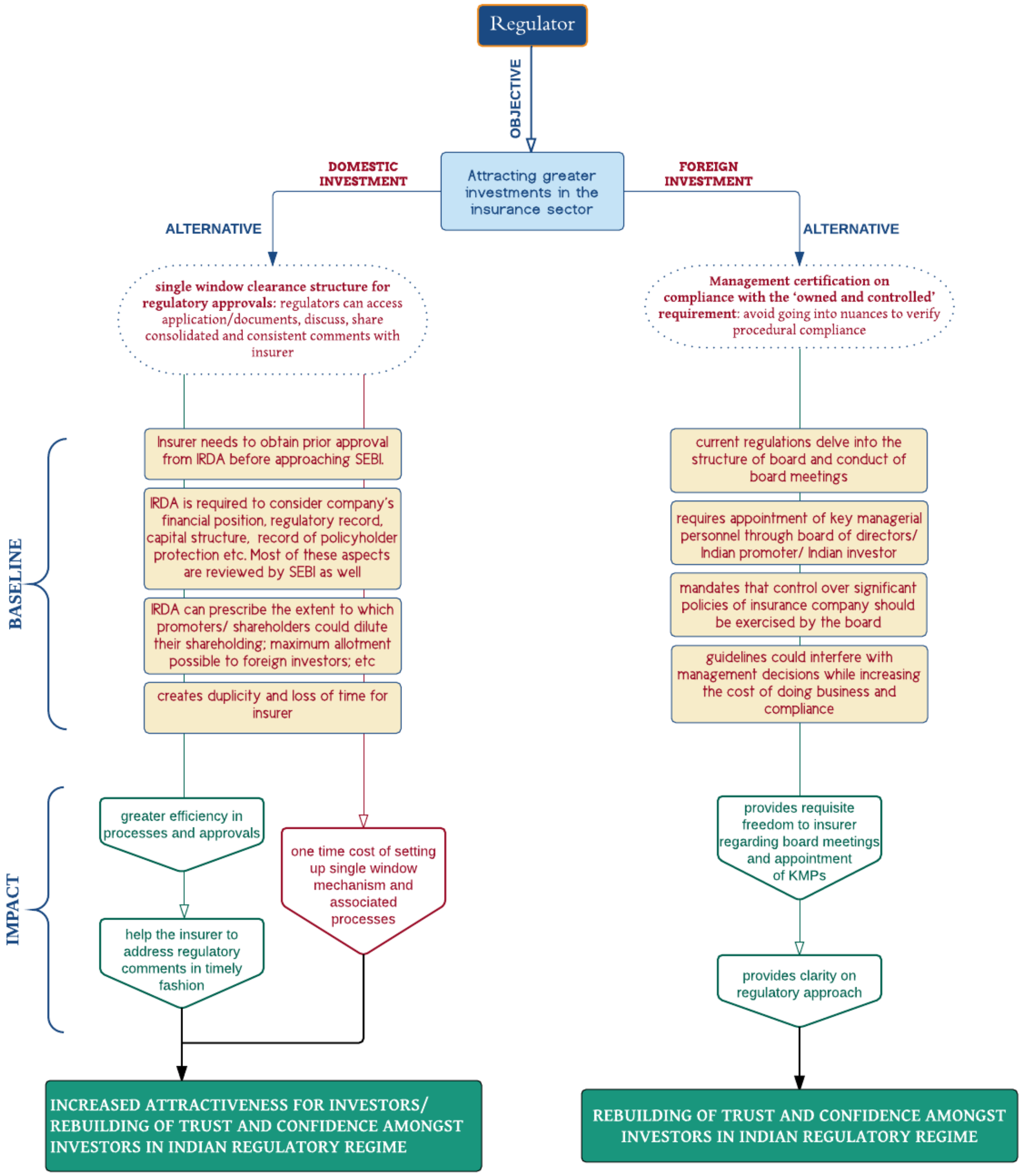
The IRDA guidelines on 'ownership and control' of Indian insurance companies do not merely rely on management certificate but delves into the structure of board and conduct of board meetings. It requires appointment of key managerial personnel through board of directors/ Indian promoter/ Indian investor. It also mandates that control over significant policies of insurance company should be exercised by the board.

While it has been argued that the detailed guidelines have been put in place to provide clarity and certainty in regulation, the guidelines could interfere with management decisions while increasing the cost of doing business and compliance. This has the potential to turn investors away.

Alternative:

The insurance regulator could rely on management certification on compliance with the 'owned and controlled' requirement and should avoid going into nuances to verify procedural compliance. This would provide requisite freedom to insurer regarding board meetings and appointment of KMPs. Such freedom is expected to provide clarity on regulatory approach and rebuilding of trust and confidence amongst investors in Indian regulatory regime.

Figure 5.3: Assessment of Alternatives: Investments in insurance companies



Reforming the process of regulation making

As indicated earlier, it took almost a decade to ensure passage of the Insurance (Laws) Amendment Act. Subsequent to the passage of primary legislation, several regulations have been include different bodies (Ministry of Finance and IRDA), through use of divergent regulatory instruments (regulations, guidelines, circulars). In most cases, regulations were not subject to effective public consultation[101] or regulatory impact assessment/ cost benefit analysis.[102] Moreover, several of these regulations have been amended multiple times within one year of their issuance.

Such sub-optimal regulation making changes leads to uncertain and unpredictable regulatory regime, resulting in the sector losing attractiveness for potential investors.

Alternative:

Efficient regulation making process has several components. These include: clarity of objective tools achieve objective, conducting of regulatory impact assessment for design a proposal potential to maximize public welfare. This is followed by effective public consultation which includes addressing stakeholder concerns. Fixing accountability of regulatory is also necessary for good regulation.

Good regulation avoids use of divergent regulatory instruments and is authorised by the board of the regulator. It is not retrospective in nature and provides adequate time to regulated entities for transition to the new regulatory regime.

Assessment of costs and benefits of possible regulatory alternatives and structured consultation is necessary for selection of such regulations, having the potential to result in maximum net benefit to the society. Reforming the regulation making process has the potential to reduce uncertainty and provide clarity in the regulatory architecture of the sector. This will increase attractiveness of the sector amongst potential investors.

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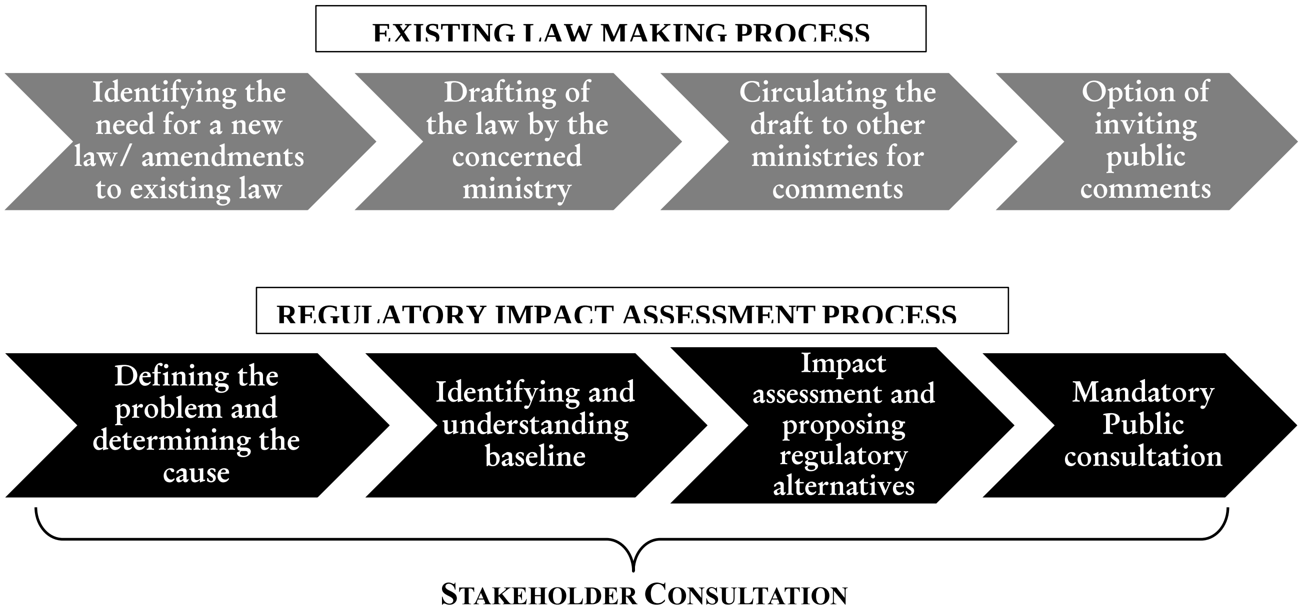
[101] Principles of effective participatory governance in regulation making have been laid out in: Bhargavi Zaveri, *Participatory governance in regulation making: how to make it work*? Ajay Shah blog, 17 January 2016, at http://ajayshahblog.blogspot.in/2016/01/participatory-governance-in-regulation.html, accessed on 22 January 2016

[102] The Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code, notes that the Financial Stability and Development Council decided that financial regulators will implement non-legislative FSLRC principles relating to regulatory governance, transparency and improved operational efficiency, including cost-benefit analysis/ regulatory impact assessment of regulatory proposals.

Figure 5.4: Reforming the process of regulation making



Chapter 6
Conclusion and Way Forward

India has a large potential market for life insurance products; however the density and insurance penetration figures remain low in comparison with the global average. There are various factors contributing to this including, low investments in the sector, inadequate infrastructure, low skills of agents, instances of mis-selling, negative perceptions about the industry in the minds of the consumer, complicated product features, unaffordable premiums among others.

This study undertook RIA on few of the critical issues in the insurance sector including investments in the sector, expenditures by insurance companies and lastly retention of customers which has been a major challenge. As seen in the findings the regulations/ lack of regulations has resulted in a scenario of low density, high surrenders, low insurance penetration leading to low revenue for the insurer thereby low return on investment for the investor. The regulatory architecture of a nation also plays a major role in the growth of a sector as complicated structures or uncertainty can create a business unfriendly environment, thereby impacting investments. Every regulation is designed to achieve certain objectives and when the relevant regulations were analysed keeping this in mind, to understand the impact – both positive and negative, on stakeholders.

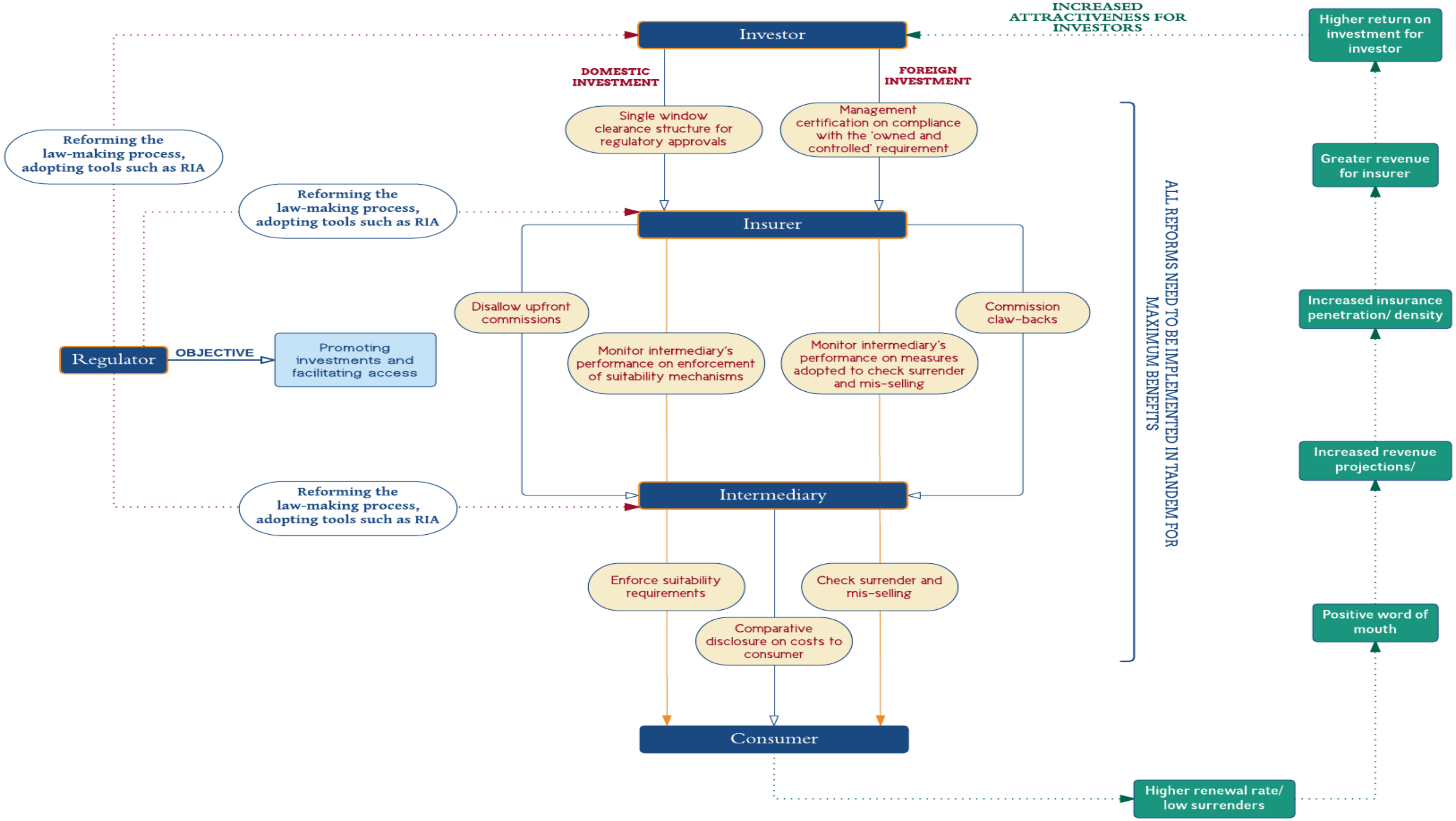
Selection of Alternatives

The final step of RIA involves comparison and selection of alternatives that have the potential to result in the greatest benefits to stakeholders. While each regulation could have both positive as well as negative impacts, the alternative(s) selected should be one that gives the maximum net benefits. Some of the identified issues have regulations in place to achieve the desired outcomes, while others do not. For instance, persistency earlier had a regulation for maintain a certain level which was eventually revised.

In case of management expenses of insurance companies while the regulator increased the cap for non-participatory non-linked policies with the objective of pushing the sale of these products, the RIA exercise revealed that this approach would be counterproductive. On the other hand other mechanisms such as, comparative disclosure on costs to consumer, putting mechanisms in place to check mis-selling and spreading the commissions across the insurance period would be more effective in terms of benefits to stakeholders. For the issue of persistency the findings of the study show that introducing commission claw-backs and enforcing suitability requirements would result in a net positive benefit.

There are various facets of an issue which need to be addressed to effectively resolve it; hence often, just one mechanism may not be able to completely address the challenges. Thus, a combination of alternatives may need to be applied rather than just one in isolation. In case of management expenses as well as persistency the findings show that implementing all the alternatives (except the regulatory alternative) together would provide the maximum net benefits to stakeholders.

Figure 6.1: Selection of Alternatives



Regulatory capacity-building

The regulator has increasingly been given greater powers and authority and has put in place various mechanisms/ structures to promote the growth of the sector while at the same time ensuring consumer protection. However, in order to keep pace with the ever-changing environment, the regulator also needs to revise its process, procedures, rules and regulations to ensure they are helping meet the desired goals and objectives. Transparency, coordination between agencies/ departments, maintaining timelines are some aspects which could be improved further. Thus, it is important for the regulators to undertake periodic capacity building exercises to enhance their skills. Various challenges faced in India may also be present in other nations and learning from international best practices would ensure that regulators in India are not reinventing the wheel.

Monitoring is another important responsibility of a regulator to ensure compliance. The regulator should have the necessary skills as well as manpower to effectively monitor the market players and check critical issues such as mis-selling. In order to apply mechanisms such as suitability checks to control mis-selling, it is essential to enhance the skills of the regulator.

Regulation making and the adoption of RIA

Regulatory instruments in India often get designed without evaluating its possible impact on stakeholders. Regulations usually have widespread impacts which affect multiple stakeholder groups in different ways. Thus, it is essential to understand these impacts while formulating any regulation so as to achieve optimal outcomes. A sub-optimal regulation can lead to higher costs of compliance, raise complexity and uncertainty associated with regulatory obligations and most importantly can limit the likelihood of achievement of intended objectives. RIA is an internationally-recognised tool which helps in designing specific and targeted policies, regulations rules etc. to achieve the desired objectives while ensuring the minimum possible burden on the stakeholders involved, resulting in maximum net benefit for society as a whole. The most important objective and benefit of RIA is its ability to help design the most effective and efficient policy design, regulatory or non-regulatory, or a mix, to ensure that the resources of the country are wisely used.

Other institutions within India have also recommended the adoption of RIA including Department of Industrial Policy and Promotion (DIPP) which emphasised the need for rigorous cost-benefit assessment of laws and regulations to help remove impediments to national growth[103]. The erstwhile Planning Commission in its report of the Working Group

[103] Workshop on regulatory impact assessment to cut red tape, http://www.business-standard.com/article/news-ians/workshop-on-regulatory-impact-assessment-to-cut-red-tape-115032600483_1.html, last accessed on 30 May 2015

on Business Regulatory Environment, released in 2011[104], Tax Administration Reforms Commission (TARC) (Third Report: November 2014)[105] and the Financial Sector Legislative Reforms Commission[106] also suggested the application of RIA. Further, the Pre-Legislative Consultation Policy of the Government of India requires government departments to conduct partial RIA of proposed legislations[107]. An Expert Committee was recently constituted by Department of Industrial Policy and Promotion (DIPP), to examine the possibility of replacing multiple prior permissions with a pre-existing regulatory mechanism. One of the principal recommendations of the Committee is the need to develop an institutional mechanism within the government for continued and independent Regulatory Impact Assessment (RIA), of not only proposed regulations but also existing ones[108]. Thus, adoption of such a tool by IRDA would help create more effective regulations.

[104] WG BRF (2011). Towards Optimal Business Regulatory Governance in India. Report of the Working Group on Business Regulatory Framework, Steering Committee on Industry, Planning Commission, Government of India. New Delhi

[105] Third Report of the TARC, http://finmin.nic.in/the_ministry/dept_revenue/TARC3rdReport.pdf, last accessed on 06 May 2015

[106] http://www.thehindubusinessline.com/opinion/columns/do-stateled-interventions-work/article7109710.ece

[107] Ibid

[108] Report of Expert Committee on Prior Permissions and Regulatory Mechanism, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, February, 2016

Annexure 1: Comparison of commission and operating expenses in different product segments

The tables below compare commission payouts and operating expenses of different products segments in life insurance sector on the basis of public disclosures made by nine life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the mentioned period have been considered.

Operating expenses comprise expenditure like employee remuneration, training expenses, rent, communication expenses, distribution expenses, sales promotion expenses, et al, for relevant product segments. Commission paid to intermediaries for relevant product segment is recorded separately, and not included in operating expenses. For purposes of the table, gross operating expenses comprise commission/ remuneration. Such gross expenses comprise substantial portion of management expenses.

Participatory non linked policies

Figures in percent

Comparison of par non linked policies for six months ending September 2015

	First year commission ratio		Renewal commission ratio		Total operating expenses ratio[109]		Gross operating expenses ratio[110]	
	2015	**2014**	**2015**	**2014**	**2015**	**2014**	**2015**	**2014**
Bajaj Allianz	22.47	29.09	3.51	3.95	22.13	21.29	28.50	29.81
Edelweiss Tokio	24.02	22.68	4.93	5.10	73.41	95.44	83.69	108.96
ICICI Prudential	19.01	21.16	3.67	3.85	20.25	30.45	28.88	42.73
DHFL Pramerica	16.45	21.02	5.24	2.75	106.37	97.88	120.17	118.76
HDFC Standard	22.54	23.82	2.54	2.73	12.38	15.29	18.29	22.19
Max Life	34.97	34.94	5.82	5.49	18.88	21.87	30.31	34.22
Sahara India	23.16	28.25	4.58	4.94	26.71	15.32	32.49	21.60
SBI Life	19.76	20.83	4.39	4.86	14.74	17.25	24.48	27.92
Star Union Dai-chi	34.12	34.80	5.17	5.89	23.15	10.16	35.27	22.86
Average	**24.85**	**26.57**	**4.21**	**4.29**	**17.89**	**20.76**	**26.87**	**31.05**

[109] Ratio of Operating expenses (excluding commission) to premium
[110] Ratio of operating expenses (including commission) to premium

Non participatory non linked policies

Figures in percent								
Comparison of non par non linked policies for six months ending September 2015								
	First year commission ratio		**Renewal commission ratio**		**Total operating expenses ratio**		**Gross operating expenses ratio**	
	2015	**2014**	**2015**	**2014**	**2015**	**2014**	**2015**	**2014**
Bajaj Allianz	13.92	14.21	1.13	1.40	37.82	29.79	41.50	36.35
Edelweiss Tokio	17.15	21.19	4.37	3.17	151.58	232.28	163.97	249.10
ICICI Prudential	11.13	-3.36	3.89	4.04	7.00	5.24	11.09	8.99
DHFL Pramerica	14.13	13.94	1.27	2.32	76.88	76.04	83.16	82.34
HDFC Standard	14.79	17.31	0.24	1.87	16.24	21.03	19.00	26.28
Max Life	25.94	15.98	2.05	2.88	19.13	12.38	29.71	16.17
Sahara India	10.45	19.76	3.45	3.83	71.31	76.71	75.18	80.47
SBI Life	4.37	11.43	2.66	3.04	8.94	14.53	11.08	19.06
Star Union Dai-chi	0.02	0.25	0.03	0.01	12.44	10.01	12.46	10.14
Average	**9.44**	**13.28**	**2.82**	**3.37**	**14.63**	**16.52**	**18.19**	**21.04**

Non participatory linked policies

Figures in percent								
Comparison of non par linked policies for six months ending September 2015								
	First year commission ratio		**Renewal commission ratio**		**Total operating expenses ratio**		**Gross operating expenses ratio**	
	2015	**2014**	**2015**	**2014**	**2015**	**2014**	**2015**	**2014**
Bajaj Allianz	3.23	2.64	0.98	1.30	32.56	56.71	33.92	58.30
Edelweiss Tokio	6.85	6.38	1.41	1.19	119.10	117.49	123.44	121.39
ICICI Prudential	5.67	5.79	1.35	1.34	13.49	13.56	16.47	16.72
DHFL Pramerica	3.80	4.46	0.30	0.59	39.55	38.20	41.09	39.16
HDFC Standard	16.47	17.77	0.52	0.64	11.00	8.88	15.66	12.98
Max Life	9.68	9.84	1.87	1.95	8.35	12.42	11.67	16.45
Sahara India	4.59	3.44	3.40	3.54	24.10	28.61	27.20	31.93
SBI Life	7.66	6.78	1.45	1.71	12.11	11.64	15.59	14.32
Star Union Dai-chi	7.24	7.33	2.34	2.26	13.58	34.58	16.15	38.77
Average	**8.43**	**8.48**	**1.19**	**1.25**	**13.08**	**14.50**	**16.53**	**17.87**

Annexure 2: Persistency ratios for life insurance companies

The table below compares persistency ratios of different periods in life insurance sector on the basis of public disclosures made by 18 life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the relevant period have been considered.

					Figures in percentage
Persistency ratios for life insurance companies for six month period ending September 2015					
Companies	**13th month**	**25th month**	**37th month**	**49th month**	**61st month**
Bajaj Allianz	48.7	36.8	29.2	25.8	8.3
ICICI Pru	75.2	62.7	55.1	52.8	17.9
DHFL Pramerica	45.15	28.46	23.54	24.23	10.46
HDFC Standard	69.47	59.96	57.38	58.96	31.99
Max Life	73	60	53	47	31
Sahara India	75.04	66.98	51.45	42.84	30.56
SBI Life	69.37	57.32	52.05	39.24	16.54
Star Union Dai-chi	47.29	36.38	28.61	31.44	17.97
Reliance Life	57.6	52.3	52.8	58.7	11.5
Shriram Life	44.6	29.7	27.3	31.4	8.7
Aegon Religare	61	66	52	35	23
Aviva Life	62	47	41	36	20
PNB Met	65.57	43.02	38.57	32.58	14.04
Bharti Axa	51.4	45.7	39.3	36.4	33
Birla Sun	59.59	54.15	49.41	54	26.91
Exide Life	62.5	60.2	58	49.6	30.9
Future Generali	35.88	33.63	29.66	26.82	10.58
IDBI Federal	57.81	55.71	47.72	53.84	55.69

Annexure 3: Conservation ratios for life insurance companies

The table below compares consistency ratios of different periods in life insurance sector on the basis of public disclosures made by 12 life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the relevant period have been considered.

Figures in percent						
Comparison of conservation ratios of life insurance companies						
	Six months period ending September 2015			**Six months period ending September 2014**		
Insurer	**Par non linked**	**Non par non linked**	**Non par linked**	**Par non linked**	**Non par non linked**	**Non par linked**
Bajaj Allianz	77.1	66.2	66.7	73	66.7	72.2
Edelweiss Tokio	79.54	69.28	88.98	63.81	66.15	86.33
ICICI Pru	88.1	97.6	85.7	83.7	87	83.9
HDFC Standard	89.18	83.56	80.81	89.92	85.26	92.24
Max Life	86	90	81	88	91	82
Sahara India	91.68	8.57	52.18	79.83	11.04	50.53
SBI Life	85.04	87.77	85.99	86.98	82.97	83.28
Star Union Dai-chi	82	57	69	64	71	68
Reliance Life	87	64	64	79	60	67
Sriram Life	67.3	5.9	30.5	60.8	-9.77	27.83
Aviva Life	54	85	67	79	83	79
Kotak Mahindra	88.23	83.51	83.83	82.56	84.95	79.21
Average	81.26	66.53	71.30	77.55	64.94	72.63

Annexure 4: Surrender payouts by life insurers

The table below compares surrender payouts of different periods in life insurance sector on the basis of public disclosures made by nine life insurance companies for six months period ending September 2015. This period has been chosen to take into account latest available data for conducting the primary analysis. All life insurance companies making relevant disclosures during the relevant period have been considered.

						Figures in thousands
Surrender payouts by life insurers for six months period						
Companies	**Half year ended September 2015**			**Half year ended September 2014**		
	Par non linked	**Non par non linked**	**Non par linked**	**Par non linked**	**Non par non linked**	**Non par linked**
Bajaj Allianz	379127		1385369	388817		2895844
Edelweiss Tokio	1393	1315				
ICICI Pru	1038929	184848	14491251	461286	185006	25297100
DHFL Pramerica		120194	173631		7560	132088
Max Life	1095255	123012	7439789	801692		11120289
Sahara	198128	2985	264371	9760	3367	845602
SBI Life	229593	1046646	9747687	1423458	1354785	17508486
Star Union Dai-chi	13569	70818	547321	3336	12069	674562
IDBI Federal	238	79893	1403224		36812	1554128
Total surrender payouts	2956232	1629711	35452643	3088349	1599599	60028099
Total payouts	12316380	10821514	41471469	10271636	15665420	66673292