

Preserving Capital & Maximising Shareholder Return in a Life Insurance Company

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< EXECUTIVE SUMMARY >

◆ Life insurance business requires capital in the range of Rs.300-400 crores (Rs.3-4 billions) or even more, it takes 7-9 years to show first signs of profit, it sells a promise, it deals directly with the lives of the customer and more so after their death, it is these characteristics that makes it a unique business in comparison with so

many other traditional businesses. The management of a life insurance company is under test to not only build a creditable operation but also make use of the capital in the most prudent manner with a long term view and in the best interest of the business. I have attempted to address this aspect in the discussion below.



Entry to life insurance business requires a prospective entity to bring Rs.100 crores (Rs.1 billion) as a start up capital in cash besides the stringent test/criteria set by the regulator IRDA (Insurance Regulatory and Development Authority). The regulator has kept such a high requirement of capital so as to create an entry barrier so that only serious players enter this business, who are serious and understand that it is a capital intensive business. It is not only because regulator has imposed a high level of starting capital but estimates of almost all new players also shows that the capital requirement does not just end at this Rs.100 crores (Rs.1 billion) but requires additional capital infusion of Rs.250 - 350 crores (Rs.2.5 to 3.5 billion) in the following years. Therefore in a business; which requires such huge amounts of capital, it goes without saying that the management/insurer needs to utilize this money in the most prudent/effective manner, which is available to them upfront.

Ability to demonstrate its capability to utilize the capital in most optimum manner will go a long way in establishing its credibility not only in the eyes of the regulator,

academicians, shareholder's, people who understand this business today and last but not the least the person who matters the most, the 'man' on the street. This 'man' probably does not understand it today but as he gets educated on the subject going forward and with increasing awareness he will be able to distinguish the insurer he wants to go with among the whole lot available to pick from. Based on my experience I am of the opinion that in this business, insurer's credibility with the regulator and the customer is what matters the most, and it is also the most important ingredient for a successful venture. Any dent to this credibility will require lot of effort, time and money to undo the damage. It is this intangible which will distinguish a company from the competition as mere ability of the shareholders'/promoters' to bring cash when required will not be a sustainable distinguishing parameter.

In my opinion, which is based on the limited understanding and experience of working in the insurance sector I have attempted to highlight the-issue and possible ways of how by way of doing things differently it can make huge impacts on this requirements of capital by the company.

Shareholders who have decided to infuse Rs.300-400 crores (Rs.3-4 billion) in a business and patiently wait for 7-9 years when they see the first profit, are definitely expecting large returns. This expectation is not wrong as nothing

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comes free in this world. To meet this apparent normal expectation of shareholders also demands on the part of the management to be capital conscious from the beginning. In other words capital preserved is capital created.

Given to operate within a set of regulations which are more or less fixed, let us explore where is the room for optimizing the use of shareholders' capital and there by preserving the wealth.

As a starting point let us see what drives or puts strain on capital. The drivers of capital in a life insurance business are namely

- i) Solvency margin requirements as set by the regulator, which is a combination of a floor limit and a mathematically derived amount, this mathematically derived amount is a function of the volume of business on books, growth rates, product mix (examined later in the article)
- ii) Level of Inadmissible assets
- iii) Expense overrun or excess of actual expense level Vs pricing allowable expenses
- iv) Actuarial reserves or policyholder reserves actuarial reserving basis (regulator prescribes GPV (Gross Premium Valuation) method to be uniformly adopted by all the companies for easy comparison) etc
- v) Other drivers which affect capital are product mix, rate of new business growth, etc.

Let us see what each one means and how they affect capital. Allow me to start from the last point of this list as I intend to discuss the top drivers in detail.

Product mix, each product has its own characteristic and effect reserve requirements differently; like Single Premium has reserve day one and has a decreasing pattern but for Endowment it increases with the life of the contract and on the other extreme for Term there is no reserve at all. A combination of the same products in different proportions have a varying impact on the Reserves, Capital requirement, Profits etc. Here I am only saying that product mix affect the reserves and how reserves affect capital is being examined later.

Now lets take rate of new business growth and how it affects capital, it is worthwhile to mention here that this is a unique business where even fast growths can also bring in closure of business, since it costs more than a Rupee to acquire a new Rupee in the form on new premium (box below), this puts strain on cash and thereby capital. As the volume of business on books grows so does the reserves and there by solvency (discussed later).

See Table 1.1 below, which shows that the company has to expend more than the new premium itself in the first year and clearly it needs cash to fund the expenses. Therefore capital is affected both from the cash flow angle and the solvency margins requirements.

Table 1.1

	(Rs.)
Say, First Year Premium is (assumed that premium of Rs.6000 will get a sum insured of Rs.250,000 at age 30 for a normal make for 25 year Term plan)	6,000
Agent's commission (40%)	2 400
Sales managers overrides (70% of agent's first year commission)	1,680
Other overheads for acquisition (Policy document, medical, processing etc)	1,500
Stamp duty (@ Rs.0.40/Rs.1000 of sum insured)	100
Other overheads for policy owner servicing (change of address, loans, change of nominee, etc.)	500
Total of expenses	6,180
Balance available for recovery all other indirect overheads	(180)

Let us discuss the effect of actuarial reserving basis, there are different methods of reserve determination some give liberal reserves values and some give conservative reserve values, so the choice of a particular method is crucial. No method is wrong but they behave differently, just like depreciation policy straight line method (SLM) or written down method (WDV) both are correct but both impact the profit line differently. In case of India, to keep it uniform for ease of comparison, the regulator (IRDA) has specified Gross Premium Valuation method to be followed for reserve determination.

Expense overrun, simply stated, if the insurer's actual expense is less than what it recovers from the premium income (based on the expense loading that it has put on the net premium while pricing), then the expense over-

run is negative thereby a situation of profit in the reverse situation a situation of loss. For an insurer a situation of negative expense overrun i.e. expense gains is a reflection of a lot of things namely the efficiency of sales force, product pricing capability insurer's market share, matured market situation, etc.

Solvency margin is the excess of assets over liabilities. Statute prescribes what this excess should at least be for an individual life insurer, ie prescribes a minimum solvency margins which is to be maintained at all times. Regulations prescribe that solvency margin be higher of;

Rs.50 crores (Rs.500 millions),

Or

Mathematically derived number, (for an insurer in business of Individual life insurances this number is 4% of Mathematical/Technical Reserves Plus 0.3% of sums at risk). So reserves affect solvency margins which affect the capital requirement.

As the new insurer starts his business he will take at least 3-4 years, even with most ambitious growth plans, before this mathematically derived amount exceeds Rs.50 crores (Rs.500 million).

Which means that in the initial few years itself an insurer has to keep at least Rs.50 crores (Rs.500 million) of assets in excess of its liabilities. Since this excess or required solvency margin of Rs.50 crores (Rs.500 million) is minimum any shortfall will have to be corrected by way of capital infusion.

In determining the level of excess of assets over liabilities, the regulations also prescribe the manner in which to value these assets and liabilities for the purpose of determining the available solvency margin. This is so to remove any inconsistencies in the methods that may be adopted by different insurers for determining the available solvency margin.

On the liabilities side we have mainly policyholders' liabilities, which are determined actuarially and some other business liabilities like payables, etc so there is little that can be done on the liability side.

Let us examine what can be done on the asset side.

Regulations talk about if the asset is eligible/admissible fully and/or partly in the first place to be considered for the purpose of valuation or not, then if it passes the eligibility/admissibility test then prescribes what should be its value.

Below is the extract of what the IRDA regulations on Assets, Liabilities and solvency margins say for value of assets:

“VALUES OF ASSETS:

- (1) The following assets should be placed with value zero,
 - a) Agent's balances and outstanding premiums in India, to the extent they are not realised within a period of thirty days;
 - b) Agents' balances and outstanding premiums outside India, to the extent they are not realisable;
 - c) Sundry debts, to the extent, they are not realisable;
 - d) Advances of an unrealisable character;
 - e) Furniture, fixtures, dead stock and stationery;
 - f) Deferred expenses;
 - g) Profit and loss appropriation account balance and any fictitious assets other than pre-paid expenses;
 - h) Reinsurer's balances outstanding for more than three months;
 - i) Preliminary expenses in the formation of the company;
- (2) The value of computer equipment including software shall be computed as under:-
 - a) seventy five per cent, of its cost in the year of purchase;
 - b) fifty per cent, of its cost in the second year;
 - c) twenty-five per cent, of its cost in the third year; and
 - d) zero per cent, thereafter.”

First impression is that any existence of a fully inadmissible asset or a partly inadmissible asset will hinder the solvency margins to the extent of inadmissible value. What this tells us is that we should not have any fully inadmissible asset or partly non admissible asset. Since a company need assets to transact business and the need for such assets is not guided by what values regulations attach to it. In my view, this is where there is lot of scope for planning that can be done, specially with regard to the depreciable assets. Since there is a need for such assets by the business, it should try to find alternate channels/modes of using those assets and yet not get them affect your balance sheet.

Let us see the effect of a fully inadmissible asset by way of an illustration with data, by comparison between two companies one going in for purchase and the other for lease/hire.

ASSUMPTIONS

Company A rents a bare shell premises at Rs.50 per square feet per month and furnishes it on its own at

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Rs.2000 per square feet. While Company B enter into a contract with the landlord for similar space but furnished by the land lord at Rs.94 per square feet per month. This Rs.94 includes the rent for bare shell of Rs. 50 and a balance Rs.44 for the furnishing. This Rs.44 is an equated monthly installment for Rs.2000 over 5 years at 14%. Everything is same for the two companies with the only difference being that A has invested their own capital in the furnishings and B has leased them from the landlord. Also Company B invests Rs.2000 in a government paper yielding 9% annually. Both take one square feet of space. Furniture and fixtures have also been depreciated over 5 year period to keep the parity.

This is how the results of the 2 companies will look.

Company A

	Profit & Loss Account				Assets in Balance Sheet (Fixtures & Fittings)	Admissible Value of the asset as per Regulations	Incremental Value to the extent inadmissible	Capital (Additional infusion Required)
	Expense (Lease Rent)	Expense (Depreciation)	Income	Net				
	A	B	C	D=C-(A+B)	E	F	G	H=D+G
	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
Year 1	(600.00)	(400.00)	-	(1,000)	1,600	-	1,600	2,600
Year 2	(600.00)	(400.00)	-	(1,000)	1,200	-	-	1,000
Year 3	(600.00)	(400.00)	-	(1,000)	800	-	-	1,000
Year 4	(600.00)	(400.00)	-	(1,000)	400	-	-	1,000
Year 5	(600.00)	(400.00)	-	(1,000)	-	-	-	1,000
							Total	6,600

Company B

	Profit & Loss Account				Assets in Balance Sheet (Government Security)	Admissible Value of the asset as per Regulations	Value to the extent inadmissible	Strain on Capital (Additional infusion Required)
	Expense (Lease Rent)	Expense (Depreciation)	Income	Net				
	A	B	C	D=C-(A+B)	E	F	G	H=D+G
	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
Year 1	(1,152)	-	180	(972)	2,000	2,000	-	972
Year 2	(1,152)	-	180	(972)	2,000	2,000	-	972
Year 3	(1,152)	-	180	(972)	2,000	2,000	-	972
Year 4	(1,152)	-	180	(972)	2,000	2,000	-	972
Year 5	(1,152)	-	180	(972)	2,000	2,000	-	972
							Total	4,860

The comparison tells us that over a 5 year time period Company A needs higher capital by Rs.1,740 (Rs 6,600 - Rs 4,860). Any investments made in inadmissible asset, becomes completely worthless for solvency margin requirements and require additional capital to that extent. Investments in inadmissible assets is advisable after a point when capital becomes indifferent to solvency margin i.e. solvency no longer puts a strain on the Capital requirement.

Also it should not be concluded that choice of company 'A' is wrong, as long as, it has been consciously chosen so by the shareholders. If shareholders have sufficient capital and they want to put money in the business then it's their choice as long they are doing so after the above analysis. All I am saying is that the same amount of business can be transacted with a lower capital base.

LET NOW SEE AN ILLUSTRATION FOR PARTLY INADMISSIBLE ASSETS.

Company A buys computers, while Company B enter into a contract with a vendor to hire the computers.

To study the comparison let us assume that both need computers worth Rs.100 which can be hired at Rs.40 p.a. for 3 years. This rate of Rs.40 p.a. is a very conservative quote and in the market place it can be closed at a much lower number along with a clause that at the end of 3 years the computers will be transferred to the company at a token amount. Also for the sake of ease of comparison the span for both the companies has been kept at 5 years. Other things have been assumed to be same for both the companies and have been kept out of this illustration.

Now, let us examine how the P&L and the BS of the two companies look, over a five year period. Since company B did not buy computers they have invested Rs.100 in a government paper earning say, 9% annually.

Company A

	Profit & Loss Account			Assets in Balance Sheet (Computer)	Admissible Value of the asset as per Regulations	Value to the extent inadmissible	Strain on Capital (Additional infusion Required)
	Expense (Depreciation)	Income	Net				
	A	B	C=B-A	D	E	F=D-E	G=C+F
	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
Year 1	(20)	-	(20)	80	75	5	25
Year 2	(20)	-	(20)	60	50	10	30
Year 3	(20)	-	(20)	40	25	15	35
Year 4	(20)	-	(20)	20	-	20	20
Year 5	(20)	-	(20)	-	-	-	-
						Total	110

Company B

	Profit & Loss Account			Assets in Balance Sheet (Government Security)	Admissible Value of the asset as per Regulations	Value to the extent inadmissible	Strain on Capital (Additional infusion Required)
	Expense (Hire charges)	Income	Net				
	A	B	C=B-A	D	E	F=D-E	G=C+F
	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)	(Rs.)
Year 1	(40)	9	(31)	100	100	-	31
Year 2	(40)	9	(31)	100	100	-	31
Year 3	(40)	9	(31)	100	100	-	31
Year 4	-	9	9	100	100	-	-
Year 5	-	9	9	100	100	-	-
						Total	93

The above results show that in case of company A the capital requirement over five years period is Rs.110 as compared to Rs.93 of company B, which is higher by Rs.17. However, in practice the hire agreement can easily be staggered over longer periods, say 4 year period, thereby making this point even stronger.

Alternative use shows that capital requirement can be flattened over the years by shifting costs to later years to

match them with income of later years after the initial ramp up has taken place in a start up, which again makes a lot of sense.

This analysis has also to be viewed from another financial implication, which cannot be quantified with precision, in light of the fact that since it takes a very long time (7-9 years) to breakeven, i.e. the losses of first few years may actually go waste as they may become time barred for being available for setoff against profits of later years. And even if available for setoff, because of time value of money that loss would have become miniscule or worthless. However, this is a matter of perception and cannot be quantified with precision.

Clearly, some financial planning and analysis can greatly impact the requirement of capital and there by the IRR for the operation by making some decisions after due financial analysis.

Similarly, it can be illustrated to demonstrate savings of capital for other assets/areas. Other assets where this savings is possible are mainly Furniture Fixtures & Fittings Cars, Equipments, employee loans, etc.

CONCLUSION:

Any capital expenditure should be considered after evaluating its admissibility for solvency margin purpose. Also, consider the amount of capital shareholder have to infuse in the business.

Identify what are those assets, which are partly or fully inadmissible. Find alternate sources of using them yet not letting it affect infusion of capital. Such alternative means being namely lease, hiring, etc. Surely these alternatives have a built in financing cost but to bear this cost is worth it.

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(TCA/02)