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Recent insurance regulatory developments & its implications

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Abstract

The development of the insurance industry in India, as in other international markets, is likely to be critically dependent on the nature and quality of regulation. The role of the regulator in most markets is to ensure efficiency, transparency and fair play, while at the same time, protect the interests of the consumer. The IRDA Act 2000 has delineated the broad regulatory framework within which insurance companies are expected to operate in India. The provisions of this act address issues related to ownership, solvency, and investment portfolio construction, commission structures, reporting formats and accounting standards.

Keywords: Foreign direct investment, Disclosure norms, Economic Capital, Implications

1. Introduction

The minimum paid-up equity capital requirement has been set at INR1 billion. The insurance business is capital intensive, and international experience suggests that, on an average, non-life insurance companies require four to five years to break even. In the interim, these companies would require regular capital infusion for funding expected losses and meeting solvency requirements. In this context, given the existing regulatory constraints of foreign direct investment by the overseas partner, a substantial part of the funding would have to be done by the Indian partner, whose financial strength is likely to influence the credit strength of the joint venture. Given the evolutionary stage of the Indian insurance industry, one of the focal points for the regulator has been to drive stability and solvency in the industry. The act also mentions broad guidelines for the construction of the investment portfolios of life insurance companies. These norms have been designed to make sure that an insurer does not take on unsustainable risks in deploying funds collected by way of premiums. Overall, the regulatory environment is favorable and takes care that players maintain prudent underwriting standards, and reserve valuation and investment practices. The primary objective for the current regulations is to promote stability and fair play in the market place.

2. IRDA New disclosure norms

IRDA has come up with the following disclosure norms:

- a. IRDA has issued disclosure norms for insurance companies, mandating them to publish accounts on a half yearly basis. The disclosure norms are seen as a precursor to allowing insurance companies to hit the primary market. According to the new norms, insurers will have to publish their balance sheet on a half-yearly basis, starting from the period ending 31 March 2010.
- b. All financial disclosures for the past five years prior to the IPO have to be available on the company website. In addition, insurance companies have to disclose the data on various parameters such as the calculation of economic capital, surrender and lapse experience of business and expense patterns for the five-year period also need to disclose required and available solvency margins for five years, capital structure and details of investment performance. A wide range of risk factors related to credit, market, insurance, liquidity, operational and asset and liability management need to be disclosed clearly by the insurers, accompanied by a report from an independent external actuary on the reasonableness of the methodology adopted and assumptions made to determine valuations.
- c. IRDA has also instructed all life insurers to explicitly disclose, in their benefit Illustration document, the exact amount of commission/brokerage paid by insurers to

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insurance agents. This circular came into effect from 1 July 2010.

Implications

The regulator has directed all firms to come up with a public disclosure framework to ensure a fair and stable insurance market. These norms would help investors to be fully aware of the financial performance, company profile, financial position, risk exposure, elements of corporate governance in place and the management of the insurance companies.

The standard on public disclosures for the insurance companies, which has been prepared out of the leading international practices followed by the International Association of International Supervisors (IAIS), will strengthen corporate governance and market discipline.

According to IRDA, the circular on the disclosure of agent commission will enhance transparency by providing prospective policyholders with details of the exact amount of commission/brokerage paid by insurers to insurance agents, thus making it pro-investor. However, on the negative side, this move may encourage many insurance agents to rebate commissions to their clients, which is an illegal practice.

3. Altered commission structure of agents

- a. Insurers would be allowed to charge up to 4% on annual premium paid on ULIPs for the first five years, and thereafter, charges will be reduced during the tenure of the policy. This figure narrows down to 3% by the tenth year in a tapered scale, ending with 2.25% after the fifteenth year. The new guidelines apply from 1 September 2010. Earlier, the regulator had allowed commissions charged by agents to not exceed 40%.
- b. For single-premium products, the maximum commission rate is 2% of the premium paid, and for regular premium products, the rate is in the range of 15%–30% of premium in the first year, followed by 5%–7% in the subsequent years.
- c. According to the draft guidelines, all life insurance agents will have to gather a minimum of INR 150,000 as the first-year premium or sell a minimum of 20 life insurance contracts. When an agent falls short of achieving either of the above, they would have to proportionately achieve more in either one to make up for the shortfall. Where the average annual persistency ratio is less than 50%, the license of the agent will not be renewed.

Implications

This move by the IRDA reflects its efforts to ensure transparency and implement more stringent disclosure norms to avoid mis-selling. This is likely to allow insurers to recover their cost in a “more transparent and informed way,” thereby reducing “unfair practices” and the “information gap” in domestic insurance to enhance market discipline. Any variation in the payment structure of agents will also help companies to reduce their costs. Further, tenure based commissions will definitely benefit the industry. High commission is also expected to come down and there will be better reward for longer-term policies than the shorter term ones. Customers are the largest gainers from this change, as

products will now be more transparent, customer-friendly and aimed at protecting their long-term interests. With the implementation of the IRDA’s new norm, insurance companies may initially face a setback in policy sale numbers and total premiums. Although the IRDA stance is in favor of bringing transparency in the commission structure of agents, this norm could negatively impact agents as well, at least in the short term. To address the impact of reduced commission, insurance companies may resort to innovative ways of compensating their top-performing agents. Non commission-based remuneration may increase. Companies may expand their different reward and recognition programs to make the sale of ULIPs attractive for agents in light of these recent changes.

In the long term, the role of agents is expected to evolve with this policy change. In future, increased transparency is likely to make agents more accountable not only in selling the right products, but also in providing better customer service. This is also likely to guarantee that agents justify the commissions they earn. From being mere agents, they will be expected to serve as financial planners selling a bouquet of financial products.

4. IPO norms for insurance company

- a. The insurance regulator has reduced the waiting period for an insurance company to make an IPO from 10 years to 5 years after commencing operations.
- b. IRDA has finalized its IPO guidelines and has sent them to the Securities and Exchange Board of India (SEBI). SEBI will club IRDA’s recommendations with its general guidelines on IPOs for any company that wants to raise money from the public through equity shares.
- c. The norms for correct valuation, disclosure of operating results and profit and loss account and filing of the draft red herring prospectus are the three essentials that a company has to fulfill when opting for a public float. Besides, companies would have to make financial disclosures, risk disclosures, investment performance, etc. (details stated in the above section — “New disclosure norms”).

Implications

Insurance companies need capital to expand, innovate and sustain in the market. Insurance companies typically prefer to raise capital by floating an IPO. There can be a mix of a fresh issue of shares as well as the sale of shares by the parent company. Most companies prefer this route when they do not have enough capital to plough back into their business. With the IPO route of raising capital, Indian promoters will get the opportunity to put their equity into the market as well as FIIs will also be able to participate and acquire stakes.

5. Promoting health insurance

- a. IRDA has allowed insurance companies to offer “Health plus Life Combi Product,” a policy that would provide life cover along with health insurance to subscribers. Under the guidelines issued by the IRDA, life and non-life insurance firms can also partner in offering the health plus- life cover. The combi products may be

- promoted by all life insurance and non-life insurance companies, however, a tie up is permitted between one life insurer and one nonlife insurer only. Thus, a life insurer is permitted to enter an alliance with only one non-life insurer and vice-versa.
- b. The sale of combi products can be made through direct marketing channels, brokers and composite individual and corporate agents, common to both insurers. However, these products are not allowed to be marketed through “bank referral” arrangements. The regulator further specified that the guidelines do not apply to micro insurance products, which are governed by IRDA (Micro Insurance) Regulations, 2005.
 - c. Under the “Combi Product” the underwriting of the respective portion of the risks will be underwritten by respective insurance companies, i.e., life insurance risk will be underwritten by the life insurance company and the health insurance portion of risk will be underwritten by the non-life insurance company.

Implications

Life insurance has a much deeper penetration in India, as compared to the non-life insurance segment. This step is in sync with the government’s, regulator’s and the insurance company’s strategy to cover more people under the insurance umbrella.

As insurers leverage on the marketing and operational network of their partner insurers, the proposed product innovation is expected to facilitate policy holders to select an integrated product of their choice under a single roof without shopping around the market for two different insurance coverage options from two different insurers. Therefore, insurers are expected to offer appropriate covers as an attractive proposition for the policyholders.

6. Alteration in ULIPs

IRDA has attempted to make ULIP a long-term protection contract covering risks related to mortality, longevity and health by simultaneously offering a fair deal to the policyholder and doing away with the excesses in the system. The key changes introduced through the new guidelines are as follows:

- a. Lock-in period: IRDA has increased the lock-in period for all ULIPs from three years to five years, including top up premiums, thereby making them long-term financial instruments that provide risk protection. All limited premium ULIPs, other than single premium products, will have a premium paying term of at least five years.
- b. Level paying premiums: All regular premium/limited premium ULIPs will have uniform/level paying premiums. Any additional payments will be treated as a single premium for the purpose of an insurance cover.
- c. Even distribution of charges: The charges on ULIPs are mandated to be evenly distributed during the lock-in period in order to eliminate high front ending of expenses.
- d. Increase in risk component: Further, all ULIPs, other than pension and annuity products, will provide a

mortality cover or a health cover, thereby increasing the risk cover component in such products.

- e. Cap on surrender charges: IRDA has recommended a cap on the surrender charges at up to 15% of the fund value in the first year for policies with a tenor more than 10 years and 12.5% for policies with a tenor of less than 10 years. This charge comes down to 5% and 2.5%, respectively, in the fifth year of the policy, and becomes nil for policies of less than 10 years after the fifth year. For tenors above 10 years, the charge in the sixth year is 2.5%, which becomes nil in the seventh year.
- f. Minimum guaranteed return for pension products: Regarding pension products, all ULIP pension/annuity products will offer a minimum guaranteed return of 4.5% per annum, or as specified by the IRDA from time to time. This will provide protection to the life time savings of pensioners from any adverse fluctuations at the time of maturity.

Implications

The impact of these new guidelines on customers will be favorable due to lower charges and guaranteed returns, among other reasons. However, these changes will also impact the margins of life insurers, as the charges, particularly surrender charges, are capped. This could have an adverse impact on their profitability. The possibility of a decline in the profitability and increase in the capital requirements of life insurers has resulted in discounting the previously high multiples assigned to the new business achieved profits (NBAP), and as such, there could be a decline in the valuation assigned to the life insurance business. The changes in ULIPs guidelines could also result in a delay in the IPO plans of a number of players as they will have to rework their product offerings. Though it may make selling difficult as it would make products inflexible, it would certainly reduce persistency risk, make AUMs stable, and boost the overall certainty on assumptions and the profitability of the business underwritten.

7. Other regulations

Besides the above regulations, IRDA and the government are in the process of drafting more regulatory reforms for the industry such as:

- a. With the private players completing nearly 10 years of existence, the industry is seeking alternative ways to meet its capital needs. The government has considered increasing the upper limit in FDI from the current 26% to 49%. Foreign partners are largely unwilling to dilute their stakes below 26%, since most of them enter the business in anticipation of the limit being increased. This may result in the local partner being compelled to reduce its stake to 49% to meet the new norms. This could create its own complications, since according to the Indian company law; a 51% stake ensures ownership.
- b. IRDA is finalizing directives and detailed guidelines for mergers and acquisitions in the insurance sector.
- c. The policy document for the smooth transition from Solvency I to Solvency II is in the draft stage.

- d. A data warehouse is being set up to monitor the settlement of insurance claims, better customer relationship management and facilitate better decision making.
- e. IRDA is considering allowing banks to tie up with multiple insurance companies to vend their products. This will give bank customers a wider menu of options to select from, so that they can buy insurance products based on their needs.
- f. IRDA will soon come up with norms to define terms such as critical illness and hospitalization cost, among others, a move that will reduce the scope for disputes between insurers and hospitals. Regulation affects the economics of both the supply side (the policyholders — supplier of funds) as well as the demand side (the insurers — borrowers of funds). The Indian consumer, being extremely price sensitive, adjusts rapidly to the altered economics, which could affect the persistency trend in the industry. IRDA's role will be critical for further industry growth and the rise in penetration levels.

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