STUDY OF

MUTUAL MODELS IN INSURANCE

PHASE II

NATIONAL INSURANCE ACADEMY

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EXECUTIVE SUMMARY

Even though India is one of the fastest growing insurance markets, she is lagging in terms of insurance penetration and density. One of the major challenges for increase in insurance density and penetration is access to insurance. Presence of alternative forms of organisations may help in increasing footprints of insurance companies and availability of more customised products. Regulator is considering opening the space for alternate organisations. With this background this study examines possibilities of insurance mutuals in India. The study attempts to understand the regulatory changes required to facilitate presence of mutual insurance organisations. A mutual/cooperative is an insurer that is owned and/or controlled by its policyholders. Mutual and cooperative insurers together known as "mutuals" are different from joint stock company insurers in their ownership, distribution of profit, governance, and service orientation. Mutual insurance is a well-developed and established form of insurance in developed economies. There are over 5,000 mutual and cooperative insurers in 77 countries across the globe. Mutual insurance has a market share of 40% or more in the USA, Japan, France, and Germany. Insurance mutuals are growing at a rate of 30% across the globe.

This study was conducted in two phases. The first phase of the study covered the landscape of insurance mutuals and cooperatives across the globe. The countries studied in the first phase of the study were the USA, European countries Germany, UK, Netherlands, Asian countries China, Japan and Philippines, and South Africa and Morocco in Africa.

This second phase of the study examined how an enabling environment can be created for mutual insurance /alternative organisations so that insurance space can be made more inclusive. We did expert interviews (key informant interviews) to get views on the current ecosystem and future changes expected. The question guide covered areas like learnings from banking sector, preferred areas for starting mutuals in India, regulatory environment for emergence and growth of mutuals and role of technology in future growth of mutuals.

Based on the discussions and observations from Phase I and from the views of the experts, the study team makes following recommendations:

1. The mutual insurance can be set up with individual or institutional sponsors pooling in seed capital.
2. The initial capital recommended for the mutuals as Rs Ten crores.
3. Area of operations is recommended to be small limited to few districts or few states at the beginning. However, the organisations having nationwide presence should be evaluated separately on a case-to-case basis.
4. The mutuals can carry short tail risks like health, motor, personal accident, asset to begin with. The life insurance products taken up could be term life, term with return of premium and credit life.
5. The members can work as distributors. New members can be inducted on referral basis.
6. The national reinsurer GIC Re or any other reinsurer (if interested) can take up the risks and act as reinsurer for mutuals at the beginning.
7. Plug and play platform solutions offered by vendors can be used by mutuals to harness advantages of technology. Setting up a common digital platform by regulator can be another alternative. The regulator also needs to take into cognisance presence of cloud mutuals in international market.
8. Mutuals should be closely monitored like that of a joint stock company and is to be mandatory. Monitoring should be on macroprudential basis, which is risk based capital/solvency supervision and market conduct. Regulation and compliance can be liberal but on key parameters like Capital, Additional Capital, Profitability, Solvency and Market conduct it should be strict.
9. The mutuals shall be governed by a board of directors having suitable representation from members, promoters, and management. An Executive Committee can look after the daily operations.

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CONTENTS

STUDY OF INSURANCE MUTUAL MODEL PHASE II

Chapter 1

Introduction to Mutual Insurance in India

1.1 Background

India is one of the fastest growing insurance markets. It is observing double digit growth for more than a decade now. However, if we compare India with peer countries or with other developing and developed countries in the world, we have a long way to go. India lagging behind in terms of insurance penetration and density. One of the major challenges for increase in insurance density and penetration is access to insurance. A large population of India is still out of reach of insurance market. The issues are both demand side as well as supply side.

India has 60 Registered insurance companies. These companies have not able to reach to the masses despite efforts made by the regulators, Government, and the companies themselves. The insurance companies have not been able to find out a viable business model to reach out to low ticket market. NITI Ayog has talked about the missing middle, which does not participate in the current insurance market as they do not find product suitable for their specific needs and paying capacity. In this background, the question arises that are there any alternative model of business and organisations which can bring desired change in this direction? This enquiry led us to look for alternative forms of organisations like insurance mutuals across the globe.

A mutual/cooperative is an insurer that is owned and/or controlled by its policyholders. Mutual and cooperative insurers together known as “mutuals” are different from joint stock company insurers in their ownership, distribution of profit, governance, and service orientation. A mutual insurer does not have external shareholders. Mutuals are owned by, governed by, and operated solely in the interests of their customers/members and help them in dealing with losses due to natural disasters and climate change (ICMIF 5-5-5 org). A mutual is further defined by the key principles of solidarity, democratic governance, and sustainability. Mutuals are considered to be more aligned with the interests of policyholders rather than generating profits for shareholders. Concept of mutual helps in maintaining a balance between the aims of offering quality insurance products and generating profits. All profits generated are put back into the mutual and used to the benefit of its policyholders also called members.

Mutual insurance is a well-developed and established form of insurance in developed economies with mature insurance markets like North America, Europe, and Japan. There are over 5,000 mutual and cooperative insurers in 77 counties across the globe. Mutual insurance accounts for more than 25% of the national market in 20 countries and has a market share of 40% or more in the USA, Japan, France and Germany. The mutual market registered a growth rate of 29.8% in last decade.

Mutual insurance runs on three basic principles – ownership to members (who are customers), functioning on democratic principles (allowing a say of policyholders in management) and profit sharing with members. These principles address the following issues present in stock companies: a. Principal-Agent problem is prevalent in shareholding companies as there is no separation of benefits between the members and the owners in a mutual. b. The issue of conflict of interest between insured and insurer as both are one and the same. c. The third problem that this model deals with is of information asymmetry, adverse selection, and moral hazard. d. Since the profits made by the entity is ploughed back for members' benefit, these common issues of the conventional insurance business model or shareholding model are automatically reduced. These merits of mutual insurance allow the model to be cost-effective and responsive to the needs of the insured. It also brings ownership by increasing trust in customers who otherwise feel cheated in the case of no claim. It can serve as a good model for bringing insurance inclusion as it addresses the prime concerns of low-income and rural populations by bringing transparency, control by policyholders and delivering value for money.

India has successful cooperative movement in some parts of the country. There is strong presence of cooperatives in banking sector. There are also few successful models of community based mutuals in informal sector. Despite good presence of cooperative in the country, why does India not have any insurance mutual and cooperative? In this reference attempt was made to understand the role played by insurance mutuals in select countries and the regulatory and market landscape in which these mutuals exist. This inquiry formed basis of the first phase of this research project.

1.2 First Phase of the Study

The purpose of this study was to examine the landscape of insurance mutuals and cooperatives across the globe and draw insights and learnings for India. We identified and organized the study around the dimensions namely mutual and cooperative culture, history and evolution, regulatory environment, support, and protection to insurance mutuals capital and solvency requirements, performance of mutuals vis a vis other competing entities and technology use. These dimensions were examined around few parameters to arrive at the conclusion that the country can be considered high, medium, or low on these dimensions. Study across these parameters helped us understand the main factor contributing to existence and growth of insurance mutuals in these countries. The countries studied in the first phase of the study are the USA, European countries Germany, UK, Netherlands, Asian countries China, Japan and Philippines, and South Africa and Morroco in Africa.

Mutual and cooperative culture was examined around history and evolution of mutuals in the country. Information was collected around the nature of existence, the spread of these organizations and conditions that led to growth of Mutuals. We also attempted to collect information about percentage of population covered and geographical distribution of these entities. The study of this dimension gave a perspective of social-economy present in the countries which led to success of insurance mutuals.

A summary of the first phase of the study is presented in the following section.

1.2 Learnings from Mutual Insurance Across the World

A cross-cutting theme that emerges from the first phase of the study of mutual insurance across the globe is that the basic factor in initiating a mutual entity is affordability. People found conventional /corporate insurance expensive and looked for an alternative in mutuals. In many countries, people wished to eliminate the role of agents/intermediaries, remove commission to make insurance affordable, and come together to form insurance mutuals.

Mutual insurance companies across the globe are non-profit companies dedicated to value creation for its members. Most of the mutuals started their function with the contribution of members, and later, they built funds from the surplus generated by the business. However, there are exceptions to this, where the Government or promoters provided seed money to initiate operations. The Netherlands is a good example of this, where the Government provided a grant to start a mutual. In France, MAIF and other mutuals started another mutual company named MACIF. Mutuals also dealt with the issue of asymmetric information and made this form of insurance viable by reducing the cost of monitoring and spillage due to fraud. Mutuals started with covering specific risks concentrated with people engaged in certain livelihoods and living in the same area. Later, in many cases, mutuals diversified by adding new products and business lines and opening their services to the general public.

There are ample examples of big mutuals turning into holding companies and floating subsidiaries which are shareholding companies to take up various functions and business lines as a means of business expansion. A study of the evolution of mutuals and cooperatives indicate that mutuals existed before the welfare state's advent to take care of financial and other social and protection needs. Some of these mutuals and cooperatives lost their relevance and ceased to exist after the advent of welfare states as states took on the responsibility of providing support. The Netherlands is a good example of this. After the welfare state took over social protection responsibilities in the Netherlands, many mutuals stopped their operations. In the 1990s, when Netherlands Government announced that it would not carry risks of individuals, many mutuals started emerging. European countries have a long history of informal, friendly societies and mutuals, which are considered precursors of insurance mutuals. Many of these mutuals lost relevance when the formalisation of organisations started during the industrial revolution. New formal mutuals took their place, which had a specific organisational structure and was guided by the Code of conduct, by-laws and regulations of the Governments/State.

Regulatory environment is expected to play a major role in development and spread of mutual insurance. We tried to understand the regulatory environment around the parameters - presence of entry and exit, regulation around product filing, capital requirement, public disclosures, and compliance requirements. This part of the study also examined the parameters like coexistence of other stock insurance companies/Govt insurance companies, reward to policyholders, and tried to compare the performance of the two. However, availability of data was a major limitation in making a conclusive remark in this direction.

Study of literature on mutualization and demutualization, impact of European Union standard insurance code and adoption of solvency regime clearly indicates that the law of the land greatly influences the characteristics and modus operandi of mutual insurance across the globe. The study of environment in which mutuals have grown also indicates that as the insurance market becomes competitive and regulatory leniency towards mutuals reduces, these organizations have to change their approach and strategies to compete with stock companies. In this process the mutuals grow in size and become more like stock companies in their operations and approach. A good example of these changes is seen in the insurance market of the USA. These changes also trigger demutualization. In some markets a large-scale consolidation of mutuals is also observed. European markets have seen both demutualization and consolidation in twentieth century, especially after countries joined the European Union.

In many countries, governments took a protectionist approach towards mutual and cooperative societies, keeping in view their non-profit nature and welfare approach. Ex- France and South Africa. In most of the countries where mutuals are strong, we can observe that these mutuals have a strong presence in other areas of social protection like health care and old age care by setting up dedicated organisations. Ex- France and UK. Later, they started insurance mutuals to take care of financial protection. Ex- Germany, France, UK and Japan. However, there are also examples of mutual insurance companies diversifying to other financial services like long-term saving, pension, and financial advisory. Ex- Old Mutuals in South Africa and MACIF in France.

In Europe, in countries part of the European Union, the requirement for a uniform code in financial services forced many countries to drop their protectionist approach toward the mutuals. This uniform code made the existence of mutuals difficult, and many of them demutualised. Changes in regulations and increased competition from shareholding companies had resulted in the consolidation of business of mutuals in both Europe and the USA. Demutualisation of mutual insurance companies resulted from three reasons- change in regulation, competition in the market and expansion. One of the limitations of mutuals is capital which restricts the growth of mutual insurance companies. This limitation has also triggered the demutualisation of many big mutual insurance companies in the USA, France, and South Africa. After demutualisation, many companies carry their value of the mutual benefit as a guiding factor. However, an equal number of companies completely convert to shareholding companies and part with their value of mutuality. Ex- Old Mutual and SANLAM in South Africa. In Japan, Cooperatives, especially agriculture cooperatives, appear to be working very closely with the Government. They seem to be an extended arm of Government and receive both administrative and other 'conditional financial support. As the size of mutuals increases, the distance between members and management increases. It results in the separation of power between owner members and management, which requires better regulatory governance and control. As mutuals grow, they also need to expand their operations to other business lines and geographies, which is restricted by the regulation. They become shareholding companies and establish shareholding subsidiaries owning 100% shares. These changes lead to increased control of the regulatory regime leading to the neutralisation of regulation vis-a-vis sharing holding companies.

The study also brings out the importance of technology in future. It will be a differentiating factor for efficient organizations. Role of technology is also emphasized in improving accessibility and reducing TAT and cost. It will be important for mutuals and cooperatives to adopt technology to remain relevant. It will also play an important role for future organizations.

Second Phase of the Study

In the second phase we intended to understand how an enabling environment can be created for mutual insurance /alternative organisation so that insurance space can be made more inclusive. We did expert interviews (key informant interviews) to get views on the current ecosystem and future changes expected. A list of open questions was framed to facilitate the process. The questionnaire covered areas like learnings from banking sector, preferred areas for starting mutuals in India, regulatory environment for emergence and growth of mutuals and role of technology in future growth of mutuals. Experts for the study were identified by examining the work profile and area of expertise. Emphasis was on identifying experts who have exposure to the concept of mutual insurance and also sound understanding of Indian insurance market.

The study is divided in three sections. The second section presents the views of the experts, and discussion and the third section are conclusion and recommendation.

Chapter II

Findings and Discussion

2.1 Mutual and Share Holding Companies

An organisational form that is prevalent in financial services, particularly in insurance, is Mutual (Mutuals). Mutual doesn't have any shareholders and capital; It does not pay dividends.

Mutuals may do loss assessment at the end of the period and recover the excess loss over premiums from the members. Successful mutuals share the surplus by way of reduction in premium or distribution of bonus.

Mutuals are known and popular for their services at lower cost; to serve people better; to be very good with product innovation by understanding the needs of the people they serve. In USA, Europe and Asia, the share of Mutuals is significant.

INDIA

Organisational Forms

The insurance legislation allows only Joint stock company and cooperative society to provide insurance service in the country.

In the year 1999, when insurance industry was privatised, Insurance Act, 1938 was amended to include Cooperative society to provide insurance services.

Mutual form of insurance organisations was part of Indian market[1]; they were in existence in the initial decades of 19th century, even prior to the Insurance Act 1938. Some amount of fund requirements for these mutuals was introduced after independence.

Insurance (Amendment) Act, 2015 removed the reference to mutual form of business from the insurance legislation.

The Insurance Regulatory and development Authority (IRDAI) has a vision of "Insurance for everyone" and one of the ways of achieving the goal is to have alternative organisations doing the insurance business. Mutuals, which are community based, may be allowed to be

[1] *Decades later, the Companies Act was amended and the mutuals were not part of the Indian business landscape. Subsequently, when Insurance Act was amended in the year 2015, the reference of the term "mutual" was deleted from the insurance legislation.*

organised at a local level to provide insurance services to more people and to pave way for more insurance inclusion. This will require changes in the Act and Regulations, wherever applicable. If mutual is going to be allowed what could be the regulatory landscape? Even after the removal of the legal barriers for the formation of mutuals; what would be their business model? which products will be most suitable for their design and pricing? What could be their strategy as far as distribution of their products is concerned? The role that technology play in the efficient and efficacy in the operations of mutuals? In this report, the summary of the views obtained from the survey, analysis of the views and the recommendations are covered.

2.2 Micro Finance and Banking

In India cooperative sector is almost 300 years old. Cooperative banks also have prominent existence for a long time. Co-operative banking system in India started way back in 1900. Experts participating in this study are of the option that RBI has facilitated existence of cooperative banks and cooperative societies by bringing regulations from time to time. .

The banking regulator RBI has played important role in bringing financial inclusion. The regulator has worked with the stakeholders and made amendments based on their feedback. The banking regulator is also flexible in building a business environment which supports functioning of the banking sector. Insurance sector is lagging behind in this sense.

There is consensus among the experts that significant learnings can be drawn from banking sector even though the nature of banking business is different from the insurance business. Especially, in reference to creating space for small organisations which cater to the specific needs of low income and rural population. The banking sector, which is the monolith in our country, was unable to penetrate the low income and rural communities of the country, which form majority of the population. Whereas, microfinance institutions, which are small in size, flexible in nature and focussed on their approach were able to reach out to the community. Cooperatives, small finance banks and the payment banks have played important role in financial inclusion. The significance of their contribution is visible by their portfolio growth and size which has reached up INR three lakh crores. So therefore, providing an opportunity just like microfinance institution, to micro insurance institutions will be a good step for bringing insurance inclusion.

The mutuals work on the foundation of trust. They have a close relationship and an organic link with the community which helps in identify the needs of the community and as a result, they devise need-based products. They also identify the losses at the micro level. Proximity with the community brings cost efficacy. It works on social capital, which helps in reducing costs.

Cooperative societies bring self-reliance among the people, especially rural poor. Self Help Groups (SHGs) are also an example of this; where members work for mutual benefit and support each other. However, the management control by rich and influential and majority members is one major concern. In banking sector this has resulted in major issues in the past.

One major learning point drawn from observing functioning of cooperative banks is the issue of multiple regulators. Duality of regulations between Department of Cooperatives and the Reserve Bank of India has created issues for cooperative banks. It has resulted in several open cracks where it doesn't fall within the area, and it falls outside the purview of the cooperatives well as RBI. These shortcomings have led to major failures in the cooperative banking.

Another successful example from micro finance sector, which can act as a guiding light for mutuals is the support and facilitation provided by NABARD to micro finance institution. At the beginning of the microcredit movement the MFIs did not have technical knowhow and capacity to bring technology individually. Government of India provided a fund to NABARD to do the capacity building of the entities, and handhold the entities willing to enter the microfinance businesses. This facilitation played an important role in establishment and growth of micro finance institutions in the initial phase. Later, these organisations became self-sustained and grew to become large banking entities. Many of the current large MFIs and SFBs are examples of this. Similar kind of guidance and facilitation will go a long way in development of microinsurance entities. This will be more significant for microinsurance sector as insurance business is more technical in nature and knowhow is limited. However, the insurance industry lacks presence of institutions like NABARD which can act as a facilitator.

2.3 Formation of Mutuals

It can be seen from the international markets and from Indian cooperative sector, sponsor(s) take the initiative, bring in seed money to start the business operations and include more members leading to the growth of business. Policyholders have a stake as a member in the mutual. They have the right to participate in the management and decision-making process of the mutual. In short, mutual is a normal insurance organisation with a difference that policyholders are the owners and manage the insurance business for themselves.

Most of the discussants pointed to the possibility of forming mutuals for insurance inclusion of the lower strata of the society and the missing middle. Respondents opined that mutuals can be formed by:

- Few influential, prominent people in society / community can join and act as sponsors, bring in equally the requisite initial funds required.
- Few existing entities like NBFCs or Micro finance institutions/companies can come together to form an insurance mutual
- Can be formed like a start- up, with capital / initial fund support coming from social Venture capital/social entrepreneurs/social enterprises venture capital funds.

2.4 Area of Operations

There was a divided opinion on jurisdiction of business. One view supported restricting area of operation to small geographical locations at the beginning. They can be allowed to upscale and expand their business after successful business in initial years. There was a suggestion that short term monitoring can follow opening into multi-state and then slowly making it up into the national level on a graded scale.

Another view is that if some organisations are already working in micro finance space in multiple states, then rather than restricting their area of operations and economies of scale, they can be allowed to have mutuals in those states where they have footprints.

2.5 Products

Experts had consensus on allowing short term products for mutuals. The examples mentioned by the experts are health insurance, crop insurance, asset insurance, hospicash, and credit insurance. There was clear view on starting the operations with localized risk, short term exposure and short claims tail. Some experts also suggested allowing composite products for rural areas. There was also suggestion of Term with Return of Premium (TROP) in life business and allowing mutuals to work as distributors in long tail products. None of the experts suggested presence of mutuals in long-term business-like pension considering the nature of business, capacity and expertise required for such business.

2.6 Distribution

There was a mixed view on the distribution system for mutuals. One school of thought suggested having systems like POSP, agents etc, like conventional business.

The other school of thought disagrees with this view. It proposes that mutuals thrive on the absence of distribution model. It opines that the motivation for mutuals is to remove intermediaries to bring down cost of distribution. So mutual itself is a distribution model as it organizes homogeneous groups of people without need to hire an intermediary. This system takes care of classical principal agent problem. Another view is that agent will play an important role in growth of business as they are dedicated work force to bring business and serve clients with necessary knowhow. However, there can be a condition that only members can be allowed to become agents, as their interests are aligned to the success of the model.

2.7 Reinsurance

The expert opinion about reinsurance is widely varied. Reinsurance was accepted by all the experts as an important aspect for existence and operation of mutuals. However, there was difference of opinion on how reinsurance can be availed by small mutual organisations.

One view is that the mutual insurers being small entities will find it difficult to get reinsurance. The other view is that few reinsurers from Europe with mutual background will be interested to provide reinsurance provided mutuals are given legal status by the regulator in India. The third view is that reinsurance function can be taken up by a federation of mutuals or by setting up a joint corpus to provide reinsurance. The fourth view is that large insurance companies can seed the risks of mutuals and act as a proxy reinsurer. It will create a business opportunity for existing insurers and in turn risk support to mutual insurance, and both can coexist in the market. Another arrangement suggested was having a group insurance product, as a top layer like a reinsurance treaty to cover excess risk of mutuals.

2.8 Technology

Technology has been significantly the driver of the growth in financial sector across the globe Experts are of the opinion that technology is changing very fast and cooperative sector is facing challenges in updating themselves. Technological developments, particularly the use of digital platforms and applications, has been difficult to implement and adapt in the cooperative sector because of lack of financial and human resource.

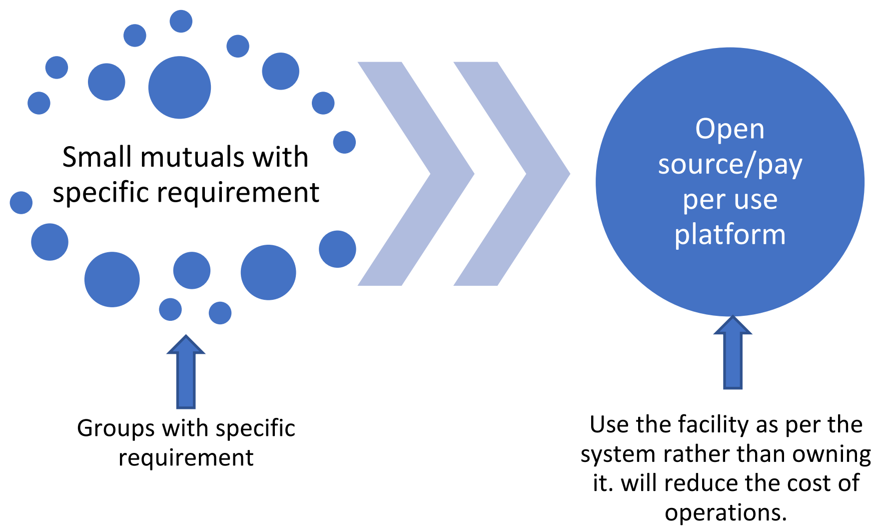
Similarly, insurance business is highly technology oriented. It will be challenge for small organisations to attract talent in IT and keep them engage to meet their requirements. Also, application of technology is a capital-intensive affair, which may become a hurdle for resource constrained organisations like mutuals.

One of the experts is of the opinion that technology development requires continuous improvement and oversight and high-quality manpower. To get the high-quality manpower, we need great leadership and market-oriented money. Both are in deficit with the mutual model. Because market-based capital seems difficult to come in near future as reward of investment by market valuations is not present in a mutual setting. This issue can be resolved by having a common or shared platform developed by pooling in resources of by the Regulator.

It was suggested that a pay and plug-in model can deal with current challenges in product design, pricing, and distribution. A digital platform can offer such services on both revenue model as well as open-source model. Where any group can register with the platform, pay registration fee and the platform will guide them about what risks to choose. Once the risk is selected, it will guide the group on pricing. Then the group can be helped with governance structure. The proposed structure is similar to the functioning of organisations working on formation and development of SHGs. In this model, the mentoring organisation mobilises individuals to form groups and chart their by-laws. Once groups are formed and rules are laid, they are guided for bank linkage. Slowly the monitoring organisation withdraws as the SHGs mature.

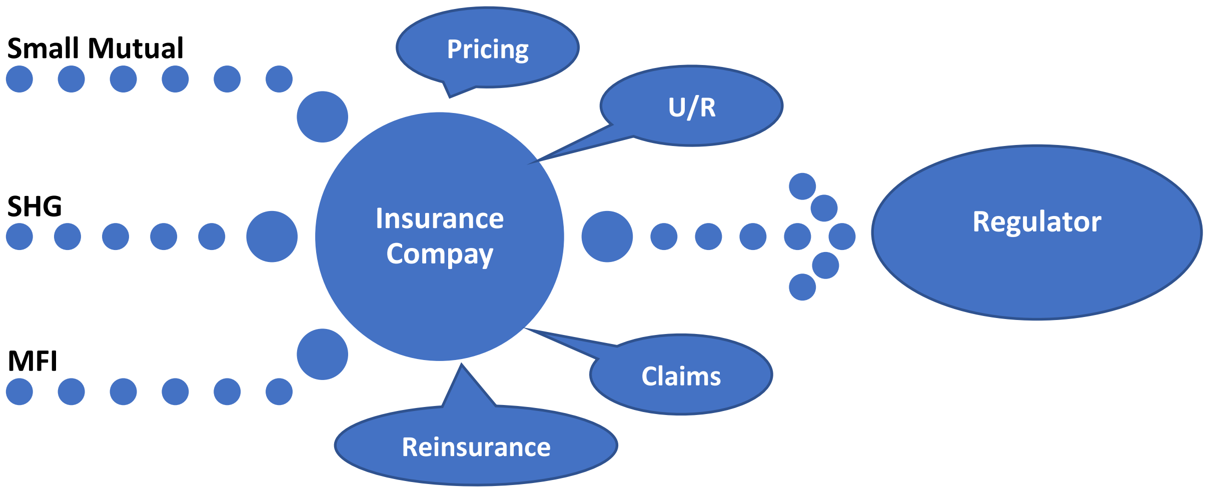
The upcoming organisations should be allowed to thrive on technological advancements. Today Tier 2, tier 3, tier 4 cities, have got strong internet connectivity with. In future 5G technology will bring better connectivity, delivery will be faster, accessibility to the end user will be much better. The new age organisations should be allowed to capitalise on these advancements. Insuretech startups using digital platforms can harbinger new era for mutual insurance.

Figure 1: Plug in Model for Facilitating Existence of Insurance Mutuals



Another model suggested was that of mentoring of small organisations by established insurance companies. These insurers will provide them technical expertise, offer them good oversight. Some large mainstream insurance company can take up the role to mentor the mutual. The insurance company can assume the role of a quasi-regulator, for the mutuals that it is mentoring. The IRDAI will continue to work as regulator for the system. Clear roles and responsibility can be defined for each stakeholder. The mentoring insurance company will get some kind of reinsurance or a coinsurance arrangement from the mentee mutual. Through this arrangement, the insurance company has the chance to look at the portfolio, underwriting, and claim's practices of the mutual. However, this arrangement will take sea change in current regulation.

Figure 2: Mentorship Model Suggested for Facilitation of Insurance Mutuals



2.9 Regulatory Changes

At present, the regulatory supervision and monitoring in the insurance sector range from guidelines for the entry to the exit of the entities. Supervision covers wide array of initial and minimum capital needs, solvency, and governance, use and file requirements of insurance products and their distribution etc.

Internationally, there are few countries in which regulators have been giving some concessions to mutuals such as fund (capital) requirements, taxes etc. There are countries like USA, where there is no distinction between a stock company and a mutual as far as funding requirements are concerned.

One of the areas that the study focused on is the regulatory landscape that would act as an enabler, facilitating the functioning of the mutuals in the insurance space when allowed by the law.

<u>Mutuals as Alternate Insurance Entity</u>

Consensus amongst the experts on allowing mutuals in the insurance sector emerged from the study. The common understanding is that insurance legislation needs to be suitably amended to pave entry of the mutuals as an alternate insurance entity. Participants in the study felt the need for entry of mutuals to increase insurance penetration and achieve insurance inclusion through low cost, innovative products, and focused customer service.

Experts opined that regulatory clarity regarding the working of the mutuals needs to be clearly spelt out, that the regulation need to specify the common characteristic of mutuals as- there is no promoter, and no promoter quota., there is lock-in because the promoters are also policyholders along with other member. Some of the areas mentioned for regulatory considerations are:

- Treatment of sponsors' funding after the formation of mutuals and in the initial years
- Return of these funds to the sponsors,

Source of funds from where this transaction would be facilitated.

<u>Capital Requirement</u>

a. Initial Funding Requirements

As per the present legislative requirements, both the forms of organisations viz., joint stock companies and cooperative societies doing direct insurance business must bring in an initial capital of Rs 100 crores to start the business.

Standalone Health entities need a reduced funding of Rs 50 crore. a committee[2] set up by the IRDAI has recommended Rs 20 crores capital as the entry norm for microinsurance entities, if they are allowed to produce insurance products,

Majority opinion was that the initial capital requirement of Rs 100 crores / Rs 50 crores may not be the ideal for the mutuals to start their business. This initial amount was considered high and was felt arbitrary. Initial capital of Rs 20 crore suggested for micro insurance providers by SAMI report was also felt to be on the higher level for the mutuals.

Limited geographical presence and low risk products to be underwritten and short tail claims to be managed by the mutuals are the major reasons cited for the low initial funding requirement.

[2] SAMI Committee

There were converged views about regulatory requirements:

- Initial capital / funding requirements is to be mandated by the legislation;
- Lower seed funding, as compared to initial funding requirements of the existing organisational forms, to be prescribed to cover initial costs and long-term funding requirements of running the business.
- Initial funding estimates ranging from Rs 1 crores to 5 crores were considered to be reasonable.

b. *Additional capital / funding requirements and Risk based Capital (RBC)*

As per the present legislative requirements, both joint stock companies and cooperative societies doing direct business in insurance must have a minimum capital of Rs 50 crores from the inception. Minimum capital is the amount below which the capital of insurance entities cannot go down for solvency purpose. In addition, quantum of the business and insurance business risks are considered as proxies for determining the additional capital/ funding requirements to determine the solvency. These proxies vary for life business (long tail, savings products) and general business (short tail, pure insurance products)

Experts did not specifically mention about minimum capital requirements. They were of the view that the capital requirement should be guided by the underlying risk, rather than tying it to an absolute number / fixed amount.

Respondents also indicated that mutuals can be supervised based on capital adequacy (like in banks)/solvency norms.

Most of the respondents were also of the opinion that subsequent funding requirement of mutuals will be lower, as compared to the entities allowed to do insurance business at present. Introduction of RBC regime; wherein capital is the direct function of the underlying risks associated with the insurance business will suit this requirement.

In the RBC based regulatory mandate, reverse calculation is possible, depending on the availability of funds. The mutuals will be in a position to decide the level of risks to be underwritten and retained in the entity. They can alter their product mix, accordingly, the underlying risks associated with the claims pattern. Similarly, the regulator will be able to prescribe the capital for the mutuals or cooperatives, depending on their business operations. Additional capital requirements are to be prescribed by the regulations.; based on the underlying risks.

Determination of the funding requirement

In risk assessment, product and geographical presence are vital contributors for understanding the capital requirement.

Product & Risk

- Saving products like life endowment and pension have long time for claim settlement and have high insurance and financial risk exposure.
- Risk exposure of general insurance products which are short term are low, especially where the time for claim settlement is also short.

Geographical Presence & Risk

- Low risk is present in the books of those mutuals that operate in few districts of a State or Union Territory
- Localised risk with claim control mechanism that normally exists among community members would help risk mitigation and management.

By linking the capital requirement to risk, it will be possible to assess the reasonable capital threshold limit for different forms of organisations operating in the insurance sector (such as joint stock company, a micro insurance organization or for a community-based insurance entity). Similarly, it will be possible to set different limits for different organizations operating in different lines of business such as life insurance, health insurance, Agriculture Insurance etc.

Reinsurance support is another factor that would determine the level of additional funding required by the mutuals. With regulatory backing of mutuals, it would be possible to enter risk transfer arrangements with big players offering insurance and / or reinsurance arrangements within the country.

Funding: Sources and difficulty associated in raising the funds

Most of the experts believed that raising the fund for the insurance mutuals would not be a difficult task. This is on the premise that if the business has growth opportunities and is attractive (in terms of return on investments), both existing as well as new entrepreneurs will come into the business with the requisite funding required by the legislation.

> Right now, the joint stock companies and cooperatives are allowed to start the insurance business only in the form of equity, contributed by the promoters. Borrowings in the form of loan or debentures are not allowed at the time of formation and initial period of operations. Equity contribution from foreign partners upto the permissible legislative limit (74%) is allowed.

Another point that strongly emerged during the discussions is that whether insurers are allowed to raise capital through their own sources; that is only from promoters' own funds? If this is not the restrictive clause in the legislation and capital can be allowed to be raised from the financial markets, whether public (through stock exchanges) or private (from Private Equity or Venture Capital). Contributors of capital may be spelt out in the regulation. Clarity regarding the minimum period beyond which the original contributions may be offloaded and the manner in which such disinvestment might take place would be part of the regulation; so as to quickly accommodate the changes that happen in the financial markets.

> Additional capital requirements may be sourced from the capital market by way of issue of equity shares.
>
> Raising of preference share capital and borrowed capital through subordinated debt up to the prescribed regulatory limits are allowed.
>
> Venture capital funding is not allowed at present by the regulations.

However, few respondents raised questions about the possibility of the collection of seed money from the sponsors or members at the pre-operating stage of the mutuals. This is based on the history / inception of mutuals (globally). these mutuals trace their origin to half a century or a century or two ago, when the industry was not regulated. There was no requirement of seed funds, minimum fund / surplus to be maintained and solvency requirements. Another premise for difficulty in raising funds is that insurance business in the last 3-4 decades is organised predominantly with capital contribution by the shareholders. Moreover, many of the mutuals started earlier have got themselves demutualised or created structures to raise funds from the market. This was done to meet capital prescribed by the regulators in order to back up the complex risks in their insurance books.

The ability to raise external funds is also seen to be closely associated with factors such as Corporate Governance, Integrity of Management for compliance and disclosure and manpower and talent management. This aspect is seen as the biggest challenge for the mutuals, irrespective of the quantum of funds required.

Surplus Distribution

Surplus is the excess of premium received over the current and future claims cost as well as administrative expenses. This amount entirely belongs to policyholders in case of mutuals. Some amount of surplus has to be retained because that provides solvency. If the business is run healthy, the members may demand the pay-outs from surplus – either in the form of reduction in premium or in terms of surplus distribution, say bonus.

As the mutuals operate with very less (profit) margin, it is important to do the balancing - between a) keeping the entity healthy and solvent and b) keeping the premium lower or pay bonus, to remain competitive in the marketplace.

In case of mutuals having long term savings linked products with guarantees (such as pension liability), the importance of building sufficient funds from surplus becomes the necessity as compared to low reserve requirement of short-term pure insurance products offered by general insurers.

Mutuals have the sole objective of providing security to their members. Initial regulations in this regard cannot be very rigid, as it has to evolve over a period of time.

Exit option of Seed Funding

There are references from international markets when mutuals have adequate surplus, after initial years of profitable operations, that are utilised for buying back or return of the funds given by the sponsors. Sponsors can continue as member policyholders in the mutuals.

However, if outside funding from P/E or VC is resorted, existing investors may want to completely exit and new investors may want to take over, depending on the business opportunities that may exist. This is a prevalent practice in financial sector and the same is seen in microfinance sector. The regulatory stand regarding the following need to be clearly stated:

- Funds that could be used for the buyback of sponsors' funds
- Impact of buyback on the capital / funding structure of the mutuals at the time of buy back and
- The disclosure requirements.

2.10 Supervision and Monitoring

Regulatory monitoring is focused on the risks involved. the long-term businesses are very closely supervised as the risk associated is significant when compared to the short-term business where the underlying risks are lower.

Following views emerged from the discussions:

- Supervision and monitoring of mutuals by the regulators is mandatory.
- Mutuals should be regulated and supervised using the insurance core principles of the International Association of Insurance Supervisors (IAIS).
- Mutuals should be closely monitored like that of a joint stock company.
- Public disclosure is very important for the mutuals as the members play a significant role. All the details about the products and service need disclosure.
- Aspects like what coverage is offered? how much premium is charged for the coverage on offer? details of the exclusions, how to get the claim serviced and the time period etc., need elaborate disclosures.

- Monitoring should be on macroprudential basis; which is risk-based capital/solvency supervision and market conduct.
- If mutuals by the very nature are writing only short-term businesses, carrying with localised risk in their books, they should be monitored on a proportionate basis.

2.11 Corporate Governance

The governance structure plays a very significant role for any kind of organisation. When it comes to mutuals, which operate on principle of 'for members and by members', following questions are relevant .

- Whether to have a separate governance structure?
- Whether separate board with independent members are needed?
- How the mutuals to be governed in terms of control, audit, and professionalism?

There was unanimous opinion from the experts for having governance mechanism in mutuals. Corporate governance norms have to be equally strong for mutuals also because there is greater chance of mismanagement. So, there has got to be no let-up in the regulation regarding corporate governance. For the corporate governance, which is of paramount importance, when the regulations are framed, they have to be framed keeping these organisations in mind. Amendments/modifications to the corporate governance Norms / Guidelines, the cost involved in implementing governance norms should be taken into consideration.

Divergent views were received on how the governance should be, such as:

- Governance will be mix of both- the monitoring by self-regulatory body based on self-reporting mechanism and governance mechanism IRDAI can form or a self-regulatory body jointly with or in consultation with IRDAI, which can define few aspects of self-regulation.
- In case of small size mutuals, regulation should have monitoring mechanism by defined set of performance parameters, rather than prescribing governance structures that are applicable for large size insurance organisations.
- For not so small entities, separate board, and internal audit team along with audit committee to ensure financial control implementation and monitoring.

- Mutuals may have smaller boards. They may not be able to hold the entire gamut of corporations like separate audit committee and other committees, as it may not be possible for them because of their limited capacity.
- There is cost involved in engaging independent directors, outside directors, specialists etc., on the Board. How much cost the mutuals can bear, especially in the initial years of their formation is the moot question.
- Governance requires good understanding of the risks carried by the entity, whether the liability is long or short tail and, asset liability matching and the right people to guide the organisation through policy decisions.

Chapter 3

Recommendations

Based on the discussions and observations from Phase I and from the views of the experts, the study team makes following recommendations:

3.1 Formation of Mutuals

The mutual insurance can be set up with sponsors pooling in seed capital. It is important that the sponsors are members of the mutuals to keep their interests aligned with the benefit of members.

Institutions can also become sponsors provided their interests are aligned with the interests of members. This is important to safeguard the basic principle of mutuality.

When mutuals have adequate surplus, after initial years of profitable operations, they can be utilised for buying back or return of the funds given by the sponsors as exit option. Sponsors can continue as member policyholders in the mutuals.

3.2 Capital Requirement

The team suggests the initial capital for the mutuals as Rs Ten crores. High capital requirement will end in high entry barrier and prevent the growth of the sector. Every year the additional capital requirement can be revised in accordance with risks carried. The system can move towards adopting risk-based capital.

3.3 Area of Operations

Area of operations is recommended to be small limited to few districts or few states at the beginning. However, it should not be made limiting for organisations already operating at large scale. The organisations having nationwide presence should be evaluated separately on a case-to-case basis. e.g. Doctors’ Associations, Alumni Associations etc.

3.4 Product

The mutuals can carry short tail risks like health, motor, personal accident, asset to begin with. They can also design composite products for rural areas. Under life the products like term life, credit life and TROP (term with return of premium) for low income and missing middle population.

3.5 Distribution

The main purpose of setting a mutual insurance is observed to reduce the cost of insurance and have products suited to the members. The members can work as distributors. New members can be inducted on referral basis. Hiring agents or any other intermediary for selling is not recommended at this level as it will add to the cost of insurance.

3.6 Reinsurance

The study team is confident that market will be ready to provide reinsurance to mutuals if their operations are allowed by the regulator. The national reinsurer GIC Re can take up the risks and act as reinsurer for mutuals at the beginning. Since mutuals are envisaged to carry limited risks in the beginning, getting reinsurance form organisations like GIC Re will not be difficult for them.

3.7 Technology

There is a common view that technology will play in important role in insurance business by any entity, especially smaller ones, as it brings efficiency at lower cost. However, the views are scattered on affordability and the role technology will play in setting up mutuals.

Mutuals need not build their own technology platform as they may not be able to afford the same. Hence, they must resort to plug and play platform solutions offered by vendors.

Setting up a common digital platform by regulator will simplify the matter. A good analogy can be drawn by the existing platform used by mutual fund companies and the digital platform available in stock exchange.

The regulator also needs to take into cognisance presence of cloud mutuals in international market. Their wide reach, easy access to policyholders and simplicity of operations have attracted large number of enrolments.

However, devising ways for protection of the policyholders' interests and data integrity will be of prime importance.

For this, the system protocols of the mutuals should allow direct access to the Regulator to remotely audit the data of the mutuals at any time it is required.

3.8 Supervision

- Mutuals should be closely monitored like that of a joint stock company and is to be mandatory.
- Public disclosure is very important for the mutuals as the members play a significant role. All the details about the products, services especially claims need disclosure.
- Monitoring should be on macroprudential basis, which is risk-based capital/solvency supervision and market conduct. Mutuals by the very nature are writing only short-term businesses, carrying with localised risk in their books, they should be monitored on a proportionate basis.
- Regulation and compliance can be liberal but on key parameters like Capital, Additional Capital, Profitability, Solvency and Market conduct it should be strict.
- Mutuals should be regulated and supervised using the insurance core principles of the International Association of Insurance Supervisors (IAIS).

3.9 Governance

- The mutuals shall be governed by a board of directors having suitable representation from members, promoters, and management. An Executive Committee can look after the daily operations. It is recommended to have proper checks and balances in place to guard against capture of mutuals. There are examples of misappropriation of funds by capturing the management by an influential group taking advantage of one member one vote practice in cooperative sector.

- Governance requires good understanding of the risks carried by the entity, whether the liability is long or short and, asset liability matching and the right people to guide the organisation through policy decisions.

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