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President

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Submission to IRDA

Comments on IRDA Circular No. IRDA/ACT/CIR/MIS/111/05/2011 dated 25th May, 2011 on Economic Capital applicable to General Insurers

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

These comments have been prepared by a Working Group constituted for the purpose consisting of Asha Joshi, Tania Chakrabarty and Anurag Rastogi.

We thank the IRDA for this opportunity to comment on the Circular.

The views of the working group of IAI on IRDA circular on EC are discussed below by section on which the group had some view, followed by recommendations. All the views on valuation of assets and liabilities are exclusively for the purpose of calculating EC and do not imply any change, whatsoever, in either the accounting standards or IRDA regulations for preparing insurers' financial statements.

Section 4.4-Economic Value balance sheet Valuation of Assets

Market value of assets has not been clearly explained in the circular, leaving scope for varying interpretation of the same by different insurance companies. It will be good to clearly lay down the different categories of assets and their valuation principle in accordance with the economic concepts of market valuation.
Assets held by an insurer can be divided under two main categories, viz;

- Admitted assets
- Non admitted assets

The regulatory valuation of assets does not allow inclusion of the value of non admitted assets. However, under an economic value either IRDA should clearly specify which assets to include in asset valuation or the AA should be authorized use his/her discretion to decide which of these non admitted assets should be included in Asset valuation for the purpose of EC.
Assets can further be divided as:

- Financial instruments and securities
- Property
- Fixed assets

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- Receivables and other current assets

IRDA should clearly specify the valuation method for each category of asset for the sake of uniformity amongst the companies. Alternatively, IAI can specify this through Actuarial Practice Standards.

Recommendation 1

The circular should clearly specify various categories of assets and their treatment rules for EC and lay down the valuation method for each category of asset. (E.g. FIMMDA valuation guidelines for G-sec).

Section 6.4- Valuation methods for Technical Provisions related to Outstanding Claims

The IRDA circular states that under the EC framework the first step is to determine a best estimate for the technical provisions and then adjust this best estimate for the time value of money to get the "discounted best estimate technical provisions".
However, the illustration excel sheet sent by IRDA asks for balance sheet value of technical provisions, which is contradictory to the provision in the circular. This is creating confusions amongst insurers and need to be clarified by IRDA.
IAI in turn may issue guidance notes as part of Actuarial Practice Standards on the process to be followed for arriving at Best Estimate and discounting of reserves.

Recommendation 2

IRDA should clarify that the technical provisions, for the purpose of EC, are the best estimate discounted provisions and not the balance sheet values. The illustrative excel sheet should also be corrected. If required IAI can provide help on this through Guidance Notes on Economic Circular.

Section 6.5- Valuation methods for Technical Provisions related to Unexpired Risks

The IRDA circular states
"The technical provision for Unexpired Risk will consist of Unexpired Risk Reserve (URR) plus a Premium Deficiency Reserve (PDR) as defined under the Insurance Act, 1938 and the Regulations notified by the IRDA in this regard."
This is the regulatory URR and is not in consonance with the principles of *"valuation of technical provisions on an economic basis"*. This also contradicts the principles of economic valuation of technical provision as stated in this very circular. For example, section 2.2 states
"The word 'economic' indicates the fact that it measures risk in terms of economic realities rather than Regulatory or accounting rules which may be designed to support non economic principles"
Further, section 4.5 of the of the circular, while referring to 'Economic value balance sheet' states
"The best estimate of liabilities refers to the expected present value of the future potential cash flows"
If we look at Solvency II guidelines about URR valuation (these refer to it as prospective premium valuation), we found several actuarial literatures upholding the principles of economic valuation for URR, some of which are

- CEIOPS QIS 5 Technical specifications (as well as QIS 4 technical specifications)

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- Specialty Guide on Economic Capital by Society of Actuaries Risk Management Task Force (RMTF)
- Valuation of Non Life Technical provisions under Solvency II-A paper by Jeff Courchene (FCAS, MAAA), Vincent Robert (IAF, FIA), Joel Van der Vorst (AAG) and Gary Wells (FIA, FSAI)
- Technical provisions under Solvency II-Detailed guidelines by Lloyds

Recommendation 3

In view of the forgoing, it is recommended that the circular should clearly state that URR has to be valued at

- First, a Best Estimate basis, which could be lower than regulatory URR
- And then, discounted for time value of money at risk free rate (Gilt Yield curve)

Section 6.6 – Determining Risk Margins

This section deals with the calculation of Risk Margin. However, neither the Appendix B of the circular-Economic Capital Related disclosures, nor the accompanying excel sheet contains any disclosure or calculation of Risk Margin. This creates confusion amongst insurers if Risk Margin has to be calculated at all or not. Since all assets and liabilities are valued at economic basis, Risk margin becomes an integral and crucial component of Economic Capital calculation.

Recommendation 4

The IRDA circular should adequately emphasize the importance of RM and Economic Capital Related disclosures should contain relevant disclosures relating to RM.

Section 7.4-EC for CAT risks

The IRDA circular is not very explicit about the estimation of expected risk to an insurer in case of a CAT event. IAI recommends that IRDA should make it more explicit. Alternatively IAI can issue guidance notes on estimation of expected risk to an insurer in case of a CAT event.

Section 8.7 – EC for Credit Risk

The circular states

"If the reinsurer has a credit rating of A (+) or lower (subject to the minimum credit rating of BBB as stipulated in the regulations) then the EC for the credit risk related to that reinsurer will be set equal to 25 BP of the reinsurance recoverable from that reinsurer. If for some reason there is a reinsurance recoverable pertaining to a reinsurer whose credit rating is below BBB, then the EC for the credit risk relating to that reinsurer will be set equal to the entire amount recoverable from that reinsurer"

In this context, it is worthwhile to look at some of the provisions of the IRDA General Insurance-Reinsurance Regulations, 2000.

Section 3, subsection 1 (a) of the regulations state that the reinsurance programme shall continue to be guided by the objective of maximizing retention within the country

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Section 3, subsections (8), (9) & (10) of the same regulations further state as under
Subsection (8): The Indian Reinsurer shall organize domestic pools for reinsurance surpluses in fire, marine hull and other classes in consultation with all insurers on basis, limits and terms which are fair to all insurers and assist in maintaining the retention of business within India as close to the level achieved for the year 1999-2000 as possible.
Subsection (9): Surplus over and above the domestic reinsurance arrangements class wise can be placed by the insurer independently with any of the reinsurers complying with sub-regulation (7) subject to a limit of 10% of the total reinsurance premium ceded outside India being placed with any one reinsurer. Where it is necessary in respect of specialized insurance to cede a share exceeding such limit to any particular reinsurer, the insurer may seek the specific approval of the Authority giving reasons for such cession.
Subsection (10): Every insurer shall offer an opportunity to other Indian insurers including the Indian Reinsurer to participate in its facultative and treaty surpluses before placement of such cessions outside India
In keeping with the above regulations, Indian insurers purchase significant amount of reinsurance from Indian Reinsurer, GIC, which is rated A (-) by S&P, requiring insurers to provide capital for all reinsurance recoverable from GIC (except for amounts recoverable under mandatory quota share treaty, which has been exempted by the above circular). Insurers also buy some reinsurance from other Indian reinsurers which are not rated for their reinsurance paying capacity.

Recommendation 5

In view of the forgoing, it is unfair to ask insurers to provide additional capital for amounts recoverable from GIC. Hence, like amounts recoverable from GIC under the mandatory quota share, all reinsurance amounts recoverable from GIC and Indian reinsurers should be exempt for provision of EC.

Appendix A1-Lines of Business

The circular has specified Lines of business that are at variance from the lines at the level of which insurers prepare their financial statements. Hence it is imperative that these Lines of business are clearly defined so as to avoid any ambiguity and interpretational issues. For example, it is not clear whether travel insurance should be a part of Health insurance LOB or Miscellaneous LOB.

Recommendation 6

IRDA should clearly create a mapping of different products and LOBs so that there is uniformity in treatment of different products for the purpose of EC.

Appendix A2: Standard parameters for Premium Risk and Reserve Risk

This appendix specifies the industry wide premium risk and reserve risk parameters and all insurers have to use the same parameters regardless of their past experience.

Recommendation 7

It is recommended that the insurers' experience and data availability be taken into account for the calculation of EC. The IRDA exposure draft on EC dated 22nd October, 2010 had recommended a credibility approach, where each insurer could use a credibility weight depending upon LOB and the

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number of years for which historical data is available. It is recommended that this credibility weighted approach may be adopted. If required, IAI can rework the EC calculation methodology based on the credibility approach.

Appendix B – Economic Capital Related Disclosures

The disclosures table requires insurers to disclose the various components of EC that have been used in calculating EC. However, since most of these are on an “Economic basis” rather than on “regulatory basis”, these cannot be validated with the amounts in insurer’s annual financial statements or regulatory disclosures. There is a need to enlarge the disclosures table so that it includes the relevant amounts on both, the “regulatory basis” as well as ‘Economic basis”.

Recommendation 8

The disclosures table should be adequately enlarged so as to include the relevant amounts on both regulatory basis and economic basis. If required, IAI can rework the disclosures table.

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