Exposure Draft on Risk Based Solvency Approach

All stakeholders are requested to review the attached exposure draft and forward their view/comments to the following address within 30 days.

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Comments may also be forwarded by email at maheshagarwal@irda.gov.in and ramanaraoa@irda.gov.in

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Member(F&I)
Dated : 6th February, 2013

Flesch Reading Ease 26.9
Flesch Kincaid Level 16.3

EXPOSURE DRAFT ON RISK BASED SOLVENCY APPROACH

INTRODUCTION:

Insurers are required to maintain sufficient assets to discharge the liabilities that arise from their business so that the interest of policy holders is protected. Part IIC of the Insurance Act, 1938 provided the detailed regulatory framework on valuation of Assets and Liabilities, sufficiency of assets and the calculation of minimum requirements of 'required solvency margin' (RSM). Sec 64V (7) of the Insurance Act, 1938 mandates Insurers to submit certificate on solvency margins from the Statutory Auditors at the end of the financial year in the case of the General Insurers and from the appointed actuaries in case of the Life Insurers. While arriving solvency ratio, the available solvency margin (ASM) is calculated upon required solvency margin (RSM). The Authority in exercise of the powers conferred by Sec 114A of the Insurance Act prescribed IRDA (Assets, Liabilities and Solvency margin of Insurers) Regulations, 2000 which further provide the detailed guidelines for valuation of assets, valuation of Liabilities and matters pertain thereof . Table II of Schedule IIIB provide the format in which the solvency certificate from the Auditor needs to provide for General Insurers. In the case of Life Insurers, the solvency ratio needs to be certified by the Appointed Actuary in the format given in Table III of Form K of IRDA (Actuarial Report Regulations), 2000 after considering the mathematical reserves and sum at risk.

Sec 64VA (1A) (i) (b) (II) of the Insurance Act mandates the percentage determined by the regulation made by the authority of value of assets determined in accordance with provisions of 64V shall be added to the RSM while arriving the solvency ratio. Accordingly, Actuarial Report Regulations provided the charge on the "Non-mandated Investments" in table II of Form K in the form of 'Third Factor'. The 'Third Factor' is a percentage of risk charge on the Corporate Bonds, Mortgages, Real estate, Preference Shares and Equity shares. Vide Note (2) to the above table, the Third Factor is defined as 'Zero' until further intimation from the Authority. At present, prudent provision against the effects of possible future changes in the value of Assets shall be made while calculating the mathematical reserves by the Appointed Actuary pursuant to the

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Schedule IIA of Solvency Regulations. However, the Authority has not prescribed minimum charge as envisaged in Sec 64VA (1A) (i) (b) (II) of the Insurance Act, 1938.

IRDA, being the Member of International Association of Insurance Supervisors (IAIS) follows the Insurance Core Principles (ICP) while regulating the Insurance business in India. ICP 17 gives the choice of 'deduction approach' (deduction of risk charge from the Available Solvency Margin) or 'capital charge approach' (inclusion of risk charge to the Required Solvency Margin) to the Supervisors for providing the charge on assets. India pursuant to provisions of Sec 64VA (1A) (i) (b) (II) of the Insurance Act, 1938 adopts the 'capital charge approach' under ICP 17.10.16 wherein capital charge of *"a potential deterioration of the economic value of the asset due to an adverse event which may occur during the defined solvency time horizon - would then need to be reflected in the determination of regulatory capital requirements(RSM)."*

CONSTITUTION OF COMMITTEE TO SUGGEST THE ROAD MAP:

As per the International practices, IRDA decided to move towards Risk Based Solvency approach in insurance sector and accordingly constituted an experts committee to suggest the road map in this regard. The terms of reference include

- the study of RBC approach of the advanced countries like USA, Japan, Singapore etc.
- stuy of solvency II approach followed by some of the Indian Life Insurers.
- Draft Solvency II requirements

Further, the committee advised to suggest the methodologies of Market Risk arising from Interest rate risk, equity risk, property risk, spread risk and concentration risk.

The Committee is in the process of deliberations to suggest the road map.

PROPOSED RISK CHARGE ON DEBT OF INSURERS:

Insurers are required to invest funds in the pattern prescribed in IRDA(Investment) Regulations, 2000. Though, majority of funds need to be invested in Govt. securities and approved investments, no risk charge is provided to the Insurers who invest in more risky investments. To begin with, the authority decided to define 'percentage '

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(third factor in case of Life Insurers) u/s Sec 64VA (1A) (i) (b) (II) of the Insurance Act, 1938 to adopt the Risk Based Solvency Approach in line with the Solvency II norms on capital adequacy requirements without considering the modified duration value. The immediate need is felt to define the risk charge on the debt instruments and loans and advances of the Insurers to address the spread risk on various categories of debt instruments.

Proposed risk charge for various categories of debt are as follows:

Rating by the Credit Rating Agency	**Total Capital Charge (in%)**
Central Govt and State Govt. Securities	0
Securities guaranteed by Central Govt. and State Govt.	0
AAA	0.9
AA	1.1
A	1.4
BBB	2.5
BB and below	7.5
Unrated	7.5

Further, the capital charge needs to be calculated in the following lines:

1. Risk charge should be applied for all mandated and non mandated assets of the Insurers. Assets pertaining to the Non-linked business only should be considered in the case of Life Insurers, as the risk pertaining to the linked business is being borne by the policy holders.

2. Loans and advances should be categorized as per the ratings of the counter parties. The capital charge on loans and advances should be

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decreased by the general provision already made as applicable to 'standard assets'

3. With regard to Non-performing assets (NPA), vide circular dated 24th January, 2007, IRDA advised the insurers on the method of classification of an asset as NPA if the interest and/or instalment of principal remain overdue for more than 90 days with regard to loans and advances. Further, the said circular also provides for provision of 100% for the loss asset and provision of 20% up to 1 year, 30% for 1-3 years and 100% for more than 3 years for the portion of the asset not covered by realisable value of the security.

   For the purpose of calculating the capital charge on the debt instruments, if the Insurers follow similar type of provisioning, no separate risk charge should be provided on NPAs.

4. Risk charge will also be provided on the debt of General Insurers. Suitable changes to the regulations are required to make the same applicable to General Insurers.

REQUIRED SOLVENCY RATIO:

After the implementation of above risk charge, Solvency margin instead of being at 150% shall be set at 145%. The said requirement shall be applicable from financial year 2013-14 and certificate to be furnished as on 31st March, 2014.

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