Equity Markets from Insurance Sector Perspective: An Insight and Analysis

Insurance companies generally invest large part of their portfolio in fixed income assets i.e. Government Bonds, Corporate Bonds. Insurance companies receive money in advance from its customers (premium) and amount is due to the customers much later (claims). The liability for a General insurance company is generally short (typically less than a year) and for life insurance companies it is long (more than 10 years). Importance of insurers' role in the equity market can be understood by large value of the equity investments made by them. The premiums received from the customers are invested in the interim to earn return. This article tries to analyse role of equity in insurance company investment portfolio. The analysis has been done using economic/ business requirements and requirements of investment regulations specified by Insurance Regulatory and Development Authority of India (IRDAI). Read on…

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Insurers even though primarily fixed income investors are also large investors in the equity markets across the world. In India the situation is similar. Table below gives equity investments by various institutional players as of 31st March, 2019.

Institutional Investor Category	Amount Invested (₹ crores)
Foreign Institutional Investors	29,24,910
Mutual Funds	10,91,379
Insurance Companies	10,01,689
Of which Life Insurance Companies	9,00,733

Source: CDSL, Life Insurance Council and SBI Life Internal calculation

It is estimated by Kotak Institutional equities that insurance companies and Banks (largely insurance companies) hold 6.26% of BSE200 companies' equity as of 31st March 2019.

Looking at it from other perspective; Equity investment of ₹ 9 lakhs crores by life insurance companies constitutes 25% of their total investment portfolio of ₹ 36 lakh crores.

Overview of Indian Equity Returns

In India we have equity market history in the form of BSE Sensex for last 40 years i.e. since 1979. Equity markets have given good returns over that period. The table below summarises performance of equity market in India. Analysis is based on all possible 5 year, 10 year and 15 year returns that one could have earned by investing in Sensex as a basket. It is assumed that investor incurred no transaction costs and reinvested dividends back

in the Sensex. The average IRR is 16% for 15 year holding period. However, this high return will have to be seen in light of government bonds yielding double digit i.e. 10%-12% during significant part of 40 year history.

Important things to note in the table are (1) in general equities have provided higher returns in long term than government bonds (2) the volatility of the returns goes down as the holding period increases. Over 15 year period equities have never given negative return. Though that does not mean it will not happen in future, it only suggests that probability of negative return over 15 year holding period is very low.

International experience across multiple geographies also suggest that over long investment horizons, equities produce 4%-5% additional return over government securities.

History of equity market investment in Indian equity markets.

IRR	5 years	10 years	15 years
Maximum	54.4%	36.2%	28.9%
Minimum	-5.8%	-0.5%	6.7%
Average	17.8%	17.1%	16.1%
Probability of Loss	4.5%	0.3%	0.0%
Probability >10% return	70.6%	80.0%	97.4%

Source: SBI Life Internal Calculation

This excess return of equities over government bonds and reduction of risk in long term is the most important factor for insurers choosing equities as an important asset class. Insurance companies infact try to maximise the allocation to equities within the constraints of the Asset Liability (ALM) framework.

Asset Liability Management

ALM for insurance is primarily a liability driven; with investment assets purchased to match the liability profile of the products sold, in a risk efficient manner.

For ALM analysis, life insurance companies' liability portfolio (hence asset portfolio) can be broadly classified into 3 categories: Non Participating (Non Par), Participating Products (Par) and Unit Linked Insurance Plans (ULIP).

Non Par products offer fixed and pre-determined benefit to customer known at the inception of the policy. They can be classified into

A) Protection policies: The benefit is in form of fixed compensation on unfortunate death of the policyholder. Fixed benefit health is also part of the protection.

B) Savings product: The benefit is in form of known amount/ guaranteed return to the customer at the maturity of the product. Death benefit is built in but large part of premium paid by the customer is for the maturity benefit.

C) Annuity products: These provide fixed cash flow till death of the policyholder.

For non-par products the equity allocations are small as the risk management requires that the guarantee element be secured by investing in fixed income securities. However, the products are long term in nature and the portfolio risk does not increase from small allocation to equities. Insurance companies in India typically invest 5%-7% of the non-par portfolio in equities as it enhances the return without adding risk to the portfolio.

Par Products are savings products with capital guarantees and the additional return based on performance of the portfolio over life of the policy. Par products have built in life protection (Par Life) or annuity (Par Pension). The additional return over the basic guarantee is given in the form of bonus. Bonuses are paid throughout the life of policy and also as terminal bonus as at the end of policy period. Since bonus rates are not guaranteed, the ability of insurance company to invest in equities is much higher in the Par portfolio. Indeed the Par product attractiveness depends on the return generated from a well-managed equity component of the portfolio. From ALM perspective Par products are complex and Allocation to equities is a very important element of ALM analysis. Life insurance companies in India invest around 15%-25% of their part portfolio in equities. Typically as the Par portfolio matures ability to invest in equities increases. However it is difficult balancing act, we have international examples in which high allocation to equities resulted in significant financial difficulty for insurers in equity market downturns.

ULIPs are investment products with life protection (ULIP Life) or annuity (ULIP Pension) built into the product. Many customers have found ULIPs attractive as they allow customers to meet their protection and investment needs in one product. ULIPs offer flexibility in investment, transparency of charges but usually take away the capital protection available in other life insurance savings products. ULIPs offer choice of many funds to customers like Equity Fund and Bond Fund. The equity allocation decision for ULIP is taken by the customer and not by the insurance company. In India due to attractiveness of equity markets, customers have preferred equity to bonds in ULIPs. Allocation to equity

in the ULIP portfolio is more than 50%.

For General insurance companies, the negative working capital cycle results in a portion of funds 'permanently' available for investment. This money is long term in nature even when the typical policy cycle is one year. General insurance companies have, therefore, invested more than 10% of the policyholders funds in equities to enhance return on their investment portfolio.

Both Life insurance and General insurance companies have to meet solvency norms (i.e. Shareholder Capital adequacy) specified by IRDAI. Shareholders Capital is almost entirely available for investment in financial assets. The scope for investment equities in India for Shareholders Capital is high as India follows traditional solvency norms (asset side risks not considered for determining solvency requirement). But many Insurance companies have considered Shareholders Capital as capital for extreme emergency and, therefore, limited the proportion of equity investment. Generally, proportion of equity in Shareholder Capital is limited to 6%-7%.

Investment Regulations

IRDAI investment regulations treat investment in equity as approved provided 'shares are issued by listed company on which not less than 10 per cent dividends have been paid for at least two consecutive years immediately preceding'. Shares issued by unlisted companies or by listed companies without the dividend track record are allowed but treated as 'other than approved investments'. Investment in private limited companies or companies registered outside India is not permitted.

IRDAI has classified of investments funds for life insurance company in following categories:

A) Life Fund: This includes all funds excluding ULIP, Pension, Annuity and Group Funds. Life Fund thus includes both par, non par and shareholders fund.

B) Pension, Annuity and Group Fund: This is a fund pertaining to Pension, Annuity and Group products.

C) Unit Linked Fund(s): Each ULIP fund offered to the customer to be maintained separately.

The asset allocation pattern specified by the regulations can be summarised as follows:

Type of Investment	Life (Life Fund)	Life (Pension, Annuity and Group Fund)	General
In Government Securities (Central, State)	Min 50%	Min 40%	Min 30%
In Infrastructure and Housing Investments	Min 15%	Not Appl	Min 15%
Other than Approved Investments	Max 15%	Not Permitted	Max 15%

Other than Government Securities, equity investments are part of all other categories. Investment limit available for equities is large and allocation to it is not constrained by IRDAI regulations.

For ULIP asset allocation is not specified in the regulations. Investment for Unit linked business shall be as per pattern of investment offered to and subscribed to by the policy- holders. However, the investment in Approved Investments shall not be less than 75% of each of such fund.

Practical Considerations

The primary aim of the insurance company while managing the investment fund is to outperform the long term expectations of the policyholder. For ULIP funds the policyholder expectation is easy to quantify and the expectation is that the fund should outperform the benchmark, for example Nifty Index, as benchmark for equity fund. For Par funds the quantification of benchmark is complex. Insurance companies strive to produce investment returns couple of percentage points higher than government security yields (before deduction of any costs). Equities play important role in getting that the additional return.

Insurers, as large investors in equity markets, participate in all avenues of equity investments viz. Secondary market, Initial Public Offerings and Follow-on Public Offerings, Anchor investor in IPOs, Pre- IPO placement of shares and pure unlisted company investments.

Insurance companies suffer couple of disadvantages compared to other institutional investors. The liquidity in Futures and Options (F&O) segment of equity market is significantly higher the cash segment. Many other institutional player take position through combination of cash and F&O segment to reduce the impact cost of their trade. IRDAI regulations prevent insurance companies from accessing F&O market and the impact cost of their trade adversely affects the performance. Anchor book of IPOs has a separate reserved section for some institutional players but not for insurance companies reducing the availability of anchor book.

Summary

The history of equity market over last 40 years suggests attractiveness of equity as asset class. Equity investments forms important part of investment portfolio of insurance company. The composition of equity is primarily determined by the nature of the product sold and risk appetite of the insurance company. ■