Overview

Solvency Margin in Indian Insurance Companies

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And one may wonder as to whether the insurance premium paid by him is safely invested and whether he would get back his sum assured at the end of the maturity period. Every insurance company is required to maintain solvency margins based on its volume of business and as per the guidelines stipulated by the IRDA. Hence, one need not bother as to the investment of his capital with any insurance company, in general.

The solvency of an insurance company corresponds to its ability to pay claims. An insurer is insolvent if its assets are not adequate [over indebtedness] or cannot be disposed of in time {illiquidity} to pay the claims arising. The solvency of insurance company or its financial strength depends chiefly on whether sufficient technical reserves have been set up for the obligations entered into and whether the company has adequate capital as security.

A case study could be used as an example of what happens when the insurance company fails to manage their asset liability composition —-

"Nissan Mutual life was a Japanese Life Insurance Company with 1.2 million policyholders and assets of JPY 2 billions. Nissan Mutual Life sold individual annuities at guaranteed rates of 5 - 5 ½ %. The Japanese economy was then on high and the interest rates wave high. And in early 90s the bubble burst. A whole host of outcomes followed the Government bond yields plunged to record low levels and a large gap was created between the company's cost of liability and returns on assets. On April 25, 1997 Japan's Finance Ministry ordered the company to suspend its business. Nissan Mutual was the first Japanese insurer to go bankrupt in five decades. Its losses totaled JPY300 billions."

What is solvency margin?

Solvency margin is the amount by which the assets of an insurer exceed its liabilities, and will form part of the insurer's shareholder's funds. Methods of valuations of assets and liabilities of an insurer are prescribed in the insurance regulations, Rules for estimating the liabilities will obviously be different for long-term and general insurance business. The regulations stipulated the minimum solvency margin, which an insurer must maintain

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at all times. Separate solvency margin will be required for long-term and general insurance business of a composite company so that each business will stand on its own and not subsidise the other.

For life insurance business, the minimum solvency will normally be related to the policy reserve as disclosed by an actuarial valuation of the liabilities. For general insurance business, it is related to the higher of a percentage of net premium or net claim. There will also be a certain minimum amount required to be maintained under statute in the solvency formula for each of the lines of business.

The Solvency Margin also denotes the capital base, defined as the surplus of assets over liabilities. It is often called shareholders' funds [in the UK] or policyholders' surplus [in the USA].

Solvency ratios

A parameter called the "solvency ratios" means the ratio of the amount of Available Solvency Margin to the amount of Required Solvency Margin.

The numerator of the ratio denotes the items such as:-

(a) capital/funds
(b) various reserve that include price fluctuation reserves and catastrophe reserves
(c) a portion of unrealized profits obtained from real estate and stocks.

The above characteristics call on the insurers to follow certain basic principles of asset management:-

- Safety – As a minimum fund value should not erode.
- Profitability – investment returns must exceed cost of liabilities. There should also be a risk buffer for sudden change in investment environments.
- Liquidity – preparing for payment of claims and surrenders.

The denominator of the ratio refers to the risks like :

- **Underwriting Risks :-** Risk of miscalculating premiums and miscalculate technical provisions.
- Risks on the expected interest rates :- It is considered to be an important factor contributing to the insolvency of an insurance company.
- Risks related to asset management :- Growth risk arising out of exercise growth not matched by sufficient resources or due to wrong selections or wrong pricing of products.

In order to maintain healthy asset liability ratio, life insurers world-over follow one or more of the following assets-liability management methods:

Cash flow testing : The actuary tests the cash flow of the insurance company under various interest rate scenarios.

Cash flow matching – Also known as dedication. A block of liabilities with identified cash flow would be matched with a block of assets with identical cash flow.

Immunization – Duration of the liability portfolio is estimated and matched with an asset portfolio of identical durations.

Insurance Regulatory And Development Authority has prescribed methods of valuation of assets and Liabilities of Life insurance and General Insurance as:

DETERMINATION OF SOLVENCY MARGINS

(a) "**Available Solvency Margin**" means the excess of value of assets (furnished in IRDA-Form-AA) over the value of life insurance liabilities (furnished in Form H as specified in Regulation 4 of Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2000) and other liabilities of policyholders' fund and shareholders' funds;

(b) "Solvency Ratio" means the ratio of the amount of Available Solvency Margin to the amount of Required Solvency Margin.

1. Determination of Solvency Margin – Every insurer shall determine the required solvency margin, the available solvency margin, and the solvency ratio in Form K as specified under Insurance Regulatory and Development Authority (Actuarial Report and Abstract), Regulations, 2000.

The boom in the insurance sector has triggered a stiff competition and it is the right time to relook at the existing solvency norms of the insurance companies.
The debate now is whether the Solvency Margin Regulations need to be restructured both for the Life and General insurance sector.

The Debate

As per the Regulation issued by the Insurance Regulatory and Development Authority (IRDA) the **General Insurance Companies** can follow the norms of the Regulatory Authorities. According to the former CMD of New India Assurance and

United India Insurance Ltd. Sh. KN Bhatnagar "A Solvency Margin of about or less than 100% in India as it is considered to be quite dangerous, this requires very close monitoring of the insurer by regulator along with stringent actions like upper limit on payment of dividends, remunerations to directors, restrictions on the business operation etc. It is generally stated that the problems arising out of the position and strength of the General Insurance Company will not be arising if this ratio is either 200% or more.

On the other hand, the **Life Insurance Companies** have been asked to maintain a 150% Solvency Margin which includes a 50% additional cushions over and above the norms specified in the regulations.

A controversy has surfaced over LIC's solvency, with the Insurance Regulatory and Development Authority questioning the lack of capital while the organization is pushing the issue of Government guarantees. All LIC policies have a sovereign guarantee.

The Life Insurance Sector also requires a quick review of the existing solvency norms. The norms are to be refurbished on the following grounds:

(a) The factors used in solvency calculations have to capture the-risks in the products more clearly.

(b) The statutory reserving the solvency requirements have to be viewed in an integrated way.

(c) The factors should give credit to a company's size and risk management policies.

(d) Clear regulatory margin should be established in solvency for risks that are of non-quantifiable nature in the business.

Anand Rao Vithoba Adsul, ex-union Minister of State for Finance (Banking, Insurance and Expenditure) says: "The guarantee is on paper. Every day there are transactions with the public guarantees will not help because this is the condition of all State Government entities". (*June'15 Economics Times*)

According to reports, LIC needs an additional capital infusion of up to Rs.20,000 crores to maintain the solvency criterion stipulated by the IRDA. ***(Sept '1 Economics Times)***

The Life Insurance Corporation of India has sought a five years time frame to meet the additional 50 percent Solvency Margin as asked by the IRDA. In keeping with the IRDA Act, LIC will meet the 100 percent fiscal year 2004, said the Corporation's Chairman Sh. S.B. Mathur. (*Sept '1 Economics Times*) ■

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