Liyaquat Khan
President 12th December, 2011

Submission to IRDA

Comments on the exposure draft of IRDA (Licensing of Bancassurance Agents) Regulations, 2011 as issued by IRDA on its website on 23rd November, 2011.

This note provides the comments from the Advisory Group on Life Insurance of the Institute of Actuaries of India and does not constitute views of the Council of the Institute.

We thank the IRDA for this opportunity to comment on the Draft Regulations.

The various section heads below reflect those in the draft regulations, on which the comments are provided.

Short title and commencement

1. The draft states that the new regulations would apply to banks that are currently licensed under the existing IRDA (Licensing of Corporate Agents) Regulations only upon expiry/termination of the existing licence. However, it is unclear on how these regulations would apply to the insurance companies that have existing bancassurance relationships:

   - Whether the existing distribution agreements between banks and insurers are required to be re-negotiated to comply with the regulations immediately, or only at the time of expiry of the agreements or at the time of renewal of the licences by the banks?

   - What happens to the “valuation discount” if any (please see our later comments under para 13 and 14) that might apply in some of the existing equity deals between banks and insurance companies? Are they required to apply the new regulations retrospectively?

   Recommendation 1: We would recommend providing clarity on the above in the final regulations.

Definitions

2. The list of various states specified under different zones does not appear to be comprehensive: the city of Kolkata is missing from Zone A.

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3. Also, specifying names of states in the regulations may mean that IRDA may need to update the list regularly (e.g. if Uttar Pradesh is split into four different states; or if the developments in certain states warrant them moving from one zone to another etc.).

Recommendation 2: We would suggest not to link the 'open architecture' model based on geographic location (please see our later comments in paragraph 11).

Specified person (SP)

4. There seems to be an incomplete statement in item# 5 in this section as given below:

   "Minimum one specified person shall supervise not more than one branch except that ***(appears some text is missing?)*** Provided that till completion of the five years from the date of notification of these regulation,"

5. It is stated that a single SP cannot supervise more than one branch (i.e. the "span of control" of a single SP would be one branch). However,
   - For the first five years from the date of being granted a licence (to the bank), a SP is allowed to supervise a maximum of three branches in Zone 'B' and five in Zone 'C'.
   - In the case of Zone 'C' a single SP cannot supervise more than two branches for the next two years.

6. We assume (although this may need to be clarified) that the reference to five years in the text here is from the date of granting the original license under these regulations (and not the date of renewal of the license).

7. In our opinion, it is important to ensure that the policyholders receive appropriate advice. While we recognise the logistical difficulties of staffing branches, particularly in remote areas, it is unclear to us how a SP can supervise (and effect the sale of insurance business) at more than one bank branch in Zones B and C, especially considering that a bank may have a lesser number of branches in any given city in Zones B and C and the geographic distance between any two branches is likely to be large.

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Recommendation 3: We would recommend providing clarity in this section.

Recommendation 4: We would also recommend revisiting the relaxed "span of control" for SPs in the first few years of the bank getting licensed.

Ceiling on number of tie ups on Bancassurance Agent and ceiling on number of tie ups on Insurance Company

8. Bancassurance Agents are limited to tying up with one life insurer, one non-life insurer and one standalone health insurer in each state, in addition to tying up with one "specialised insurance company". A "specialised insurance company" is not defined.

Recommendation 5: We would recommend clarifying what a "specialised insurance company" means.

9. On the other hand, insurance companies, other than the "specialised insurance companies", cannot tie-up with a particular Bancassurance Agent in more than nine areas listed under Zone 'A' and six areas listed under Zone 'B', while there are no such limits specified for Zone 'C'.

10. We are of the opinion that the proposed regulations provide significantly more flexibility to the banks (they can potentially tie up with all life, non-life and health insurance companies in India in different states) and significantly restricts the flexibility currently available to insurers (who cannot tie up with a bank in more than a certain number of places in different zones).

11. In our opinion, the proposed "statewise multiple tie-ups" for the banks and limiting the insurance company's tie-up with a given bank to a limited number of geographic areas runs the following risks:

- At the least, this could lead to severe administrative problems in the system; apart from the issues that may arise due to differences in cultures, practices etc. adopted by different insurance companies.

- The proposed regime might also not serve the customers' interests appropriately. For example, a bank customer who seeks advice on the purchase of an insurance policy in Mumbai through, say Bank A, may find that in the neighbouring district of Thane, he is recommended a rival

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company's product by a different branch of Bank A. Further, if he purchases the policy in Mumbai and moves to Thane, it may not be possible to be serviced by the Thane branch of Bank A, if the branch is tied to a different insurance provider.

- The "bargaining power with insurers" of banks would go up as compared to that enjoyed currently. This may not be in the interest of the insurance industry. Admittedly, there are other regulations which restrict the payouts to the banks. However, we would argue that such restrictions on payouts to banks exist even today and despite that, insurers are believed to be incurring significant payouts to the banks. Thus, unless the new regulations on restrictions on payments to the banks are implemented effectively, the proposal may only result in a higher cost for the insurance industry;
- It is unclear how a bank can sell one insurance company's products in one state and another insurance company's products in another state. The 'focus' required to have a committed bancassurance relationship would get lost under the proposed structure, which would not benefit the insurance industry;
- Any increased "cost" of the bancassurance distribution system would ultimately be borne by the policyholders (particularly for participating policies). As such, a "geography based open architecture" may also not be in the interest of the policyholders at large given that policyholders do move from one location to another.
- Restrictions on bancassurance partnerships based on geography will be difficult to implement. Will it be based on the address of the Policyholder or the address of the bank branch? Geographical boundaries of states can be 'porous' and clients based in the location of one branch can easily be booked in another branch in a nearby location. This problem will be severe when the segregation is around the state capital and the rest of the state. This kind of state of affairs has the potential of leading to regularity arbitrage of unspecified kind.
- This will also have a severe impact on the valuation of insurance companies currently having a pan-India tie up with a bank. Significant resources have already been invested by such insurance companies in tapping the distribution infrastructure of the given bank over many years to build capacity to write new business over the future years. Cession of business activity in 4 states in Zone 'A' and 3 states in Zone 'B' to another insurance company would mean that the value of the future new business in these states would be lost by the current insurer. Considering a numerical example, if the company was writing Rs. 200 Cr. worth of new business premium in these states and this has to be given up, this will give rise to a loss of value of approx Rs. 450 Cr (assumed NBAP Margin of 15% and new business multiple of 15).

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Natural justice would demand that the insurance company be compensated for such a loss of value. The fact that for the concerned insurer, these states would open up for another tie up with a different bank is little consolation considering that significant resources would again need to be invested to tap the infrastructure of the new bank, so that business may flow at some future date with a great deal of uncertainty around the success of the new tie up.

- The geographical restriction seems to militate against the essential freedom of an insurance company to carry out business in any part of the country with a distribution partner (bank) of choice, based on which the licences were granted in the first place.

- When obtaining a licence to carry out insurance business, the insurance companies would have had a strategy or a business model in place. The JV partnership agreements of the insurance companies with sponsor banks would have 'bancassurance with the sponsor bank' as the overarching model/strategy. The proposed regulation restricting geographies would be a severe set-back to these business ventures.

Recommendation 6: We would recommend IRDA revising the draft regulations in the light of the comments above.

Qualifications

Recommendation 7: We would request correcting the reference 'Actuarial Society of India' to 'Institute of Actuaries of India'.

Sale of equity shares of insurance company

12. The draft regulations suggest that if the insurer offers its equity shares to the bank partners at a discount to its Market Consistent Embedded Value or "MCEV" (based on the guidelines published by the Institute of Actuaries of India), such a discount ("valuation discount") should be amortised over a five year period and the amortised amount should be treated as a part of the compensation payable to the bank.

13. In our opinion, linking the compensation to any "valuation discount" along the lines suggested looks to be fraught with difficulty:

    - Firstly, we believe that the valuation of equity shares of an insurance company is a commercial matter affecting two investors / shareholders

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(e.g. the insurance company and the bank). IRDA may not wish to specify regulations that are dependent on such aspects.

- Secondly, we believe that if one really wishes to consider the benefit (if any) the bank would have received by buying the equity shares of an insurance company "at a discount", we would consider the discount to be measured against the "market value" of the business, which could be significantly higher (or lower) than the MCEV. Such a "market value" of business can be determined provided the shares of the company are actively traded on stock markets. In other situations (such as that currently applicable in India), the price negotiated between two willing partners is the only benchmark to determine the "market value".

- Thirdly, the nature of the embedded value (to be disclosed for the purpose of IPO) is currently under discussion in the Institute of Actuaries of India, and will shortly be the subject of professional guidance/practice standard.

Recommendation 8: We recommend that if embedded value is to be taken as benchmark of value in the context of an issue of shares to a bancassurance partner, its calculation should be in accordance with professional guidance to be released by the Institute.

- Fourthly, the "embedded value" is an area that applies more to life insurance business. The draft regulations, however, seem to apply to all insurance companies. There would be a need to clarify how this would apply to non-life insurance companies.

- Fifthly, the draft does not consider a scenario where the price paid by a bank to acquire shares in a life insurance company is actually higher than the MCEV. Why should the bank not been given "additional compensation" for the same (i.e. negative amortisation)?

Recommendation 9: We would request that if Embedded Value is to be used in the calculation of the "valuation discount", the method(s) should be specified by the Institute of Actuaries of India, and not prefixed with "Market Consistent" as in the current draft.

14. If IRDA goes ahead with its proposals to link the "valuation discount" with the compensation payable to the banks, we may run the following risks:

- Treating the amortisation of a 'valuation discount' (if applicable) as part of compensation may result into significantly lower commission payouts to the bank. This may run the risk of banks losing interest in future bancassurance

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sales. This may not be in the interest of the insurance industry.If MCEV (or any such valuation metrics) acts as a floor price for offering equity stakes, many banks may not wish to take stakes in insurance businesses, given capital and other considerations. Instead, they may prefer to act as a pure “distributor”. In such a scenario, the insurers wishing for equity tie–ups with banks on the grounds that they should promote a better alignment of interests for a bancassurance partnership may not achieve their objectives. This may not be in the interest of the insurance industry.

- We believe that trying to link “valuation discount” to compensation payable to the banks would create significant room for subjectivity. This is because any ‘valuation discount’ to the banks (if offered), would really be paid for by the shareholders as opposed to policyholders.
- IRDA’s intentions to protect policyholders’ interests would be well served by ensuring that the commission limits as per Section 40A of the Insurance Act and those specified in the draft bancassurance regulations are met.

Recommendation 10: We would suggest removing this link from the draft regulations.

Remuneration

15. The proposed cap on remuneration (being 85% of the maximum commission specified in Section 40A of the Insurance Act 1938), will result in a cap for many traditional lines of life insurance business (after the first 10 years of operations) of 29.75%. This is less than the existing commission cap of 30% to brokers and is not easily explained.

Recommendation 11: We would recommend IRDA to simplify the commission caps applicable to the bancassurance distribution channels and make them consistent with other channels.

General

16. In various places, a variety of durations are specified. The “valuation discount” is amortized over 5 years. The license is for a period of 3 years and the concession regarding span of control is for 5 years. Whilst these address differing issues, there is a clear link between the amortization period and the duration of the license (as one normally amortizes a cost over the life of the “asset”). It would not be in an insurer’s interest to have a tie-up with a bank for only 3 years, as most of the first year will be spent on resolving administrative issues.

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Recommendation 12: We would suggest IRDA to revisit the period for which the licenses would be granted in the interest of generating a longer term focus in the system.

Code of Conduct

17. It is specified that no Bancassurance Agent can become or remain a director in any life insurance company. While we agree with the logic behind this, it is unclear how this can work in practice for bank sponsored life insurance JVs in India asthe Board of the JV would have representatives from the bank concerned?
18. Although we accept the need to reduce churning of business purely guided by salews motives, in our opinion, insisting that no policy can be sold to a given policyholder for a period of 3 years after the termination of an existing policy may not always be in the interest of policyholder. Besides, it will be difficult to monitor. It may perhaps be more appropriate to monitor sales quality by specifying controls at the bank level in terms of maximum lapse rates etc.

Recommendation 13: We would suggest that IRDA revisit this area.

Regards,

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