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Enhancing Profitability In Indian Life Insurance Industry-A Proposition

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***Abstract:** With more than 35,000+ crore deployed as capital and over 11003 branches becoming operational Life Insurance companies are still grappling to wipe out accumulated losses. Going slow on expansion Insurance companies are attempting to take an evaluated risk. Commencing operations without grasping the determinants of profitability is bound to be fragmentary and incomplete. Because of long term nature of Insurance business there is no predetermined criterion to measure the effectiveness of operating companies. Hence for accounting purpose insurance companies rely on bookkeeping practices to land at profit for the financial year. This may offer us fractional info and will not provide us the factual viewpoint. Concept of embedded value where we examine the future cash flows at present moment is also not extensively received as it lacks accepted criterion. During initial years Insurance companies were investing heavily to build distribution but the ROI took unusually long time. Companies are adopting standard practices thanks to regulatory interventions at frequent intervals which only reiterate a point that cost effective products need to be offered to customers to gain their confidence and market share.*

I. INTRODUCTION

At present many insurance companies are suffering loss which is a disturbing trend. It is because of the descending fortunes of the Indian life insurance industry which until a few years before was considered to be a sunrise industry guaranteeing decades of uninterrupted growth and loads of profits for shareholders. And year-on-year there is a decline in new business premium which is the yardstick to measure the efficiency of capital deployment. Charges of ambiguous sales pitch by agents led to the Insurance Regulatory and Development Authority step in with fitted controls on how a product is sold. The field that was unregulated i.e. agent commission which was never regulated also drew regulatory attention. There was a massive correction in the way insurance is being sold after both the regulators – SEBI and IRDAI indulged in public animosity on who controls the Unit Linked Insurance Plan (ULIP) which was similar to mutual fund units. Commission on unit-linked products has come down to 5% from as high as 18%. Hence, the sales also decreased which made insurance companies incur further losses.

Industry had lost more talents with a massive breakout of agents since 2010. The total number of agents dropped by 5 lakhs from 26.39 lakhs in March 2010 to 20.67 lakhs at the end of March 2015. Economic mishandling over the last few years had its undesirable influence. Inflation also averaged 10% at the consumer-level for much of the past decade and lowering employment coupled with drop in savings ratio all have compounded the already struggling insurance industry into chaos which kept potential buyers away from buying insurance policies. When industry is struggling not everyone would be willing to commit for a long haul in this scenario especially when growth rate was falling to decade low of 5% and salaries are forecast to grow only between 10 and 12% against the 20-30% in the past magnificent years. While we have many factors which influence the profitability of Life Insurance Companies the most prominent one are mentioned as below.

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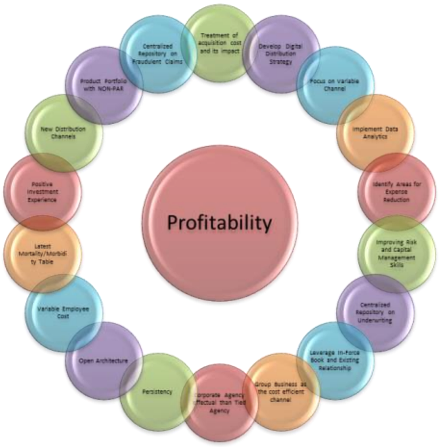

Figure 1

A. TREATMENT OF ACQUISITION COST AND ITS IMPACT

Since Indian Life Insurance Companies do not follow IFRS 4 Accounting which allows for deferring the acquisition cost we make as if the business is loss making. IRDAI should standardize the accounting practices and align with global practices wherein the initial acquisition cost is deferred so that companies would make profit from the accounting perspective. Current accounting practice would discourage Insurance Companies to infuse further capital as everything gets reflected in the accounting year. The Ministry of Corporate Affairs (MCA), Government of India has notified the Companies (Indian Accounting Standards) Rules, 2015 on February 16, 2015.As per that Insurers shall comply with the Indian Accounting Standards (Ind AS) for financial statements for accounting periods beginning from April 1, 2018 onwards, with comparatives for the periods ending March 31, 2018.

B. DEVELOP DIGITAL DISTRIBUTION STRATEGY

Digital signifies an incessant form of disruption to current or new business models, products, services or experiences enabled by data and technology. Efficiently leveraging digital revolution can let life insurance companies to lessen customer service costs while augmenting both customer satisfaction and retention. Currently Insurance Companies are sourcing only term plans through online sales... Since it is only beginning we cannot compare the quantum of premium source through online since term plans ticket size will be very low. Biggest advantage here would be reduced cost of acquisition which can be passed to customers which in turn enhances topline and bottom line. Also marketing insurance products through the e-commerce model will profit consumers and companies equally as it would present instantaneous connect and unleash digital touch points to bring in more obviousness.

C. FOCUS ON VARIABLE CHANNEL

Insurance companies are focusing on variable channel wherein instead of Sales Managers you would have Chief Agents recruiting agents under them and developing them. These Chief Agents are on variable pay wherein they are paid an ORC on the advisor commission. While the model is not formally approved by the regulator we have 13+ companies practicing this model and generating business through this. This is a big shift from the existing direct channel where the payout is made only once the business is sourced. It is still not a major channel for most of the Insurance Companies since the productivity of Chief Agents is not predictable as most of them are part time. With enhanced productivity from Chief Agents this is surely a game changer.

D. IMPLEMENT DATA ANALYTICS

Life insurance industry always remained very competitive. And amidst this uncertainty and inflated costs the only tactic to grow both topline and bottom line is by acquiring quality customers and retaining them. However identifying quality customers and retaining most of them requires a focused approach and this is possible only through analytics viz., understanding customer priorities, behavior and buying patterns. Analytics can be defined as studying the historical data to identify a particular trend and predicting the future. Main aim of analytics is to study the behavior of the customer and manufacturing a product basis his need. In the life insurance industry, analytics can aid a company craft an all-inclusive roadmap for handling the entire lifecycle of a customer, from acquisition to lapse or maturity. Analytics also supports an insurer gain a holistic view of a customer, draw inferences and ascertain opportunities across all business lines. This is a sure shot way to initiate both cross and upsell opportunities with the existing customers. With so many data available for analytics this is a sure shot way to reduce the cost of acquisition and approach the existing customers for future sales by observing a pattern or trend in consumer behavior. This is called predictive modeling.

E. IDENTIFY AREAS FOR EXPENSE REDUCTION/EFFICIENCY BUILD UP

According to calculations a life insurer can enhance its return on equity by 2.5 percent through cost-cutting, and a further 0.6 percent by optimizing commission structures and processes. It is simply that cost reduction must be seen at the strategic level. Companies of course, typically have a number of cost-reduction programs underway at any one time. But these are very limited in scope. What we are discussing here is perpetual cost containment and that denotes rationalizing and restructuring the operational model. This eventually leads to Efficiency Build up. Many companies are by now exercising the shared services model to produce genuine advances in process and service fineness in support functions like IT and finance as well as principal insurance functions such as claims and call centers. But to achieve maximum benefits this move to shared services must be combined with the company’s digital revolution, generating a more cost-containment operating model that extends to all the business units and offering a customized digital stage through which life insurers interact with both clients and business partners. Major cost containment needs to happen at employee level since employee cost contributes close to 50-55% of the overall operating expense. With regulatory guidelines in place the average commission came down drastically and the only area which needs to be focused is optimum utilization of existing resources.

F. IMPROVING RISK AND CAPITAL MANAGEMENT SKILLS

Integrated risk and capital management is emerging as a source of competitive advantage in the insurance industry. The days of seeing risk and capital management as purely defensive business processes are nearing an end. Insurers have come to identify enterprise risk management as central to creating and enhancing shareholder value through improved risk-based decision making and capital allocation. Senior executives are according integrated risk and capital management greater importance and attention than ever before, establishing high-level accountability befitting a legitimate tactical function. Risk management deliberations have begun dominating business decisions in such conventional areas as investment/asset strategy, annual business planning, product pricing and reinsurance purchasing. Reinsurance is the most effective way for managing integrated risk. Organizations handle Market Risk, Insurance Risk and operational risk. Companies need to have long pronged strategy to handle this risk.

G. CENTRALIZED REPOSITORY ON UNDERWRITING

In underwriting, contemporary data sources and inventive platforms to stock and store data or simply computerize existing processes can lower the length and tactlessness of risk assessment, refine risk selection and improve policy pricing. Mechanization of underwriting a developing trend will be pressed to new frontiers by improvements in cognitive computing, while Big Data and innovative analytical tools will advance the still-budding stage of predictive modeling in underwriting. Data sharing platforms for end consumers will reduce the cost of collecting health information and provide cost efficient way to gather information. Having a centralized repository on customer details and sharing the same is surely going to reduce the overall costing of underwriting for all the insurance companies. Policies will fall under Non-Medical do not require any spending on underwriting except authenticating data which can be done accessing centralized repository.

H. LEVERAGE IN-FORCE BOOK AND EXISTING CUSTOMER RELATIONSHIPS

The Indian life insurance sector has underperformed compared to its Asian counterparts, said a report by McKinsey & Company. The report 'The Life Journey India' said that none of the private insurers in India are generating value as per the market potential. It further said this is because all insurance companies are serving a tiny segment of customers primarily to meet their narrow investment needs. However the report added that even within this restricted space they could demonstrate significant performance which is driven primarily by voluminous distribution. The report further states that industry is driven by banc assurance model because of cost efficiency and less capital expenditure. Growth in Indian Life Insurance Industry can be related more closely to the growth witnessed in equity market than the actual GDP. For more than a decade private industry delivered a performance which is far below the cost of capital and way below the returns in other Asian Markets. For value growth insurers should develop capabilities in agency and minimize costs, reinvent relationships with customers and distributors by using digital tools and analytics. They should also build risk and capital management skills and leverage the in-force book and existing customer relationships through cross sell and up sell opportunities.

I. GROUP BUSINESS AS THE COST EFFICIENT CHANNEL

The foremost appeal of group insurance is the capability to cover voluminous database in a cost efficient manner. Group insurance is cost effective because it pays comparably lesser commissions and incurs lower acquisition cost; by its nature obstructs the need for individual underwriting; makes use of a master contract with the plan sponsor instead of having to issue individual policies; and effectively gathers premium collection through payroll deductions or as onetime payment from the employer. The insurance cover also has comparatively effortless data requirements. If the risk assessment is prudently done then it will generate enough underwriting surplus. Also since it follows the pattern called experience rating we would be charging premium proportionate to the accepted risk. Group Fund Business remains vital since companies make good on FMC charges and also MRTI (Mortgage Reducing Term Insurance) products which allow them to cover customers on their properties. Insurance Companies generate profit through Asset Management and also prudent underwriting.

J. CORPORATE AGENCY EFFECTUAL THAN TIED AGENCY

Unlike an agent that can only sell insurance, properly trained bank staff can dedicate themselves to serving all their customers' financial needs in one-stop. Many would prefer to call banc assurance as a channel. Instead it is a business model created to leverage the distribution capability of a bank without incurring any further capital expenditure. Banc assurance can be multi-channel, selling through face-to-face interactions, online, through the mail or telephone—fundamentally it is selling insurance to bank's internal customers through the bank's existing distribution.

K. PERSISTENCY

As the undercurrents of the industry have transformed, companies understood how retaining existing customers is vital to profitability, making 'persistency' the new catchword in the life industry. With margins showing a downward trend emphasis shifted from growth to profitability. That is insurance companies started focusing more on profitability and sustainability than growth in new business premium. In this light, discontinuation of a policy has an adverse impact on all the stakeholders. The policyholder drops his risk cover and

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fails to meet his long term financial goals; the agent fails to earn renewal commission and sustain the existing relationship; and the insurer is unable to recover the initial acquisition cost or build a justifiable base of polices. Understanding this simple equation has compelled insurers to redefine their strategies and strike a balance between new customer acquisition and retaining existing customers. Insurers operating tied agency are experiencing a considerable increase in the number of orphan policies because of more inactive agents or maximum agents leaving the industry thus making the renewal collection more vulnerable and in turn affecting the already depleting persistency ratio. Also since new business pays higher payout there is a tendency with insurance agents to ignore renewals for new business.

L. POSITIVE INVESTMENT EXPERIENCE

The main source of revenue for insurance companies will be premium from underwriting activities and returns on investment income. Life insurance companies invest revenue in order to generate a profit. Insurers invest in diversified assets but however should be careful and not greedy in investing in riskier asset class as they need to maintain safety and liquidity also. Insurers invest in stocks, bonds, real estate, and a number of other asset classes. Net investment income is deployed as the numerator because it eliminates the expenses associated with creating the investment income. The denominator of the investment income ratio is earned premiums. We may take written premium as the denominator but it means that the calculation will include premium which is still considered a liability. Earner premium would give us the exam picture. The investment income ratio is deployed in the assessment of an insurance company's overall operating ratio, which is a measurement of the insurer's overall performance. Operating ratio is equal to sum of loss ratio and expense ratio minus the investment income ratio. An operating ratio below 100 indicates that the insurer is generating profit from its operations. Life Insurance companies provide guaranteed products in addition to non-guaranteed. They will earn or lose, based on the investment experience of the company. A strong investment team with futuristic approach will surely help the company register Investment surplus in the long run. Insurers were allowed to deal with Financial Derivatives only to the extent approved and in Accordance with the guidelines issued by the Authority vide Regulation 11 which got included in 2004 in the IRDA (Investment) Regulations, 2000.Subsequently, the Authority circulated comprehensive Guidelines on Fixed Income Derivatives vide Circular no. INV/GLN/008/2004-05dt.24/08/2004. The said guidelines authorizes Insurers to enter Forward Rate Agreements (FRAs), Interest Rate Swaps (IRS), Exchange Traded Interest Rate Futures (IRF) with a maximum tenure of 1 year to hedge the Interest Rate risk on Investments and the forecasted transactions.

M. NEW DISTRIBUTION CHANNELS

There is a growing need to develop new and cost effective channels for distribution. Both Agency and Banc assurance channels have their own merits and demerits. We need to have multi-channel distribution for optimum utilization of resources. With the advent of technology innovation there is a scope to reduce the cost of acquisition which in turn the benefit can be passed to the customer. IMF (Insurance Marketing Firm) is the new channel for distributing insurance products who work on multi-product platform which is initiated by the regulator. Following are the new channels which come in the forefront for distribution.

- ✓ Online/internet gateways
- ✓ •Direct marketing and Telemarketing
- ✓ •NGOs and affinity groups
- ✓ Insurance Marketing Firms
- ✓ Web Aggregators
- ✓ Worksite Marketing

N. PRODUCT PORTFOLIO WITH NON-PARTICIPATING PLANS

The Insurance Regulatory and Development Authority (IrDA) is tightening its noose around the expenses of management in life insurance companies. In a draft circular, it has asked companies to opt for the lower of either the expenses as mentioned in the file and use (F&U) filing with IrDA and the norms under Rule 17D of the Insurance Rules 1939. Feedback has to be sent by next week. Further, the expenses for two similar-looking products in the participating (par) and non-participating (non-par) segments cannot be different. PAR funding is done from Policy Holder's account whereas Non-PAR is from Shareholder's account. Insurance Companies need to distribute surplus to policy holders on PAR products at 90:10 Ratio wherein 90% gets distributed to policy holder's basis the actuarial valuation. However there is no surplus distribution on NON-PAR products and entire profit gets into shareholders account. Hence the need to have more NON-PAR portfolio which eventually allows shareholders nullify most of their accumulated losses through the profit generated from NON-PAR products.

O. CENTRALIZED REPOSITORY ON FRAUDULENT CLAIMS

According to the analysis of KPMG India Financial Services, insurance is the most susceptible sector when it pertains to deceitful activities. Recently, the losses triggered off to the insurance sector due to frauds are over 30000 crores annually which are nearly 9% of the total projected size of insurance industry a report by India Forensic Centre for Studies.\Under Section 45 of the Insurance Laws (Amendment) Ordinance, no claim can be rejected after three years for any reason. Hence the need to have a multi-pronged strategy to handle fraudulent claims which is denting the profitability of life insurance companies in India. There is a need to have a centralized repository on fraudulent claims which can be built by all Insurance Companies. Prospective customer details applying for a product can be authenticated through centralized repository and give a go ahead with the proposal. This will aid companies with anti-selection.

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P. OPEN ARCHITECTURE IN BOTH BANKING AND TIED

Companies which are bank promoted and with banc assurance tie up are the ones hitting profitability at the earliest. This happens because of leveraging with the existing banking network and Insurance Companies will not be required to infuse capital on branch expansion. However banking ties up is only restricted to select companies till recently... Now the regulator has come with Open Architecture and we can expect some momentum on this front... We are yet to see renewed interest since it is currently offered on voluntary basis and bank promoted companies are not interest in open architecture. Similarly Tied is dominated by LIC which has got a base of 10lakh+ agents which is close to 50% of the total base. We do not have even spread of agent deployment across companies. Hence a need to have open architecture even for tied set up where we can leverage with the existing base which eventually can increase the penetration.

Q. VARIABLE EMPLOYEE COST

Manpower cost is between 40-50% of the overall operating expense which is an alarming trend in the current scenario. We cannot trim the employee strength as it is very much required for distribution buildup... Hence a need to plan employee cost which is a combination of fixed and variable. We need to incentivize employees more on variable which in turn will help us enhance their productivity. This will also reduce the fixed cost which is costing huge for the organization. We can surely have more employees on variable than fixed. And variable is paid basis the business achievement. This is to say that you will add on cost only with business coming in else you will continue to spend the same amount without adding any additional costing.

R. LATEST MORTALITY/MORBIDITY TABLE

Currently we are using the following Mortality/Morbidity Tables for Life Insurance Industry.

- ✓ INDIAN ASSURED LIVES MORTALITY (2006-08) ULT.
- ✓ MORTALITY FOR ANNUITANTS - LIC (A) (1996-98) ULTIMATE RATES

We need to have the latest mortality/morbidity tables which reflect the current scenario. With advancement in Medical technology and innovation our recent experience been much favorable and we are witnessing an increase in life expectancy. The same needs to get reflected in the table which can happen only when we follow the latest one. This will not only help reduce the mortality/morbidity charges but will also allow insurance companies to pass on this benefit to our customers which will in turn increase the top line thus contributing to profitability.

II. CONCLUSION

Insurance Companies need to ponder upon efficiency and this can happen only we see growth in both Top Line and Bottom Line on YOY basis. Building efficiency is the only way to tide over and square off accumulated losses which gets clearly reflected in surplus generation on underwriting, investment and expense ratio.

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