

Report of The Advisory Group on Insurance Regulation Part II and Final: Executive Summary

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The Standing Committee on International Financial Standards and Codes (Chairman: Dr. Y.V. Reddy) constituted the Advisory Group on Insurance Regulation (Chairman: Shri R. Ramakrishnan) "...to chalk out a course of action to achieve the best practices..." in the field of insurance regulation in India (Annexure I). The names of the members of the Group are given in Annexure II. The Group evaluated the present Indian insurance legislation on the basis of international standards and codes, in areas in which these are available and in the backdrop of cross-country experiences, otherwise.

Insurance regulation can be classified into two parts, viz., a) licencing of new companies and b) supervision of existing companies. The Part I of the Report, which was submitted on September 23, 2000, dealt with licencing of new companies in India. The Part II of the Report, which was submitted on February 14, 2001, deliberated on solvency and actuarial issues. The major findings of the Group, with regard to solvency and actuarial issues, are as follows:

- In the matter of estimating the liability under life insurance policies, the Indian standard is on par with the international standard (*para II.28, p.15*).
- Regulations in respect of the linked life insurance business are yet to be developed on a sound basis even at the international level (*para II.30, p.15*).
- Unit-linked life insurance business could be brought under the definition of life insurance business, both in letter and spirit, so that life insurance companies do not engage in mutual fund operations under the guise of life insurance (*para II.31, p.15*).
- In India, close co-ordination between the regulators is required so as to have an efficient unit-linked insurance business (*para II.32, p.16*).
- In calculations of the Unearned Premium Reserve, some marginal gaps are observed between the Indian and international standards. However, with the passage of time, these

could be addressed and appropriate changes be initiated to bring the Indian standard on par with the international one (*para II.36, p.17*).

- In the matter of estimation of the Loss Reserve, the Indian standards could be considered to be on par with the international standards. There are some deficiencies with regard to collection of claims statistics. These could be filled up with experience in the coming years by positioning appropriate data base systems (*para II.41, p.19*).
- With regard to the Incurred But Not Reported (IBNR) Reserve, no comparison can be made at this stage between the Indian and international standards, as the standards at the international level are yet to be evolved (*para II.44, p.20*).
- In the matter of setting up Catastrophe Reserves, an appropriate Indian standard is yet to be evolved on par with the international standard. However, the Group is confident that in a period of next 2-3 years, suitable standards could be developed after gaining sufficient expertise in this area (*para II.48, p.21*).
- The supervisory authority, generally, attempts to protect the interests of both policyholders and shareholders. At best, this role should encompass the investment of assets pertaining to policyholders' funds and assets of shareholders' funds corresponding to the minimum solvency margin stipulated in the governing insurance act (*paras III.10-1, p.25*).
- Regarding investment of shareholders' funds, although we have some standards in India, at the international level, no standard has been prescribed so far (*para III.12, p.25*).
- The current regulations apropos the valuation of assets pertaining to policyholders in respect of life insurance are on par with international standards (*para III.28, p.29*).
- The Indian approach to solvency margin requirements could appear to be more stringent than those of other countries. This may be due to the fact that the insurance industry is being thrown open to competition after more than four decades and these requirements may be by way of abundant caution. In the next 2-3 years, as we gain experience, the higher prescriptions may be scaled down suitably, depending upon the evolving situation (*para IV.17, p.34*).
- The norms in respect of the Working Solvency Margin in India are somewhat stringent than in other countries (*para IV.19, p.34*).
- The taxation of the shareholders' share of surplus could be at the corporate rate and the balance surplus could be at a rate below the current rate. The Group is of the view that this would be fair and equitable (*para V.14, p.40*).

- The Indian standard regarding the taxation of life insurance companies is not only on par with the international standards, but is also one of the simplest (*para V.15, p.40*).
- In case of general insurance, if an insurer feels that provision for the Unexpired Risk Reserve as a percentage of premium for different classes of business (which includes the unexpired premium reserve) is not adequate in specific cases and is able to establish the same scientifically, a provision for transferring the additional amount required from the pre-taxed profits could be considered in the regulations (*para V.18, p.41*).
- The importance of providing for catastrophe reserves has been duly recognised by the IRDA and the Government. However, the transfer to this reserve has to be made from profit after tax. As in other countries, the transfer to this reserve could be allowed to be made out of pre-taxed profits (*para V.20, p.42*).
- In the matter of taxation of general insurance companies, the Indian standard is marginally below that of the international one (*para V.21, p.43*).

I. Introduction

I.1 The Part I of the Report dealt with licensing standards. The second and final part of the Report deals with solvency and actuarial issues. A discussion on solvency issues *ipso facto* implies a discussion on valuation of assets and liabilities, since solvency cannot be determined otherwise.

I.2 In respect of licensing of new companies, standard international practices are available for comparison with the standards prevailing in India. However, in the case of solvency issues, there are wide variations in the practices of different countries. The International Association of Insurance Supervisors (IAIS) has also not yet finalised its views on these issues. The sub-committee on Solvency and Actuarial Issues, constituted by the Technical Committee of IAIS, has released the final version of its "Issues Paper" on this subject on March 15, 2000. The Technical Committee is expected to finalise its recommendations during the current year (2001).

I.3 The solvency requirements in all the countries have some common features. These are,

- the insurer has to keep sufficient assets to meet obligations under most circumstances,
- the value of assets should exceed the value of liabilities by a certain minimum amount (minimum solvency margin), and
- the supervisor should intervene if the difference falls below the prescribed level.

I.4 The sub-committee on Solvency and Actuarial Issues found that while there is agreement among all countries over these basic features, wide variations exist in their implementation. For example, how could the values of assets and liabilities be quantified? Unless these are quantified, it is not possible to say whether the assets are sufficient to meet the liabilities. How large should the solvency margin be? At what point of time should the supervisor intervene? The solvency model to be adopted depends on answers to these basic issues and it is not possible to develop a universal model unless common answers are found.

I.5 The sub-committee noted that the answers to these issues depend on the attitude of the public and this attitude is a by-product of the cultural, economic and political environment. The issues involved are as follows:

- what degree of importance is attached to the integrity of an insurer's promise and whether it leaves more room for competitive and at the same time riskier behaviour?
- how does the public weigh the benefits against the risks of an insurance contract?
- how is the marginal benefit to consumers of increasing the minimum capital requirements weighed against the marginal cost of capital to the insurer? and

- can a high level of bankruptcy resulting from greater competition be accepted and a certain level of compensation provided by a guarantee fund?

I.6 It is, therefore, not proper and also not possible to prescribe a standard or classify any one system as the best. Each system has to be evaluated against the background of the socio-economic and political environment of that country. However, the Group felt that it would be better if the current practices in India were compared with the standards followed in some of the leading countries in order to examine whether our system is adequate enough to ensure the basic requirements of solvency. For this purpose, the method of valuation of assets and liabilities and the determination of the solvency margin have to be analysed.

II. Valuation of Liabilities

Life Insurance

Conventional or Non-Linked Business

II.1 The liability of a life office to its policyholders on any given date can be broadly defined as the sum of the liabilities under all the policies on its books on that date. The liability under a policy could, in turn, be defined as the (present value of benefits payable + present value of expenses likely to be incurred) *less* the present value of premiums receivable. The valuation of the liability would thus require assumptions in respect of certain parameters, *viz.*, the rate of interest, the rate of mortality, level of future expenses and under certain circumstances, the amount of future bonuses. Of these parameters, for most of the plans of individual insurance marketed in India, the most important is the rate of interest and the least important is the rate of mortality.

II.2 The principle on which this definition is based may appear quite simple, but there are many variations in the way this principle is applied in practice. However, all these variations fall into two broad groups, *viz.*, the gross premium valuation and the net premium valuation.

Gross Premium Valuation

II.3 Under this method of valuation, the liability under a policy is defined as the (present value of the benefits contracted to be payable + present value of future expenses likely to be incurred + present value of bonuses likely to be declared in future) *less* the present value of premiums receivable. While estimating the present value of future expenses, the effect of inflation on expenses has also to be taken into account.

II.4 In this method of valuation, the valuing actuary has to make appropriate assumptions regarding all the parameters involved, *viz.*, the rate of interest, the rate of inflation, the level of future expenses (in relation to the sum assured under both active and premium-ceased policies and also in relation to the premiums), the level of future bonuses and the future rate of mortality. These assumptions have to be based on best estimates of future values with provisions (margins) for adverse deviations.

II.5 An important feature of this method is its transparency. It is possible for any one examining the valuation report to judge whether sufficient margins have been provided for possible adverse developments. At the same time, the method has one serious drawback, *viz.*, its sensitivity to the various parameters used. A marginal increase in the valuation rate of interest or a decrease in the expected level of future bonuses could lead to a significant reduction in liability and release of larger surplus for distribution than what could be considered as prudent.

Net Premium Valuation

II.6 In this method, the liability under a policy is defined as the present value of the benefits contracted to be payable *less* the present value of true or net premiums. No explicit provision is made for either future expenses or future bonuses as under the gross premium method.

II.7 The true or net premium under a policy is defined as the premium that would have been charged under the contract for payment of initial contractual benefits, had there been no explicit loading for expenses and bonus and the basis adopted for calculating the premium had been the same as that being adopted for valuing the liability. In simple terms, the true or net premium could be deemed to be the actual premium charged *less* the expense and bonus loadings in the premium. In order to provide for recoupment of acquisition costs, an adjustment known as the Zillmer adjustment is permitted to be made, the effect of which is to increase the net premium. This adjustment, however, is subject to a ceiling.

II.8 Under this method, no provision is made for expenses likely to be incurred in future. At the same time, however, credit is also not being taken for the expense-loading portion of the

premiums receivable in future. In effect, this method takes the assumptions to be made regarding future expenses and inflation out of the purview of the valuing actuary.

II.9 While valuing the benefits, the bonuses expected to be payable in future are not taken into account. It is presumed that for the major part, the difference between the actual yield obtained from investments of the life fund and the rate of interest employed in the valuation is sufficient to take care of the liability in respect of future bonuses.

II.10 Generally, the statute would also prescribe a ceiling on the rate of interest employed in the valuation. The limited freedom that the valuing actuary may thus be left with in determining the valuation rate of interest is also not very significant since this method of valuation of liability is not very sensitive to variations in the rate of interest.

II.11 Thus, the only parameter in respect of which the valuing actuary would have full freedom would be the rate of mortality, the least important of the parameters. It is thus quite difficult to undervalue the liability in this method of valuation and this enhances the reliability of this method.

II.12 The net premium valuation may look artificial and indirect and may also lack transparency. Its greatest merit is that it ensures that the surplus is released for distribution only after it actually emerges. Being a passive method of valuation, it is generally used along with the passive method of valuation of assets, *viz.*, the book value method.

Practices in Different Countries

II.13 Currently, the United Kingdom may perhaps be the only industrial country in which the net premium valuation is prescribed as the statutory method of valuation. A ceiling, based on the yield earned on gilts has been placed on the valuation rate of interest. The valuing actuary could adopt a different method of valuation, provided the liability so determined is not less than what would have been the liability had the statutory method been used. However, focussed discussions are now taking place in the UK as to whether it is advisable to fall in line with the other major countries and switch over to the gross premium method of valuation.

II.14 The statutory method of valuation prescribed in Canada since 1992 is known as the Policy Premium Method (PPM). The PPM is a gross premium prospective method of valuation. Policy premium simply means the premium charged under a policy, *i.e.*, gross premium. Canada switched over to this method of valuation in order to conform to the accounting requirements of GAAP (Generally Accepted Accounting Practices). Since it is

the office premium that figures in the books of accounts, it was felt by the accounting profession that the same should be used in the valuation of policy liability and not the net premium.

II.15 The assumptions regarding valuation parameters are based on the best estimates of future experience with provision for adverse deviations. Though this method is similar to the gross premium valuation discussed earlier, there are some significant differences. These include,

- explicit provision is made in the valuation for policies likely to go out of the books by way of lapses or surrenders. The effect of this provision would be to capitalise immediately the likely release of reserves in future, thus weakening the valuation,
- though future bonuses are to be valued explicitly, there is a provision for valuing future bonuses at rates lower than current levels if the actuary has sufficient evidence that a change is intended. The effect of this provision would be to decrease the liability and release more surplus, again weakening the valuation. Since the attention of the policyholders need not be specifically drawn to such under-provisioning for future bonuses, this also reduces the transparency of the method, and
- the reserve held under a policy could not only be less than the surrender value payable under the policy (in case the policy is surrendered) but could also be negative. That is, a policy could be treated as an asset. This would lead to capitalisation at inception of a part of the future profits. This goes against the basic tenets of actuarial principles.

II.16 The statutory method of valuation prescribed in Australia is the “Margin on Services Method”. In this method, the liability is defined as the sum of i) the best estimate value of policy liabilities, which is the amount required to meet future expenses and benefits and ii) the value of future expected profit margins on the services provided to policyholders such as insurance of mortality risks and on-going expenses of administration. The best estimate assumptions are defined as assumptions about future experience, which are made using professional judgement, training and experience and are neither deliberately overstated nor deliberately understated. All-important factors like taxation, options under the policies, probability of lapsation, *etc.*, are taken into account while estimating the liability on the basis of best estimate assumptions. Provision is also made for future supportable bonus, including terminal bonus. In order to ensure that all future profits do not get capitalised immediately as a result of determining the liability on the basis of best estimates assumptions, but are released systematically over the balance period of each policy, additional items known as "Profit Margins" are incorporated and the effect of these margins is to increase the quantum of the liability determined on the basis of best estimates.

II.17 These profit margins are related to the services provided to policyholders by the company. The guiding principle behind the Margin on Services Method is that the profits should be allowed to emerge either at the time of provision of service or at the time of receipt of income relating to that service, whichever occurs later and no scope should be provided to capitalise them earlier.

II.18 The different services provided by a company to its policyholders are,

- insurance of mortality/morbidity and other similar risks,
- investment management, and
- on-going administration.

II.19 The amount of claims paid, investment return provided to the policyholders, administrative expenses, fund management costs and bonus allocated to participating policyholders are examples of the expected "cost of services". The (office) premium charged, the investment income on the assets corresponding to the policy liability and the explicit expense charges provided in the policy (*i.e.*, policy fee) are examples of the expected income items relating to services. By expressing the profit margin as a portion of the expected cost of services and the expected income items relating to these services, the required timing of their release is ensured.

II.20 Though just a variant of the Gross Premium method, by providing for explicit rather than implicit margins, the Australian method brings in more transparency to the valuation process. At the same time, it is necessary to mention that all the three weaknesses pointed out under the Canadian system are also present in the Australian system.

II.21 In Germany, it is the gross premium method of valuation that is generally used. The net premium method of valuation, with Zillmer adjustment, is also permitted.

II.22 Like the premium basis, the actuarial basis for the valuation of liabilities has also to be approved by the statutory authorities. This results in valuation bases that are common to almost all companies for all products within certain commencement dates.

II.23 Most actuaries now use DAV 1994 mortality tables, published by the German Actuarial Society, for valuation. The maximum rate of interest allowed to be used in the valuation is 60 per cent of the interest rate on government bonds, which in mid-1999 would have implied a maximum rate of interest of around three per cent.

II.24 Till the formation of the Insurance Regulatory and Development Authority (IRDA), no statutory method of valuation was prescribed in the Indian Insurance Act. However, since

1986, the Indian insurance industry has been following the gross premium method of valuation. The principles governing the valuation are,

- the assumptions regarding valuation parameters are based on the best estimates of future experience with provision for adverse deviations,
- neither explicit nor implicit provision is made in the valuation for policies going out of the books by way of lapses or surrenders. That is, any likely release of surplus due to early termination of the contracts is not being capitalised,
- future bonuses, at rates equal to current levels, are valued explicitly, and
- the reserve held under a policy cannot be negative and also cannot be less than the surrender value payable under the policy (in case the policy is surrendered). That is, no policy is treated as an asset.

II.25 Hence, the system in vogue in India is considered to be theoretically perfect. The Indian insurance industry adopted this method of valuation well before its adoption by Canada and Australia. In fact, the Canadian and Australian systems could be considered as variations of the Indian system. Though the Indian system may not be as stringent as the British or the German systems, unlike these two systems, it provides enough scope for actuarial judgement.

II.26 Let us now look at the provisions under the IRDA regulations. The regulations have formalised the prevailing practice. There is no specific provision that the liability in respect of future bonuses has to be valued explicitly at rates equal to the current levels. The regulation (Schedule II-A) on valuation of assets, liabilities and solvency margin, however, states that "the level of benefits shall take into account the reasonable expectations of policyholders with regard to future bonuses, including terminal bonuses, if any, and any established practices of an insurer for payment of benefits". This clause would ensure that the value of future bonuses could not be estimated at levels lower than the current levels without the permission of the regulator and explicitly bringing it to the attention of the policyholders. It has also been stipulated that future bonuses, including terminal bonuses should be consistent with the valuation rate of interest. That is, while formalising the current standards, some flexibility has been built in.

II.27 However, it is important to mention that the IRDA regulations, *vide* Section 3 of Schedule II-A, states, "... the gross premium method of valuation shall discount the following future policy cash flows at an appropriate rate of interest:

- a) premiums receivable, if any, benefits payable, if any, on death, benefits payable, if any, on survival, benefits payable, if any, on voluntary surrender of contract, and the following, ...".

II.28 Voluntary surrender of contracts implies lapses and surrenders. That is, one of the inherent weaknesses in the Canadian and Australian systems has now been incorporated in the Indian regulations. The Group felt that in the coming years, in the light of gaining more expertise in this aspect, the regulator would have opportunities to revisit this aspect. **The Group, nevertheless, felt in the matter of estimating the liability under policies, the Indian standard is on par with the international standard.**

Linked Business

II.29 There is, at present, virtually no linked life insurance business in the country. The Insurance Act, 1938, therefore, dealt only with the conventional life insurance business. At the international level, this class of business has developed fully, mainly in the USA, UK, Canada and Australia. Even here, life insurance companies are able to engage in pure mutual fund operations by incorporating a token life cover in their schemes. In South-East Asia, the linked business is of recent origin.

II.30 **It can, therefore, be said that regulations in respect of this class of business are yet to be developed on a sound basis even at the international level.**

II.31 With the opening up of the insurance sector, this class of business can be expected to develop in the coming years. **When such development takes place, the Group is of the view that the unit-linked life insurance business could be brought under the definition of life insurance business, both in letter and spirit, so that life insurance companies do not engage in mutual fund operations under the guise of life insurance.**

II.32 It is also not clear, at present, whether the unit-linked insurance schemes to be operated by life insurance companies would be subject to the purview of the Securities and Exchange Board of India (SEBI). Allowing dual control by the IRDA and the SEBI over this class of insurance may raise issues relating to co-ordination among regulators. **In India, in this regard, close co-ordination between the regulators is required so as to have an efficient unit-linked insurance business.**

General Insurance

II.33 While well defined procedures are in place in almost all the countries for the valuation of liabilities under the life insurance business, it is not so in case of the general insurance business. The systems in vogue are more general than specific. The only stipulation is that the

system followed should be in accordance with the GAAP. As per the European directives, the balance sheet needs only to show the directors' opinion about the financial position of the general insurance company. In the USA, the directors have liberty to place an appropriate value on the liabilities. In general, it is the responsibility of the accounting profession to ensure that the value placed on the liability is fair and reasonable. In many European countries, it is the tax authorities and not the insurance regulators who require that the amount of reserves shown be estimated scientifically.

II.34 The liability (known as the Technical Reserve) under a general insurance portfolio can be broadly defined as the sum of,

- the amount of premium estimated as required to cover the risk during the balance policy period falling after the balance sheet date (Unearned or Unexpired Premium Reserve - UPR),
- the amounts expected to be paid in future in respect of the claims already reported by the balance sheet date (Loss Reserve),
- the amount expected to be paid in future in respect of claims that might have occurred but could not be reported to the insurer till the balance sheet date (Incurred But Not Reported - IBNR),
- the direct expenses expected to be normally incurred for the settlement of the above two classes of claims, and
- reserves required to be held on a prudent basis towards catastrophe losses or a single incident giving rise to multiple claims.

Unearned Premium Reserve

II.35 In respect of the Unearned Premium Reserve (UPR), well-defined procedures are followed in almost all countries. Under the European Directives, the UPR has to be shown for each class of business, in the form prescribed according to the month of issue in the case of gross premiums and according to amounts paid for reinsurance, in the case of net premiums. This Directive ensures that the method adopted takes into account the distribution of business during the year and is scientific. As per the IRDA regulations, UPR would be 50 per cent of the net (of reinsurance) premium for all classes of business except the marine hull business, for which it is 100 per cent. This does not take into account the distribution of business during the year and is more empirical in nature. It is, however, quite conservative from the point of view of the distribution pattern being experienced at present. However, if the distribution pattern changes with the entry of new players, the system may prove to be inadequate.

II.36 So, in the case of calculations of the UPR, some marginal gaps are observed between the Indian and the international standards. However, with the passage of time, these could be addressed and appropriate changes be initiated to bring the Indian standard on par with the international one.

Loss Reserve

II.37 As per the Schedule II-B of the IRDA regulations for determination of liabilities, the reserve for outstanding claims (*i.e.*, the loss reserve) is to be determined as follows:

- where the amounts of outstanding claims of insurers are known, the amount is to be provided in full, and
- where the amount of outstanding claims could be reasonably estimated according to the insurer, he may follow the case-by-case method, after taking into account the explicit allowance for changes in the settlement pattern or average claim amount, expenses and inflation.

II.38 The above regulation is quite general in nature. In other countries too, there are no clear directives in this regard. The case-by-case method stipulated in the regulation may be the only viable one in respect of small portfolios of business and may be quite adequate in the case of the new entrants. But, it has many inadequacies while dealing with large volumes. It is time consuming, difficult to verify and subject to personal bias. To get over these deficiencies, statistical techniques are being developed for estimating this reserve. The insurers could be given freedom to adopt either the case-by-case method or the statistical technique, whichever is found to be appropriate. In the latter case, the insurer has to justify to the IRDA the adoption of the statistical technique for that part of the business.

II.39 In order to adopt any statistical technique, a company should have reliable database with regard to its past claim experience. Detailed formats have been prescribed in Europe for assimilating claims experience on cohort-by-cohort basis and for major homogeneous groups for enabling the regulator to judge whether an insurer has made any under-estimation of liabilities. Such a database would also enable the application of appropriate statistical techniques. In India, formats have been prescribed only for presentation of accounts and supporting schedules. No detailed formats have been prescribed for cohort analysis of claim experience. The Group feels that this aspect needs to be looked into.

II.40 As in the life insurance business, the loss reserves can be discounted over the duration of the expected claim settlement, at a rate related to the expected investment return on the

part of the loss reserves. The actual investment income earned would thereafter be credited to the loss reserve account every year, against the current practice of taking the entire investment income to the profit and loss account. In Europe, such reserves are used and where such discounting is used, the basis for discounting should be explicitly stated. In India, the IRDA regulations do not allow discounting.

II.41 In the matter of estimation of the Loss Reserve, the Indian standards could be considered to be on par with the international standards. There are some deficiencies with regard to collection of claims statistics. These could be filled up with experience in the coming years by positioning appropriate data base systems.

Reserve for Incurred But Not Reported Claims - IBNR Reserve

II.42 Schedule II-B of the IRDA regulations concerning the estimation of liabilities states that the IBNR reserves shall be determined using actuarial principles. In such determination, the appointed actuary shall follow the Guidance Notes issued by the Actuarial Society of India, with the concurrence of the Authority and any directions issued by the Authority in this regard.

II.43 This is just a statement of intention/principles. A satisfactory estimate of IBNR reserve can be made only through statistical techniques and the actuarial profession in all the countries is, at present, engaged in developing more sophisticated techniques.

II.44 No comparison can, therefore, be made at this stage between the Indian and international standards, as the standards at the international level are yet to be evolved.

Direct Expenses Expected to be Normally Incurred or the Settlement of Outstanding and IBNR Claims

II.45 Generally, no regulatory directives are issued in this regard. It is the responsibility of the accountants to ensure that the provisions made in this regard are appropriate.

Reserves Towards Catastrophe Losses

II.46 A catastrophe could cause a serious financial strain unless adequate reserves are built systematically over a period of time to meet such contingencies. It is, therefore, customary in many countries for insurers to establish special catastrophe reserves to meet such contingencies. Transfers to such reserve are also recognised for tax purposes.

II.47 The IRDA has provided for the regular creation of a catastrophe reserve in the prescribed format of accounts. The maximum annual transfers to such a reserve and the overall maximum have to be spelt out. The precise utilisation of this reserve in case of adverse financial results of the insurer caused by a catastrophe (and not supported by reinsurance recovery) has not, however, been clearly indicated. The IRDA could also recommend allowing such additions to the reserve out of pre-tax profits, as is being allowed in many countries. In the absence of any tax incentive, the general insurance industry has also not taken the initiative in this regard. The recommendations of the Expert Group (Chairman: Shri A.C. Mukherji) constituted by the Ministry of Finance to examine issues relating to solvency margin requirement and methods of valuation of assets and liabilities of insurance companies in India may be referred to in this connection.

II.48 In the matter of setting up catastrophe reserves, an appropriate Indian standard is yet to be evolved on par with international standard. However, the Group is confident that in the period of next 2-3 years, suitable standards could be developed after gaining sufficient expertise in this area.

III. Investments and Valuation of Assets

Investments

III.1 Generally, under life insurance policies, premiums are received in advance and after providing for acquisition and management expenses, the current cost of claims and other outgo, the balance of premium is available for investment. These balance premiums and the investment income is available to meet claims, which would occur in later years. The objectives governing the investment are liquidity, safety and optimisation of yield, provided that the asset profile is broadly attuned to the liability profile. The liquidity, *i.e.*, the ability of an asset to be converted into cash immediately and without loss, is more relevant in the case of the general insurance business as its contracts are for very short terms and it is also more susceptible to sharp and random fluctuations in claim outgo than the life insurance business. The liquidity may also be of importance to a life insurance company during its formative years, because of higher incidence of expenses of management. However, this would gradually diminish with growth in size, since the premium and investment income together would then be more than sufficient to meet operational expenses and policy outgo. Safety and optimization of yield are what any insurance company would look to normally.

III.2 The International Association of Insurance Supervisors (IAIS) observes:

“Technical provisions must at all times be backed by equivalent assets that belong in full to the Insurance Company and are set aside to guarantee its commitment. Policyholders should have preferential claims on the assets of the insurer in case of liquidation. In order to ensure the safety, profitability and liquidity of its investments, the insurance company must ensure that its investments are sufficiently diversified and dispersed”.

Let us now examine the practices in different countries.

III.3 In Canada, Australia and the UK, the insurance companies have no restriction in the matter of investment of funds. Controls are exercised, not at the time of investment, but only at the time of demonstration of solvency. For the purpose of this demonstration, there are valuation rules for assets, cap on each asset category in any one organisation and admissibility rules, so as to lead the companies towards maintenance of a prudent asset profile.

III.4 In the USA, although both the society and the Government have accepted that competition should be the driving principle that should guide their economy, there are both qualitative and quantitative investment restrictions in insurance. The qualitative limitations specify eligible types of investments and minimum quality criteria for eligible investments. Quantitative constraints have the dual objective of ensuring portfolio diversification and preventing undesirable control of other firms by insurers through large investments in any one firm. Until 1951, insurance companies were not permitted to invest in common stock.

III.5 In Germany, the regulation prescribes the principles to be followed by the insurers while investing their funds. These are:

- the safety/security of an investment should be as great as possible,
- the income/yield from an investment should be as high as possible, and,
- the investment should be as marketable as possible.

That is, same as prescribed by the IAIS.

III.6 Since July 1, 1994, after the implementation of the Third Life Directive of the European Union, the insurers are allowed to invest 30 per cent of their assets in equities. It was earlier ranging between 20 per cent and 25 per cent. However, because of the Assets Valuation Regulations, which requires that the value of properties and shares be shown at the lower of the book value or market value, the insurers are not fully availing of even this comparatively limited freedom of investment.

III.7 The IAIS specification covers only assets corresponding to the “technical provisions”. Under general insurance, these would mean the outstanding claim provisions (including those in respect of claims incurred but not reported to the insurer) and the unexpired risk premiums. In case of life insurance, these would be the life fund/s held by the insurer. There is no stipulation regarding investment of shareholders’ funds.

III.8 What is the position obtaining in India? Section 27 of the Insurance Act, 1938, deals with investment of funds of insurance companies. This section, along with Sections 27A (applicable to life insurance companies) and 27B (applicable to general insurance companies), comprehensively regulates the investment of funds of insurance companies. Minimum percentage of funds to invest, and keep invested, in Central Government, State Government and Government guaranteed securities, socially oriented securities (including infrastructure) and the category of approved assets in which the balance of funds could be invested have been prescribed. The IRDA (Investment) Regulations, 2000, prescribe how the “controlled fund” of the life insurance business and “total assets” of the general insurance business should be invested. These regulations are on the same lines as the provisions of the Insurance Act.

III.9 The Indian system is akin to that of Germany, but slightly more restrictive. The provisions in the Insurance Act and the Regulations satisfy two of the three conditions prescribed by the IAIS, *viz.*, security and liquidity. It may appear that these stipulations would result in a reduction in the yield on investments compared to what it would have been had there been complete freedom of investment. However, if we consider the limited investment opportunities and the volatile nature of the Indian stock market, it can be seen that the existing regulations have ensured maximisation of yield.

III.10 The Insurance Act, 1938 defines the “controlled fund” under Section 27A, which includes all the funds of the insurer. This has been interpreted as to include the shareholders’ funds also and accordingly, the investment parameters are equally applied to shareholders’ funds. In other countries, such a provision does not exist.

III.11 Generally, the supervisory authority attempts to ensure the protection of the policyholders and shareholders. **At best, we could say that this role should encompass the assets pertaining to policyholders’ funds and assets of shareholders’ funds corresponding to the minimum solvency margin stipulated in the governing insurance act.**

III.12 Thus, in the matter of investment of shareholders' funds, although we have some standards in India, at the international level, no standard has been prescribed so far.

III.13 The guidelines postulated by the IAIS have taken into account only the financial aspects of investment but not the social aspects. An insurer has obligations not only to the policyholders but also to the society. The Indian regulations have taken both these aspects into account.

III.14 It can be seen from the foregoing that there is no common international standard in the matter of investment of assets of insurance companies. There are wide variations in the practices of even the developed countries, with the UK and Germany occupying the two opposite ends. The UK practice of extending freedom for investment of technical funds of the insurer but ensuring that they remain solvent according to the valuation rules for assets and liabilities conforms to its principle of "freedom with publicity". However, its practice of controlling investment at the time of valuation of assets instead of at the time of purchase of assets could at best be an example of locking the stable after the horse had bolted. It may be suitable for some countries during certain periods, but cannot be prescribed as an example for others to follow at all times.

III.15 As compared to Germany, India is at the other end of the economic spectrum. Still, its regulations governing investment of assets are quite close to those of that country.

III.16 The investment regulations cannot be viewed in isolation but have to be judged in the context of available scope for investment, the robustness of the economy and the needs of the society. Viewed in this context, the Indian regulations for investment of policyholders' funds can be considered to be fair and reasonable.

Valuation of Assets

III.17 In the method of valuation of assets, there are some variations in the practices of different countries, especially in the case of the life insurance business. At the one extreme is the system in which the value of an asset is taken as the lower of the book value and market value. At the other extreme is the system in which the value of an asset is always taken as its market or realisable value. It is not possible to say which system is better. It depends on the compatibility between the valuation of assets and liabilities. Again, the perception differs from country to country.

III.18 When the gross premium method of valuation is adopted, the valuing actuary has to make appropriate assumptions regarding all the parameters involved, *viz.*, the rate of interest, the rate of inflation, the level of future expenses, the level of future bonuses and the future

rate of mortality. The assumptions have to be based on the best estimates of future experience with provisions (margins) for adverse deviations. This method of valuation of liabilities could thus be termed dynamic. It is only logical, therefore, to apply the same principle to the valuation of assets and use the market values. The net premium method of valuation of liabilities could be termed passive and conservative. It is, therefore, necessary to value of assets in the same way and take the lower of the book value and market value as the value of an asset.

III.19 The revenue of a life insurance company may be invested in fixed income or growth oriented assets. The income from the latter type of assets is generally low and the holder of such assets is supposed to get compensated through appreciation in the market value of these assets. When the regular income from both types of assets gets reflected in the revenue account, the appreciation in market value does not get reflected in the account until the profit is booked by actual sale. If the office is not able/willing to book such profits before the final payment is made under a policy, the policyholder is permanently deprived of his share of the profit.

III.20 In Australia, where the gross premium method is used for valuing the liabilities, the assets are valued at their market values.

III.21 In the UK, where the statutory method of valuation is the net premium method, the book value or market value, whichever is lower, is taken as the value of an asset. But with one difference. When the market value is higher, provision has been made for writing up the book value. The extent to which the book value is to be written up is left to the discretion of the company and its appointed actuary. This is a prudent and pragmatic provision.

III.22 The system followed in Canada is well balanced and appeals to one's common sense. In the case of fixed interest securities and mortgages, the amortised book value is used. In the case of equities and properties, only specified percentages of the reserve account created by change in the value of equities and the change in the value of properties is brought into the revenue account every year for distribution to policyholders. The balance would remain as a reserve account. The percentages are 15 per cent and 10 per cent for equities and properties, respectively. The reserve account is adjusted every year for the appreciation or depreciation. That is, the full extent of appreciation or depreciation in the market values is not taken into account immediately and identical treatment is applied to both appreciation and depreciation. This system ensures that there would be no sharp increase or decrease in the value of assets and the yield on investments pertaining to policyholders.

III.23 In Germany, the market value or book value, whichever is lower, is used for valuing the assets.

III.24 Of the above four systems, the system followed in the UK may be considered safe, prudent and, at the same time, equitable. Automatic adoption of market values, either fully or in stages, leaves no room for professional judgement and, when the investment market is shallow and/or highly volatile, could land an insurance company in serious difficulties. At the same time, sticking to the lower of the book value and market value would not be equitable from the point of view of the policyholders.

III.25 The UK system, with built-in flexibility based on professional judgement could, therefore, be considered fair, prudent and equitable.

III.26 Till the introduction of the IRDA Regulations, 2000, India was following the German, or rather, the European system. The new regulations have provided scope for adopting the UK system, with a small difference. If the market value is higher, the appreciation in the market value is taken to the reserve accounts and a percentage of these (to be prescribed) could be brought into revenue account (without an actual sale), with the prior approval of the IRDA. That is, professional judgement has to be exercised at two levels: initially at the company level and then at the IRDA level. Further, a percentage ceiling has been placed on the amount of appreciation that could be transferred. These two modifications to the UK system are quite fair and prudent.

III.27 It is, however, necessary at this stage to mention the recommendations made in this regard, in May 1995, by the Mukherji Expert Group. The Expert Group had recommended a ceiling of ten per cent on the transfer of appreciation in market value to the revenue account. The determination of this ceiling was influenced by the volatility of the Indian stock markets. For example, the difference between the market value and book value of assets of the Life Insurance Corporation of India (LIC) worked out to, respectively, Rs.1,931 crore, Rs.10,515 crore, Rs.3,758 crore and Rs.9,241 crore as on March 31, 1991, 1992, 1993 and 1994. One has, therefore, to be extremely careful before transferring a part of the difference between the market value and book value through the revenue account. The Expert Group has also given a formula for determining the percentage of the difference between the market and book values of the assets that could be brought into the revenue account without an actual sale. This formula would have also ensured that new life insurance companies would not be able to use in this way any temporary appreciation in market value of their assets for declaring bonus to their policyholders.

III.28 The current regulations for the valuation of assets pertaining to policyholders are on par with international standards.

IV. Solvency Regulations

IV.1 An insurance company could be considered to be solvent if the value placed on its assets exceeds the estimated value of its liabilities. The difference between the two values can be defined as the available solvency margin (ASM).

IV.2 The threat to the solvency of an insurance company could arise from,

- changes in the level of interest rates,
- increase in the level of claims, including catastrophic claims,
- spurt in expenses of management, and
- fall in the real value of assets, not arising from an increase in the rate of interest.

IV.3 Whereas, the changes in the level of interest rates is critical in the case of a life insurance company, it is the change in the level of claims that is critical in the case of a general insurance company.

IV.4 Initially, the regulators felt that in order to minimise the probability of such a threat to solvency of the insurers due to adverse movements in the values of the above parameters it would be adequate, if sufficient margins were provided while estimating the liability. It was, however, soon realised that such built-in margins, either explicit or implicit, alone were not adequate to protect the interests of the policyholders and what was really needed was an early warning system to alert the regulatory authorities as soon as an insurance company begins slipping into the danger zone, so that remedial measures could be initiated in time. This realisation led to the concept of minimum solvency margin or the required solvency margin (RSM).

IV.5 How big should this RSM be in order to provide for all possible contingencies? A very high solvency margin requirement would result in wastage of capital, a scarce commodity. A very low solvency margin requirement may, on the other hand, jeopardise the security of the policyholders' fund. Where should the proverbial golden mean be? The perception may differ from country to country. These aspects will be discussed separately for life and general insurance.

Life Insurance

IV.6 The methods in vogue at present in different countries for determining the RSM could at best be called empirical. Some formulae have been developed based on statistical models. And, there is every chance of these formulae being revised in the coming years. It is enough, therefore, if the general principles governing the development of RSM are discussed. It can then be checked whether the requirements prescribed in the Indian regulations are in conformity with these general principles.

IV.7 Let L represent the liability to the policyholders of a life insurance company, A , the value of its assets, and S , its sum at risk. The sum at risk could roughly be defined as the total sum assured under all its policies *less* the reserve or liability held in respect of these policies. With each type of asset, in the portfolio of the company, a factor could be attached to represent the probability of that type of asset not being realisable in full. This factor could be taken as zero in the case of government and government guaranteed securities. In respect of other assets, the value of this factor could range from zero to hundred. There can be no objective method for determining the value of this factor and only subjective methods have to be used.

IV.8 Let the estimated value of the assets after applying the probabilities of realisation be A_1 and let A_2 represent the difference between A and A_1 .

IV.9 The RSM can be defined as a function L and S and the ASM as the difference between A_1 and L . The UK and other countries of the European Union follow this method.

IV.10 A variation of this method is to define the required solvency margin as a function of L , S and A_2 and the ASM as the difference between A and L . The solvency regulations prescribed by the IRDA fall under this category. There is no significant difference between the Indian regulations and those of the UK and the European Union.

IV.11 Yet another method to determine whether the company is solvent or not is to calculate the ratio (A_1 / L) . The company can be considered solvent only if this ratio is greater than 1. Under this system, instead of the required solvency margin, the required solvency ratio is defined. Canada and the USA follow this system. These countries have also introduced a new element in the calculation of the solvency ratio. Just as the value placed on the assets is reduced from A to A_1 by taking into consideration the probability of an asset not being realisable, the value of L is increased by taking into consideration the size and risk profile of the company.

IV.12 It is necessary to point out here that the Mukherji Expert Group had recommended that the required solvency margin is to be a function of not only L and S, but also of the size of the company.

IV.13 It can thus be seen that, in defining the required solvency margin, there are only cosmetic differences in the approaches of different countries. If the solvency margin (or ratio) falls below the required solvency margin (or ratio), intervention by the regulatory authorities is required. The degree of intervention depends on the level attained below the RSM. For a marginal shortfall, the companies would be required to submit a time-bound business plan for satisfying the solvency requirements and, during this period, the companies would be kept under scrutiny. For significant shortfalls, the regulator could direct stoppage of new business, restructuring the asset portfolio, *etc.*

IV.14 The function of L and S adopted by the UK and European Union for determining the RSM is,

(4 per cent of L) + (0.3 per cent of S), with some adjustments to take care of reinsurance arrangements (a minimum of 50 per cent is to be taken for reinsurance outgo during the preceding year or the actual figure, if higher). In the IRDA regulations, the value of A_2 , *i.e.*, the amount by which the value placed on assets would be reduced if the probabilities of non-realisation of assets were taken into consideration, is added to this function. That is, instead of deducting A_2 from A (the value of assets), it is added to the RSM. Even though the two courses of action are algebraically equivalent, there is a subtle difference, as will be seen shortly.

IV.15 In addition to the RSM, another absolute minimum amount, known as the minimum guarantee fund, is also defined. This minimum guarantee fund varies according to whether the office is a pure re-insurer or mutual or proprietary office. If the available solvency margin falls below this statutory minimum, the intervention measures would be serious and the company would also be required to bring in additional capital. No new business would be allowed to be transacted by the company till the additional capital is brought in. In the case of the UK and the European Union, this statutory minimum is ECU 8,00,000, depending on the class of business. In India, this minimum has been kept as Rs.50 crore, a fairly high amount for new companies.

IV.16 Though the RSM is defined as the (minimum) required solvency margin, some countries, which are nervous about the prospect of insurance company failures, have informally prescribed what may be termed as the working solvency margin (WSM). The

WSM is a multiple of RSM, say, 1.5 times the RSM. Both India and Australia come under this category. As mentioned earlier, when the value of A_2 (the amount arrived at by applying the probability of non-realisation to the value of assets), the WSM will get further magnified. In the opinion of the Group, this over cautious approach would lead only to wastage of capital and cannot be justified.

IV.17 The Group felt that the Indian approach to solvency margin requirements could appear to be more stringent than those of other countries. This may be due to the fact that the insurance industry is being thrown open to competition after more than four decades and these requirements may be by way of abundant caution. In the next 2-3 years, as we gain experience, the higher prescriptions may be scaled down suitably, depending upon the evolving situation.

General Insurance

IV.18 In the case of general insurance, the determination of solvency margin requirements is much simpler.

IV.19 The minimum solvency margin in Europe and the UK, and also in India, is based on a specified percentage of gross premiums or another specified percentage of the average of the last three years' incurred claims (*i.e.*, claims paid during the year adjusted for claims outstanding), whichever is higher, multiplied by a minimum of 50 per cent (or higher actual percentage) for reinsurance outgo or recoveries, as the case may be. In Europe and the UK, the percentages are 20 per cent and about 16 per cent, respectively. In India, the percentages are 20 per cent and 30 per cent, respectively. The minimum allowance for reinsurance varies from 50 per cent to 90 per cent for different classes of the general insurance business. **Here too, the working solvency margin is expected to be 1.5 times the required solvency margin. Hence, the norms in India are somewhat stringent than those in other countries.**

V. Taxation of Insurance Companies

V.1 In India, the taxation laws pertaining to insurance are spread over the current statutes of the Income Tax Act, 1961 and the Wealth Tax Act, 1957. The Expert Enquiry Committee, appointed by the Government of India, in 1935, considered the suggestions made by the Life Offices Association and its recommendations were adopted in the Income Tax (Amendment) Act, 1939. Similarly, the Taxation Enquiry Commission appointed by the Government, in

1953, considered the taxation of insurance companies and its recommendations were adopted in the Income Tax (Amendment) Act, 1953.

V.2 An individual, a company or a partnership, unless specifically exempted, pays tax on the total income or gains in a chargeable period, *less* allowable deductions. The assessable income in respect of a company is the profit emerging from its trading activities. While general insurance companies come under this definition of assessable income, the assessable income of life insurance companies does not come under this definition.

Life Insurance

V.3 The taxation of a life insurance company is distinct from that of a trading company. Life insurance basically consists of the business of issuing life policies and granting of annuities on human life. The contracts are typically long-term and insurers charge an equated premium payable for the specified benefits under the contract. The profit could be estimated under a group of contracts only at the end of the contract period, when the batch of contracts has run off. That is, in the case of a life insurance company, there is no equivalent to the normal concept of "trading profit". So, the assessable income for the purposes of taxation is determined by either of the following two methods, *viz.*,

- investment income less expenses, and
- valuation surplus.

Investment Income less Expenses

V.4 The insurer invests the balance premium left after meeting the claims and expenses and builds up a fund, known as the life fund. The "income" (I) of the insurer under this method of taxation is defined as the income generated through the investment of this fund. This is similar to taxation of an investment company. I normally include interest income from debt securities, dividend income from equity and preference shares, rents from properties and realised gains through sale of investments. Currently, the dividend income is tax free in the hands of the recipients. The realised gains are subject to capital gains tax. I could, therefore, be partitioned into non-taxable investment income, taxable investment income and realised gains.

V.5 There can also be other adjustments to the investment income. A life office, besides transacting basic life assurance business, could carry on business of pensions for the benefit of individuals and also groups of individuals. The build-up of pension entitlement is usually

tax-free under the approved schemes or policies, while pensions are taxed at the hands of the individual beneficiaries. The investment income and gains in respect of pension business is on gross basis for an insurer. Hence, if a combined life fund is being maintained by the insurance office, the income in respect of each branch of the business has to be separately worked out before a tax rate could be applied to each.

V.6 Normal rules would be applicable with regard to expenses of management (E), which are permitted to be set off against taxable income. If the investment income in respect of one class of fund is not taxable, the expenses in respect of that class cannot be set off against the income of another fund. The interest content of annuity payments is also treated as a part of E. In the initial years of a new life office, E would exceed I and the unrelieved expenses would be carried forward to the future years. This "initial year" period would vary depending on the business growth of the insurer. In some countries, in view of the high expenses incurred by some insurers, a ceiling is placed on the "management expenses" which may be deducted from the investment income. In India, the Income Tax Act, 1961, before its amendment in 1977, provided in Rule 2(a) of the First Schedule, that the management expenses would be limited to 90 per cent of the first year premium and 15 per cent of the renewal premium.

Valuation Surplus

V.7 Alternatively, the tax could be levied on the valuation surplus disclosed in the actuarial valuation conducted in accordance with the provisions of the Insurance Act, 1938. The valuation surplus would be reduced by the amount of surplus brought forward from the previous valuation, as this amount would have been subject to taxation in the year in which it was carried forward.

V.8 The components of the surplus, besides the brought forward amounts, include interest surplus (*i.e.*, the excess of earnings over what has been assumed), mortality surplus, morbidity surplus, expense surplus, surrender surplus, lapse strain (strain due to default in premium payments before the recovery of excess initial expenses), new business strain (because of excess first year expenses), surplus emerging from the bonus loading component of the premium and any surplus from miscellaneous items. Any brought forward portion of the unappropriated surplus from the previous years could be considered to be the capital items within the surplus. Expenses would have been debited to the Fund before arriving at the amount of the fund and therefore, no special treatment would be necessary for the expenses.

V.9 As stated earlier, there can be other adjustments to the valuation surplus. If the build-up of investment income and gains in respect of pension business is on gross basis, the surplus emerging from the pension business has to be worked out before a tax rate could be applied on the assessable surplus amount. In some countries, the surplus amount arrived at is reduced by a percentage of surplus paid to, reserved for or expended on behalf of policyholders to arrive at taxable surplus. For example, before the Income Tax Act was amended in 1977, Section 3(a) of the First Schedule to the Income Tax Act, 1961, provided that 80 per cent of the surplus reserved for the policyholders could be deducted from the valuation surplus to arrive at the taxable surplus.

Comparison of the Two Methods of Assessment of Tax

V.10 Most of the countries follow either of the two methods of assessment of tax. Some countries have adopted a combination of the two methods. If the "income *less* expenses" method is adopted, a new life insurance company would not be pay tax during, say, the first 15 - 20 years of its existence even while its shareholders may receive some dividends during most of this period. Disputes could also arise between the tax authorities and the companies as to whether an item of management expense is tax deductible or not. The "tax management" strategies adopted by the companies could be another source of dispute.

V.11 Under the surplus method, once the 'company' starts declaring bonus to its policyholders, it would have to pay tax on its policyholders' fund. Since the amount of tax payable and the amount that could be transferred to the shareholders as their share of profit, are both determined as percentages of the surplus, any attempt at tax management so as to reduce the amount of surplus would result in corresponding reduction in the shareholders' share of the profit. Hence, "tax management" may not yield any gains. On the other hand, however, the insurer may resort to dilution of the valuation bases so as to increase both the policyholders' and shareholders' surplus. Since expenses are not tax deductible, there would also be no disputes in this regard. So, the "surplus" method of assessing the taxable income is preferable.

V.12 Under the investment income *less* expenses method, a life insurance company would not be paying any tax during the initial years of its existence. However, the amount of tax computed would thereafter gradually increase and exceed the amount of tax payable under the "surplus" method. So in those countries where most of the life insurance companies are quite old, the "income less expense" method is preferred. In India, where the insurance sector

is just being opened up, all companies except the LIC, would be new and hence the "surplus" method of taxation is preferable. Applying two methods of taxation, one to the LIC and the other to the new companies, would not, of course, be equitable.

V.13 In the case of the LIC, it was taxed on (I - E) basis until April 1, 1977. When the Government switched over to the "surplus" method of assessing the taxable income, the rate of tax to be applied to the surplus was arrived at by dividing the amount of tax payable under the (I - E) method by the amount of surplus. The rate of tax applicable to surplus was fixed at 12.5 per cent (excluding surcharge). This rate of tax has remained unchanged until now, even though the general tax rate for companies has come down substantially.

V.14 In the light of the above discussions, the Group felt that it could be possible that the taxation of the shareholders' share of surplus could be at the corporate rate and the balance surplus could be at a level below the current rate. The Group is of the view that this would be fair and equitable.

V.15 Nevertheless, in the matter of taxation of life insurance companies, the Indian standard is not only on par with the international one, but is also one of the simplest.

General Insurance

V.16 There has not been any notable special treatment for the taxation of a general insurance company. It is taxed as a normal trading company.

V.17 The general insurance contracts are usually for one year or less and profit under general insurance business is arrived at or is estimated at the end of this contract period. The premium charged for the risk cover and the contract period fall in two successive accounting periods. In accordance with the mercantile system of accounting, the premium, claims and expenses have to be appropriated to the correct accounting year. This requires that the premium is allocated to the year of issue in proportion to the period of risk falling in that year, assuming that the risk is uniformly spread over the period of the contract. The amount of premium for the unexpired portion of the contract is carried forward to the following year. This carried forward amount is known as the Unexpired Premium Reserve. Where the risk of claim is not uniform over the contract period, the allocation between the year of issue and the following year is effected on actuarial principles. A certificate by the actuary is to be appended to the revenue account for this purpose. Most of the countries in the Europe, including the UK, allow a further amount to be set up as reserve, where such unearned

premium reserve is felt not adequate to cover the risk. In these countries, this additional amount is taken into account while arriving at the unexpired premium reserve to be set up.

V.18 In India, the IRDA regulations allow for provisions for the Unexpired Risk Reserve (URR) as a percentage of premium for different classes of business (which includes the above unexpired premium reserve). **However, if an insurer feels that this is not adequate in specific cases and is able to establish the same scientifically, a provision for transferring the additional amount required from the pre-taxed profits could be considered in the regulations.**

V.19 Although most of the general insurance contracts are for a period of one year or less, there is a noticeable trend towards longer-term contracts in recent years. Deferred health insurance contracts, under which the cover commences between ages 55 and 60 of the life assured and then span his/her balance lifetime is a typical example. The project insurance that provides comprehensive cover against all the risks associated with the execution of big projects, is another example. The contractor's all risk cover (CAR) and the marine cum erection risk cover (MCE) that are increasingly becoming popular are also components of project insurance. These contracts cover the risk for periods ranging from 6 months to 5 years. Under these contracts, the required premium is collected either in a single installment or in multiple installments. While arriving at the premium to be charged for the risk cover, future cash flows in respect of claims payable and the estimated future expenses are discounted at an appropriate rate of interest. At the end of the year, while that portion of the premiums covering the risk in future come under the unexpired premium reserve, the interest earned on the unexpired premium reserve is not added to the unexpired premium reserve but credited to the shareholders' account. These contracts are similar to long-term life insurance contracts. The unexpired premium reserve method of reserving for the liability is inadequate in such cases and the liability has to be estimated by actuarial techniques, in the same way as in case of life insurance contracts. To address this, general insurance companies could be allowed to set up appropriate reserves on this basis.

V.20 The IRDA regulations also provide for a transfer out of the policyholders' revenue account to a catastrophe reserve, on an annual basis, up to a specified aggregate amount. This reserve is over and above the reinsurance cover arranged by the general insurance office for covering the catastrophe claims after payment of a suitable premium. The need for such a reserve has been recognised by many countries in Europe, including the UK, and the reserve

has been allowed to be set up, or added to, out of pre-tax profits. **In India too, the importance of providing for catastrophe reserve has been duly recognised by the IRDA and the Government. However, the transfer to this reserve has to be made from profit after tax. As in other countries, the transfer to this reserve could be allowed to be made out of pre-taxed profits.**

V.21 In the matter of taxation of general insurance companies, the Indian standard is marginally below that of the international one.

**Standing Committee on International Financial Standards and Codes -
Constitution of Advisory Group**

Kindly recall my telephonic discussion recently regarding the constitution of the Standing Committee on International Financial Standards and Codes by the Governor, Reserve Bank of India under my chairmanship with Dr.E.A.S.Sarma, Secretary, Economic Affairs as alternate Chairman (a copy of Governor's Memorandum is appended). As I apprised over the telephone, the terms of reference of this Committee encompass identifying and monitoring developments in global standards and codes, considering aspects of applicability " these standards and codes to Indian financial system, to chalk out a road map for aligning India's practices to international best practices, to periodically review the status on progress and to make available reports to all concerned in public and private sectors.

2. The Standing Committee had its first meeting at Delhi on January 13, 2000 and deliberated upon the work methods and procedures to achieve the above objectives within a time frame. Considering the fact that there are a number of codes in widely different subject areas, the task of collection of as much information on international standards and codes, studying them for their immediate relevance and applicability to Indian conditions was considered an enormous task and it would be useful to constitute Advisory Groups in varied and specialised subject areas. Based on a discussion on the present status of various standards and codes already evolved at the international level, 10 different subject areas were identified by the Standing Committee for the purpose of constituting Advisory Groups. A list of subject areas along with the set of relevant codes and standards is enclosed. The agencies and departments connected with the implementation are also broadly indicated.

3. In this context, as discussed over the phone, I have great pleasure in requesting you to be the Chairman of the Advisory Group for 'Insurance Regulation'.

4. The broad frame work for the working of the Advisory Group would include:

- (i) To study present status of applicability and relevance and compliance in India of the relevant standards and codes,
- (ii) To review the feasibility of compliance and the time frame within which this can be achieved given the prevailing legal and institutional practices in India,
- (iii) To compare the levels of adherence in India, vis-a-vis, in industrialised countries and also emerging economies particularly to understand India's position and prioritise actions on some of the more important codes and standards; and
- (iv) To chalk out a course of action for achieving the best practices.

5 It would, perhaps, be useful to consider quickly the aspects relating to implementation of certain standards and codes with immediate priority which could be considered for inclusion in the forthcoming Union Budget for 2000- 2001. This will require a quick interim report on the subject area, preferably before February 15, 2000. I shall be glad if you will seriously consider this suggestion.

6 The Advisory Groups will be assisted by one of the Secretaries to the Standing Committee as a convener. There could be a co-convener drawn from the relevant operating department/agency from Government or the Reserve Bank. I would leave to your judgment to select a set of, professionals/experts to join as members in the Advisory Group who would be

in a position to spare time and contribute to the fulfillment of the objectives of the Advisory Group. I may add here that the Advisory Group may be requested from time to time to produce status report for the benefit of the Standing Committee. Many a times this task may have to be accomplished within short duration. As soon as you suggest the names of other members, it would enable the Standing Committee to formally announce the constitution of the Advisory Group.

7. I am requesting the Secretariat to the Standing Committee to send you some background material and notes in the subject area for your immediate reference.

With kind regards

Yours sincerely,
Y. V. R eddy

Annexure II

The Advisory Group on Insurance Regulation

Shri R. Ramakrishnan	Executive Director (Retd.), Life Insurance Corporation of India	Chairman
Shri L.P. Venkataraman	Executive Director (Retd.), Life Insurance Corporation of India	Member
Shri R.C. Rao	Secretary (Retd.), Life Insurance Corporation of India	Member
Shri T.G. Menon	General Manager (Retd.), United India Insurance Company Ltd.	Member
Shri N.C. Gupta	General Manager (Retd.), The Oriental Insurance Company Ltd.	Member
Dr. R. Kannan	Adviser, Department of Economic Analysis and Policy, Reserve Bank of India	Convenor
Shri Indranil Sen Gupta	Assistant Adviser, Department of Economic Analysis and Policy, Reserve Bank of India	Co-Convenor