A Paper on
Deficits in the Policyholder's Fund

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Introduction

The paper deals with the deficit arising in the policyholder's fund in India. The policyholder's fund is kept separate from the shareholder's fund due to requirements by the Insurance Act 1938 ("the Act" or the "Insurance Act") as well as Insurance Regulatory and Development Authority (IRDA) regulations.

The policyholder's fund can be broken down separately in to two broad funds. They are the participating fund ("the par fund") where all the participating business resides and the non-participating fund ("the non-par fund") for non-par business. The non-par fund is less of an issue because all surplus (total funds less liabilities) belong to the shareholder.

The par fund is special due to the restriction in the Insurance Act where the shareholders are only entitled to ten percent of the surplus arising. However, when a negative surplus (deficit) occurs in the par fund, the policyholder relies on the shareholders to fund one hundred percent of the deficit. There is a controversy because of the shareholders' burden of funding all deficits but only are entitled to a portion of any surplus arising. This paper focuses on the deficit in the par fund because of this controversy.

It is important to note that regardless of how the deficit in the policyholder's fund is funded (or not funded), the company must at all times be solvent as required by the Act and IRDA regulations. Therefore, the deficit is always funded either in the policyholder's fund itself or in the shareholder's fund.

This is an important issue to resolve because capital is scarce. Shareholders are reluctant to start life fund unless there is a fair mechanism to earn a return on their capital. Certain jurisdictions with regulations that are viewed as unfair have not had a new life fund started. This is detrimental to consumers who want to purchase participating business.

The options listed below are meant to be an exhaustive list of methods to deal with the deficit. The options are drawn from the experience of other countries as well as the views of knowledgeable people within the ASI. Each has its own advantages and disadvantages and will require certain actions from the IRDA as well as the ASI.

Option 1 – Deficit Covered by Immediate Injection

As the name of the option implies, no deficit is allowed in the fund. All deficits are made up by shareholder injections into the fund. The main advantage is that it eliminates the deficit and is simple and straightforward. However, the shareholder's injection is viewed as "trapped". The tax treatment of any injections is still unclear.

Singapore and Malaysia adopt this approach. However, it has been viewed as onerous and therefore no new par fund has been created for a long period of time in these jurisdictions. There is discussion in the insurance community to change this requirement.

Legislation

It is believed that the requirement can be handled through promulgation of IRDA Regulations and no new legislation is required.

Regulation and IRDA Action

IRDA need to promulgate Regulation(s) to not allow for any deficits. In the regulations, it must be made clear whether the test for deficit be at all times or only at certain point in time. Other creditors (of the shareholders) should be made clearly subordinated to policyholders by Regulations.

ASI Action

Would the IRDA leave the basis for deficit testing up to the ASI? This is an important issue since the accounting in the fund currently assumes a conservative basis through the use of Margins for Adverse Deviation (MAD) in the liabilities. There is also conservatism in setting the minimum liability at zero or surrender value. Book value of assets is also used which may not be realistic for deficit testing. Although the nature of the discount rate used should theoretically depend on the nature of the asset-reporting basis. In any event, the existing basis for testing deficit may be artificial and not revealing the true nature of any deficits.

Option 2 – Deficit Allowed

This option is almost the opposite of Option 1. The deficit would be allowed to continue as long as the company in total meets all solvency requirements.

Legislation
Section 49 of the Act which prohibits deficits if dividends are to be declared would have to be modified if dividends are allowed when the fund is in deficit.

Regulation and IRDA Action
The IRDA would also need to promulgate clear Regulations to allow for this option. An important question to answer in the regulations is "Should IRDA limit policyholder and shareholder dividends when there is a deficit"? After all, dividends are meant to be generated from surpluses.

ASI Action
The question of the basis used to determine the deficit is also important and should be set by the IRDA in consultation with the ASI. However, this is less of an issue as the deficit is unfunded. The ASI should also decide how Asset/Liability Management (ALM) should be performed in light of assets being lower than liabilities. ALM can still be performed using shadow portfolios but ASI would need to specify the methodology.

Option 3 – Hypothecate Assets

This option allows the deficit to be covered by assets in the life fund. But these assets are NOT injected in the life fund and can be released when the deficit is erased without having to share the assets with policyholders.

This method is used on an ad hoc basis for life funds in Singapore. The use is temporary and for emergency purposes such as during the 1997 Asian financial crisis.

Legislation
Section 49 of the Act which prohibits deficits if dividends are to be declared would have to be modified. This Section should allow for dividends taking into account that deficits are erased due to hypothecation of assets.

Regulation and IRDA Action
Should IRDA limit shareholder dividends when there is a deficit? The question of "What assets can be hypothecated?" should be answered. The quality and yield of the assets must be dealt with. The specific procedure of hypothecating and releasing the assets should also be covered by regulations. Other creditors (of the shareholders) should be made clearly subordinated to policyholders.

ASI Actions

ASI actions would be the same as in Option 1. In addition, the ASI can help answer the question "What would investment expense, investment income allocation between funds in deficit (with hypothecated assets) look like?"

Option 4 – Loan From Shareholder Fund

This option allows a loan from the shareholder's fund to cover the deficit in the policyholder's fund through subordinated debt or other means. It must be clearly stated that the debt is subordinated to policyholder's interest.

This approach is used in Britain.

Legislation
Existing legislations does seem to allow policyholder's fund to service "debentures". Hence no legislative action seems needed except to change Section 49 of the Act to allow for dividends when a deficit is supported by a loan.

Regulation and IRDA Action
Should IRDA limit shareholder loans to a reasonable amount and should dividends when there is a deficit? What assets can be loaned or is it cash only? What is the loan rate?

These are all important questions to be addressed by IRDA regulations. Regulations must also avoid double counting of loan asset in both policyholder and shareholder funds leading to the creation of "phantom" capital. The IRDA regulations would also need to address how a loan to the policyholder's fund affects the Investment Regulations.

ASI Actions

The issue of deficit determination (as in Option 1) needs to be addressed by the ASI. The ASI would also need to address what ALM and reserve calculation assumptions should be employed when the policyholder's fund owes a loan to the shareholder's fund. Investment expense and the allocation of loan asset and interest expense would also need ASI guidance.

Option 5 – Reinsurance

This option is different from the use of reinsurance to mitigate risk. Mitigating risk is an important use of reinsurance that most if not all insurers use, and is sound. There is already capital relief (in the form of lower solvency margin) in the IRDA regulations when reinsurance is employed.

This option is an additional use of reinsurance specifically to remove all or a portion of deficits in a fund. The idea is to use of reinsurance to reduce the liability in the fund while reducing the asset in the fund by a lesser amount. This increases the solvency of the fund by increasing the asset value over the liability value. There is of course a cost that the reinsurer demands for the use of its capital. This is usually paid by the ceding insurer through future reinsurance premiums. Therefore, the relief is temporary.

The financial stability of reinsurers is very important. If a reinsurer is in financial trouble, a reinsurance agreement is very difficult and time consuming to unwind. Quick action by the IRDA can be difficult because of these issues.

This approach is used in Britain.

Another reinsurance option is to allow reinsurance between funds. An example would be reinsurance of risks from the par fund to the non-par fund there by reducing/eliminating the deficit in the par fund. The company must of course be totally solvent. This eliminates the financial stability issue because it eliminates an outside reinsurer.

Legislation
There is no specific legislation requirement for the use of reinsurance for deficit reduction purposes.

Regulation and IRDA Action
IRDA Regulation currently limits the use of original term reinsurance. This makes it difficult to transfer enough risk (specifically asset risk) to reinsurers. IRDA regulations do allow for a minimum credit rating for reinsurers which mitigates the credit risk

somewhat. New Regulations should also exempt mandatory reinsurance (e.g. to GIC) from being applied to surplus relief reinsurance.

There is a growing body of thinking that reinsurance without true risk transfer should be viewed as a loan and any reduction in policyholder liability should be offset by an increase in reinsurance liability. Therefore it is important to specify what is true risk transfer.

Any IRDA Regulations on reinsurance would need to address the limits on reinsurance as well. Currently, reinsurance allows the reduction in solvency margin credit but only up to 50% of the risk. Regulations should also specify whether dividends should be paid when there is a deficit being covered by reinsurance. The IRDA should also specify if reinsurance between funds is allowed.

ASI Actions

The issue of deficit determination (as in Option 1) needs to be addressed by the ASI. The ASI would also need to address what ALM and reserve calculation assumptions should be employed when there is reinsurance to ensure that the effects of reinsurance is properly reflected. The ASI should also specify the methodology for reinsurance between funds in order to have fair treatment for policyholders.

Option 6 – Separate Accounting for Shareholder's interest in Policyholder's fund.

This is a promising method of dealing with deficits arising in the life fund. Amounts injected into the life fund are counted as shareholder capital and is accounted for separately. The capital is counted as an asset in the life fund and is clearly subordinated to the policyholder's interests. These amounts cannot be withdrawn until the life fund (less the amount to be withdrawn) is no longer in deficit. All amounts withdrawn belong to shareholders. This protects the policyholder's interests by requiring injections whenever there is a deficit and allows returning of shareholder's capital in a "fair" manner when no longer needed.

This approach is adopted in Australia.

Legislation
There is no specific legislation prohibiting this type of arrangement.

Regulation and IRDA Action
IRDA Regulations (including modifying accounting regulations) would be needed in order for the shareholder interest to be accounted for separately. Regulations should also specify that shareholder interest can be taken from the fund fully.

ASI Actions

The issue of deficit determination (as in Option 1) needs to be addressed by the ASI.

Overall ASI Action

Funds in deficit and methods of dealing with them must go hand in hand with setting proper Policyholder's Reasonable Expectation (PRE). This is very important because policyholders should not expect to be paid large bonuses in the future if there is an existing and continuing large deficit. Disclosure of deficits in terms of how they arise, when they are expected to be erased and methods of funding deficits are also important.

The ASI is the best forum to discuss these issues as the ASI has the technical knowledge to deal with these issues. The ASI should work with the IRDA and the Life Insurers to properly address the PRE so that policyholders and potential customers are not misled.

Taxation Issues

The taxation for life insurance company situation in India is still developing. This is especially true for amounts injected into the life fund by shareholders. The main question is: "Are these amounts tax deductible?"

Two different approaches may be considered. The first would be to allow for amounts injected to be tax deductible when injected. Profits would be taxed under current rules. This method is not as fair to new insurers as they tend to have tax losses anyway and cannot use the deduction. And losses carried forward are limited.

A second method would not allow a tax deduction when capital is injected but then profits (or shareholder entitled portion) would not be taxed until the shareholder amounts injected to cover deficits are fully recovered.

Conclusion and Recommendation

Any methods chosen must protect policyholders while treating the shareholders fairly. This is the only way to ensure a healthy life insurance industry going forward.
The IRDA already has broad powers as per the Insurance Act to require companies to take steps to ensure solvency. The Appointed Actuary system is also in place to allow for these issues to be raised to the IRDA much before a company is in trouble. Companies are required by the Act to be solvent overall regardless of any deficits in the policyholder's fund. Therefore legislation should not be needed.