IIF Occasional Paper
Number 4

THE INSURANCE MARKETS OF SOUTH ASIA:

Bangladesh, India, Nepal, Pakistan, and Sri Lanka

W. Jean Kwon, Ph.D., CPCU
Associate Professor of
Risk Management, Insurance and Actuarial Science
Saint John's University
New York, NY / USA

INTERNATIONAL INSURANCE FOUNDATION
1233 Twentieth Street, NW
Washington, DC 20036

About the Author

W. Jean Kwon is Associate Professor at the School of Risk Management, Insurance, and Actuarial Science (SRM) of St. John's University in New York. He completed a master's program in insurance at the same institution when it was known as the College of Insurance. He earned a Ph.D. degree in risk management and insurance from Georgia State University, where he taught insurance subjects for several years. He also holds the American Institute's Chartered Property Casualty Underwriter (CPCU) designation.

During four years in Singapore he worked as director of special projects of the Insurance Department of the Monetary Authority of Singapore, taught insurance subjects at Nanyang Technological University, and provided consulting services to Singapore College of Insurance as well as local insurance companies and organizations. He also provided consulting services to several regional and international insurance organizations including United Nations Industrial Development Organization. As Director of Curriculum for the American Institute for CPCU (AICPCU) and the Insurance Institute of America (IIA) in Malvern, Pennsylvania, USA, he was responsible for courses in insurance operations, insurance accounting, and international insurance.

Author of several books, including *Risk Management and Insurance in Singapore*, he has also published papers in academic journals, presented research findings at various conferences, and served as the co-editor of *Singapore International Insurance and Actuarial Journal*. He co-authors *Insurance Operations* for the non-life industry, serves as a member of the editorial board of *Journal of Insurance Studies* and *The Geneva Papers*, and continues his consulting work in the U.S. He currently serves as a vice president of the Asia-Pacific Risk and Insurance Association, which he helped to establish.

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Introduction

Nearly one quarter of the world's people live in South Asia. For the past decade, it has been (after East Asia) the second fastest-growing region in the world, with an average annual growth rate of 5.3 percent. South Asia is also the site of the world's highest mountains, some of its largest rivers, and one of its oldest civilizations. More than four thousand years ago the inhabitants of the Indus River valley developed an urban culture based on commerce and sustained by agricultural trade. Modern languages, philosophy, and mathematics trace their origins to this region, and two of the great religions, Hinduism and Buddhism, were born there.

Despite the accomplishments of this civilization, South Asia remains one of the world's poorest regions. Forty-five percent of the population lives below the international poverty line of $1 a day. Moreover, the region is prone to natural disasters, which all too often destroy lives, homes, families, and communities without warning.

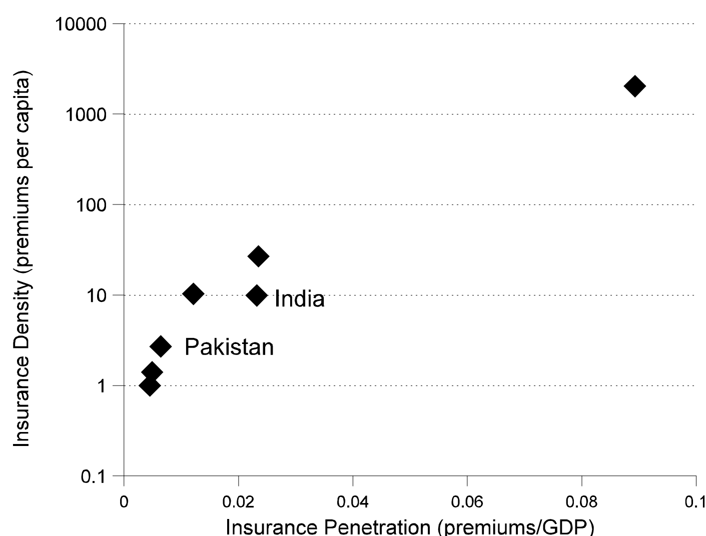
Intra-regional conflicts and political instability also impede South Asia's economic progress. These conflicts often obscure the common heritage of South Asian countries. Not only the ancient culture, but also the vestiges of British rule during the 19th and early 20th centuries color the political, legal, and business institutions of most South Asian countries. Religious conflict prompted the British to partition India prior to granting independence in 1947. Muslim Pakistan and Hindu-dominated India took control of their destinies in the midst of dissension. The secession of Bangladesh, the former East Pakistan, in 1971, brought further fragmentation.

Attempts at regional cooperation led to the formation of the South Asia Association for Regional Cooperation (SAARC) in 1985. Its members are Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. SAARC encourages cooperation in agriculture, rural development, science and technology, culture, health, population control, narcotics, and terrorism while carefully avoiding divisive political issues. In 1993 the seven SAARC countries concluded a South Asian Preferential Trading Arrangement, which promises a gradual reduction and eventual elimination of tariffs within SAARC.

These developments, although often obscured and sometimes threatened by the political conflicts, signal the potential of South Asia. After years of inward-looking economic policies and tight regulation, sweeping reforms during the 1990s led to a period of accelerated growth. South Asian nations reduced tariffs, removed trade barriers, dismantled restrictions on domestic and foreign private investment, and reformed their financial systems. With some political stability, fiscal discipline, infrastructure improvements, more human resource development, and further reforms and increased transparency, South Asia's long-term economic prospects are promising. Continued high rates of growth will help to overcome the pervasive poverty and provide resources for better education and healthcare.

Given the region's vulnerability to natural disasters and extreme income volatility, the underdeveloped financial sector deserves particular attention. The ability to transfer risks efficiently plays a key role in economic development. During the 1960s and 1970s social goals led to the nationalization of insurance in South Asian countries, but the recent economic reforms have reversed this

Insurance Consumption and Penetration



process. The insurance market in each of the countries is thus in transition from a nationalized, or national insurer-dominating, market to a private sector-driven market.

This study examines the insurance markets of South Asia. It explains the latest developments and recent regulatory reforms in Bangladesh, India, Nepal, Pakistan, and Sri Lanka. Thus except for the tiny countries of Bhutan and Maldives, each of the SAARC countries is included in this study, facilitating a comparison of their market opening strategies.[1]

Not only are South Asian countries far behind economically developed countries in general, their financial services sector, particularly insurance, is extremely underdeveloped. Purchasing power parity-adjusted per capita GDP for 1999 ranges from US $1,100 in Nepal to $2,600 in Sri Lanka.[2] Total revenue of the insurance industry, as measured by the total written premiums, is exceptionally low in South Asia. According to a Swiss Re study, India—the world's second most populous nation—generated premiums of only $9.9 billions in 2000. The figures for other countries were much lower: $19 million for Nepal, $178 million for Bangladesh, $ 197 million for Sri Lanka, and $377 million for Pakistan. Of the world's $2.4 trillion insurance premiums written in 2000, South Asia accounted for less than one-half of one percent.

Two other measures—insurance consumption and insurance penetration—provide further evidence of the underdeveloped state of South Asian insurance industries. The chart above compares insurance consumption and

[1]A previous study examined Southeast Asia. W. Jean Kwon, *Toward Free Trade in Services: The ASEAN Insurance Market* (Washington, DC: International Insurance Foundation, 2001).

[2]Purchasing power parity-adjusted GDP is calculated using standardized international dollar price weights that are applied to the quantities of final goods and services produced in a given economy.

penetration of South Asian countries to the averages for ASEAN and OECD countries. Insurance consumption data—measured by per capita premium in US dollars—show that in 2000 a Nepalese spent, on average, the equivalent of about one US dollar for both life and non-life insurance protection. Other South Asian countries show similar results, the amount varying from about $3 in Pakistan to $9.9 in India. The average per capital consumption of insurance among OECD countries was $2,023 in 2000. Insurance penetration ratios—measured by the percentage of written premiums to GDP—are also low in the South Asian countries, ranging from 0.4 percent for Bangladesh and Nepal to 2.3 percent for India. In contrast, the ratio for OECD countries was 8.9 percent for 2000.

Insurance products available in South Asia are rather simple. Term life and whole life insurance products prevail in life insurance business. Investment-oriented products, also known as unit-linked insurance products, are relatively new in some countries and not yet found in others. In non-life insurance, marine insurance, fire insurance, and compulsory insurance—such as motor liability and workers' compensation insurance—dominate. Domestic reinsurance transactions are under strict government scrutiny.

The economy is weak, the financial services industry is not fully formed, and the insurance industry is immature in South Asian countries. However, these findings do not necessarily indicate that these countries will remain unattractive to foreign investors and insurers. To the contrary, the insurance markets in those countries, especially in India, not only possess a great potential for growth, but they can also be appealing places for foreign insurers wishing to expand their business internationally. A local market can become attractive when its government develops and preserves a competitive market environment, practices prudent supervision according to international standards, and emphasizes public education regarding the importance of insurance for individuals, businesses, and the economy. Only financially sound and operationally competent insurance entities—direct insurers, reinsurers, and insurance intermediaries—should service the market. When a market is in transition toward open competition, all participants of the market—the regulator, the insurer, and the policyholder—must also be ready to tolerate growing pains, including losses arising from insolvency of incompetent insurers.[3]

India and Pakistan recently introduced new insurance laws. All countries examined in this study have plans to stimulate the insurance industry, and to open, albeit slowly and partially, their insurance markets to foreign investors. It is thus critical to have a better understanding about the insurance market in each country and its regulatory environment.

The next section discusses the regulatory and supervisory environment in Bangladesh, India, Nepal, Pakistan, and Sri Lanka in turn. After combining this information into an aggregate picture of the region, the author offers some conclusions and recommendations.

[3]Refer to Kwon, *ibid*, for a discussion about regulation, deregulation, and liberalization of the insurance industry.

Country Studies

For each country considered here, the author has divided, whenever possible, the discussion into four segments. The first segment deals with regulation related to market access. This subject includes openness of the market to local private firms and foreign insurers, licensing requirements including initial capital requirement, and other conditions warranting some elaboration. The next segment discusses the solvency regulation imposed on licensed insurers in the country. The third segment describes investment guidelines, including accounting principles, applied to insurers operating in the country. The last part summarizes market conduct regulation with respect to insurers' pricing, product designs, reinsurance arrangement, and policyholder protection.

Bangladesh

The world's most densely populated country, Bangladesh seceded from Pakistan in 1971 during the war between India and Pakistan. Most Bangladeshis (about 88%) are Muslims, but Hindus constitute a sizable (11%) minority. Despite its predominantly Muslim population, Bangladesh maintains a secular legal and economic environment. Under its 1972 constitution, Bangladesh is a parliamentary democracy, and its legal system follows British law.

Rising life expectancy and literacy demonstrate the great strides Bangladesh has made in improving the lives of its people, yet it remains one of the poorest countries in the world. Moreover, this low-lying river delta coastal country is extremely vulnerable to natural disasters such as floods, tropical cyclones, tornadoes, and tidal waves. The death toll from the 1991 cyclone was 132,000.

When the statist economic model adopted by its early leadership resulted in inefficiency and economic stagnation, the government gradually gave greater scope to private sector participation in the economy. A few state-owned enterprises have been privatized, but many, including major portions of the banking and jute production sectors, remain under government control. Economic performance has been relatively strong in the past decade, with annual GDP growth averaging 5 percent. Bangladesh's predominantly agricultural economy has achieved near self-sufficiency in food production although it depends heavily on erratic monsoons. In recent years sizable foreign direct investment flows have spurred development of infrastructure, energy, and export-oriented manufacturing.

Financial sector reform programs are also underway. The government has privatized three formerly government-owned banks, as well as Uttara Bank and Pubali Bank, and the sale of 49 percent of a national insurer, Shadaran Bima Corporation, to the public is under consideration.[4] It also plans to strengthen the two stock exchanges in Dhaka and Chittagong.

Insurance in Bangladesh dates to the British colonial era when a number of private insurers operated in the market. Following independence from Pakistan, the government introduced the Insurance Corporation Act of 1972, which nationalized the insurance industry. The act established, as of January 1973, two state-owned monopoly insurers, Jihan Bima Corporation for life insurance

[4]Privatization Commission, the Ministry of Finance [http://www.bangladeshonline.com/pb], 2001.

business and Shadharan Bima Corporation for non-life insurance business.[5] Although these national insurers experienced management problems and failed to make insurance widely available, the government did not re-open the market to the private sector until 1984.[6] In 1990, the government took a further step by allowing private insurers to underwrite 50 percent of public sector risks, the other 50 percent being underwritten by the national insurers.

At present, 18 life insurers and 43 non-life insurers—including 11 new life and 18 new non-life private insurers licensed during 1999-2000—operate in Bangladesh. Three of the insurers operate in Islamic *Shariah* compliant ways, and offer *takaful* insurance products.[7] However, the market is closed, and likely will remain closed for some years, to foreign insurers. An exception is American Life Insurance Company, which has long offered insurance coverage to selected members of the population.[8]

The Department of Insurance, headed by the Insurance Directorate, of the Ministry of Commerce is empowered by the Insurance Act of 1938 (including its amendments) to act as the insurance regulatory authority. The supervisory guidelines are more or less governed by the Insurance Corporation (Amendment) Act and the Insurance (Amendment) Act both of 1990. These guidelines address authorization procedures, management of insurance companies, financial statement requirements, and uses of insurers assets, among other issues. Provisions specifically regarding insurer solvency are not found in the guidelines.

Market Access Regulation

The minimum paid-up capital is 75 million taka (approximately US $1.5 million) for life insurance or 150 million taka for a non-life company. However, the Department of Insurance may allow a new insurer if it has raised at least 40 percent of the required capital prior to its commencement of business and plans public share subscriptions to raise the remainder within three years of operation, provided that sponsors of the new insurer underwrite the future public share subscriptions as a guarantee. An individual sponsor's share of the paid-up capital must be more than 200,000 taka for a life insurance company and 500,000 taka for a non-life insurance company, but not more than 20 percent of the paid-up capital (counting shares owned by other family members).

[5]The act is also known as the Presidential Order No 95, or the Bangladesh Insurance (Nationalization) Order, of 1972.

[6]Findings from a study indicate that the operating performance—measured by premium income, investment performance, claims experience, and profitability—of Sadharan Bima Corporation was deteriorating during the period of 1983-1997. See Abhijit Barua, Muhammad Z. Mamun, and Nazrul Islam, "Performance of the Nationalized Insurance Company of Bangladesh," *The Fourth Annual Conference Proceedings of the Asia-Pacific Risk and Insurance Association*, July 16-19, Perth, Australia.

[7]They are Islamic Insurance Bangladesh, Farest Islamic Life Insurance Company, and Islamic Commercial Insurance Company. See Kwon (2001) for a discussion about *takaful* insurance operations worldwide.

[8]Kasi Md. Mortuza Ali, "Growing Insurance Industry of Bangladesh and Requirements for Sustainable Human Resources Development Programs," *The Third Annual Conference Proceedings of the Asia-Pacific Risk and Insurance Association*, July 19-21, 1999, Hong Kong.

Other Regulation

The Department of Insurance bars any person with a history of default—according to the Bangladesh Bank—with any financial services institution from being a sponsor. Nor does it allow a director of a financial services institution to be appointed concurrently as a director of an insurance company.

Private non-life insurers in Bangladesh are subject to mandatory reinsurance cession to Shadharan Bima Corporation. Between 1984 and 1990, this national insurer underwrote 100 percent of all reinsurance risks in Bangladesh. The amendment of the Insurance Corporation Act in 1990 allowed private insurers to place up to 50 percent of their reinsurance risks overseas. Nonetheless, they still cede 100 percent of their reinsurance risks to Shadharan Bima Corporation.[9] Regarding life insurance business, the revised Insurance Corporation Act permits private insurers to cede up to 100 percent of their life reinsurance risks to overseas reinsurers.

The current insurance act does not require a minimum solvency margin for life insurers. The Department of Insurance simply maintains a philosophy that life insurers should meet their insurance liabilities. In contrast, non-life insurers must meet the minimum solvency margin such that the excess of their assets over their liabilities is the greater of 500,000 takas (approximately US $10,000) or 10 percent of net premium income.

To comply with statutory accounting guidelines, life insurers must estimate and reserve policyholders' liabilities based on an actuarial basis for every two years. Non-life insurers should estimate their unearned premiums at 10~100 percent of net premiums, the percentage depending on the line of insurance. Although there is no provision regarding estimation of IBNR claims, non-life insurers are not allowed to discount their outstanding claims. There is no provision in the act which valuation method—book value or market value—that life or non-life insurers should use.

[9]Abhijit Barua, Muhammad Z. Mamun, and Nazrul Islam, "Performance of the Nationalized Insurance Company of Bangladesh," *The Fourth Annual Conference Proceedings of the Asia-Pacific Risk and Insurance Association*, July 16-19, Perth, Australia.

India

India is growing fast not only in population but also in terms of its potential influence on the world economy. Its population is expected to be the world's largest by 2025. Its economy may be the third largest in the world, in terms of gross national product, by that year.

The Indian government nationalized key industries in the 1950s, including life insurance. It also nationalized the country's fourteen largest banks in 1969, and general insurance in 1972. Its monopoly on investment and production in most major sectors of the economy frustrated many types of economic enterprise.

Since the early 1990s, the government has gradually privatized a number of industries, including the financial services industry, and introduced several reform measures to revive the economy. Liberalization of the insurance industry is a key part of these reforms.

Historical Perspective of the Insurance Market

The first known life insurers in India were Oriental Life Insurance Company, established in 1818 in Calcutta, and Bombay Life

Assurance Company, founded in 1823. A large number of life insurers followed. By 1956, there were 245 life insurance companies—including 16 foreign insurers and 75 cooperative societies—operating in India. At that time, however, the government decided that insurance was essentially a social device, the industry must be free of profit-motives, and insurance coverage should be available to all people. The Life Insurance Corporation Act of 1956 merged all life insurers into the Life Insurance Corporation (LIC) of India. The LIC had an initial capital of 50 million rupees and the exclusive right to engage in life insurance business.

A large number of private non-life insurers, both local and foreign, also operated in India prior to the nationalization of the industry. Those insurers provided insurance protection primarily to individuals in the urban sector and to organized trades and industries. To increase their underwriting capacity, they created India Reinsurance Corporation in 1956, to which all non-life insurers made a mandatory cession of 10 percent of their direct business. With the General Insurance Business (Nationalization) Act in 1972 nationalized the non-life sector, and all 107 non-life insurers, including branches of foreign insurers, were merged into four state-owned companies. They are National Insurance Company in Calcutta, New India Assurance Company in Mumbai (also known as Bombay), Oriental Insurance Company in New Delhi, and United India Insurance Company in Madras.[10]

The then newly established national insurer, the General Insurance Corporation (GIC) of India, wholly owned these four companies. The GIC is now the national reinsurer, and was recently renamed India Re.

Regulation of the insurance industry began with the Indian Life Insurance Companies Act of 1912. The government added in 1928 the Indian Insurance Companies Act, in part, to collect statistical information about life and non-life insurance business in India. The Insurance Act of 1938 empowered the government to impose such regulatory measures such as capital requirements, ceilings on shareholdings (especially of life insurers), investment scopes, accounting and expense procedures, and expense controls. Government regulation became more stringent with the 1968 amendment of the Insurance Act, which also replaced the tariff committee of the General Insurance Council and the four regional councils with the Tariff Advisory Committee (TAC). With the enactment of the General Insurance Business (Nationalization) Act of 1972, the chairperson of the GIC became also the chairperson of the TAC.[11]

During the era of monopoly, the GIC and the LIC introduced new insurance products, continued to expand their distribution channels in the rural sector, and made available a policyholder protection program—better known as the Ombudsmen Scheme in India—in twelve cities. Each ombudsman may redress complaints from holders of personal insurance policies with up to 2 million rupees, or 20 lakhs in rupees. The LIC has about 2,000 branches across the country and employs about 560,000 agents. The GIC also began to operate regionally. These national insurers continued to grow at a rate of 11 percent per annum for life business and at a higher rate for non-life

[10]Rohit Bhasin, "Insurance in India," *Asian Insurance Journal* (July 2000), 11-15.

[11]This resulted in relatively non-transparent or more politics-based rate settings in non-life insurance.

business. The Indian market generated premiums amounting to US $8.4 billions, of which US $2.3 billion was from non-life business, in 1999.

Nevertheless, the national insurers failed to satisfy insurance needs for majority individuals and businesses. They provided coverage for only about 10 percent of individuals and 5 percent of businesses in India. For example, the LIC had only 80 million policies in force in 1999. The causes of this failure were twofold. On one hand, national insurers depended primarily on selling traditional insurance products and fell short of developing new or hybrid products having both insurance protection and investment elements. Also, they repeatedly settled claims unfairly, thus not gaining strong faith from policyholders.[12] On the other, they had little flexibility in doing insurance business. The Insurance Act of 1938 required—and still does to a certain degree even after the Insurance Regulatory and Development Authority Act of 1999—that all insurers make coverage available to rural dwellers and non-life insurers provide compulsory coverage for third party motor liability insurance. The terms and conditions of the insurance contracts were subject to prior approval of the government. The Tariff Advisory Committee set premium rates for non-life insurance business. In fact, those four subsidiaries of the GIC offered basically the same products. Besides, the investment portfolios of these national insurers—including subsidiaries of the GIC—comprised mostly government securities, investment in infrastructure, and loans to businesses engaged in infrastructure development projects.

[12]"India's Insurance Market Opens to Bidders," *Financial Times* (August 2, 2000), 6.

The government acknowledged the aforementioned problems, indirectly admitted the shortcomings of the nationalized insurance market system, and sought remedial measures. In 1993 it commissioned an investigation of the insurance industry's future direction.[13] A former finance secretary and governor of the Reserve Bank of India, R. N. Malhotra, headed this committee. The committee's report presented a new vision of the insurance market:

- The government replaces the office of the Controller of Insurance in the Ministry of Finance with a new, independent insurance regulatory body.
- The government reduces its ownership of the national insurers, and permits greater freedom in insurance operations. The GIC spins off its four subsidiaries as independent non-life insurers. The government reduces mandatory investment of LIC's life fund in government securities. The GIC and its subsidiaries divest, over a period of time, ownership of any company to no more than five percent.
- The private sector competes with the national insurers. For this, only one state-owned life insurance operates in each state. Private firms with a minimum paid-up capital of 1 billion Indian rupees may enter the market, provided that they do not operate in both life and non-life

[13]The Indian government took similar actions for other financial services industries. For example, a 1992 Narasimha Committee report proposed allowing banks to approach capital markets to raise funds, reorganizing the interest rate structure, and introducing capital adequacy and other tests to the banking institutions. The government also proposed reform of foreign exchange regulation through its Foreign Exchange Management Act.

classes. Foreign companies may form joint ventures with domestic firms to write insurance, provided that the foreign participation is below 40 percent of the joint venture. Postal life insurance should also be available in the rural sector.

- The LIC pays interest on benefit payments in arrears for more than 30 days. Insurers offer unit-linked (investment-linked) pension plans, and modernize their operations.

The report did not say where insurers should divest their investments away from government securities, how the premium deficiency arising from providing insurance to the rural sector would be subsidized, and how the regulatory body would protect policyholders from insolvent insurers. Nevertheless, the committee made clear that privatization and some liberalization of the market was imperative for the furtherance of the Indian economy.

Based on the committee's recommendations, the government formed the Insurance Regulatory Authority in 1996, and proposed to the Parliament a bill opening the insurance market. The government met substantial opposition, in particular against the proposed 40-percent equity ownership allowance for foreign insurers. Three years later the Parliament finally passed a revised version, the Insurance Regulatory and Development Authority (IRDA) Act, on December 2, 1999. The IRDA Act empowers the IRDA, established on April 19, 2000, as a new regulatory body of the insurance industry, and amended the Insurance Law of 1938, the Life Insurance Corporation Act of 1956, and the General Insurance (Nationalization) Act of 1972.[14] This new act addresses most of the key issues related to the liberalization of the insurance market better than the act proposed in1996, but it reduced the maximum permitted foreign equity ownership of a joint-venture insurer to 26 percent.

The IRDA began to accept applications in July 2000, and on October 23, 2000, it issued licenses to three applicants—Reliance General Insurance, HDFC Standard Life Insurance, and Royal Sundraram Alliance Insurance—and in-principle clearance for registration to three other joint-venture applicants—ICICI Prudential Life Insurance, Max New York Life Insurance, and IFFCO Tokio General Insurance. More applicants have since been licensed. The IRDA also accepted until February 2001 applications for insurance agents' training institutes, and granted licenses to a number of qualified institutions domiciled in major cities across the country. As of March 1, 2002, there were 12 life insurers (including eight joint ventures), 10 non-life insurers (including five joint ventures), and one reinsurer, the General Insurance Corporation of India, now called India Re.

The IRDA Act of 1999 and IRDA Regulations

The IRDA Act of 1999 comprises three parts. The first part covers matters related to the establishment and operation of the IRDA. Although the act states that the IRDA is an independent body of the Ministry of Finance, whether it can in fact function independently is somewhat unclear. The Authority is subject to central government's directions, other than those relating to technical and administrative matters. Further, the government has the power to dissolve the IRDA, discharge its members and officers, appoint a person to be

[14]In fact, the IRDA replaced the interim Insurance Regulatory Authority formed in 1996, to which the powers of the Controller of Insurance had already been conferred.

the Controller of Insurance as an interim regulator, and reconstitute the IRDA by a fresh appointment of the members—including the chairperson—and officers. The IRDA act states that this measure could be made under such extreme circumstances as the Authority's failure to comply with the directions given by the government or to perform the duties imposed by the act, as well as the Authority acting against the public interest. The act requires the IRDA to submit to the government an annual report of its activities related to the promotion and development of the insurance business during the previous year. The act prescribes that the chairperson and full-time members of the IRDA may hold office for five years and can be re-appointed. Their terms of appointment will, however, end at age 65 for the chairperson or at age 62 for the full-time members.

The second part of the act addresses the IRDA's general power in dealing with insurance business. It empowers the IRDA to regulate, promote, and ensure orderly growth of insurance and reinsurance business in India. The IRDA oversees all insurer activities, both operational and financial. It can formulate regulations, and has in fact announced a series of regulations since April 2000. The authority accepts insurance business applications, and grants licenses—certificates of registration—to qualified applicants, including insurance intermediaries. It protects policyholders' interests, determines insurer solvency margins, regulates insurer investment activities, and collects information from registered insurers. It can control premium rates, insurance contracts, the portion of insurance business to be taken in the rural sector or social insurance, reinsurance cession, and means of advertisement of insurance products.

The last part of the law details modifications of the Insurance Law of 1938 to conform with the IRDA Act. It also amended the Life Insurance Corporation Act of 1956, and the General Insurance (Nationalization) Act of 1972 such that the LIC and the GIC—as well as their successors—no longer have the exclusive privilege of carrying on life and non-life insurance business, respectively, from the date the IRDA Act became effective.

Market Access Regulation

The IRDA Act, in fact through the amended Insurance Act of 1938, prescribes that a newly licensed company must be an Indian company, and raise an initial paid-up capital of at minimum 1 billion rupees (or 100 crores, or approximately US $22 million) for direct insurance business or 2 billion rupees (or 200 crores) for reinsurance business. The Authority does not permit insurers to conduct life and non-life businesses concurrently. However, it may give preference, when granting licenses, to those applicants for life or non-life business that plan to offer individual or group health insurance policies.[15] Each license is valid for three years and can be renewed, for three years per renewal, upon the holder's meeting the licensing requirements at the time of renewal.

The Insurance Act amended in 1999 defines an "Indian insurance company" as a company formed and registered under the Companies Act of 1956 in which the aggregate holdings of equity shares by a foreign company do not exceed 26 percent paid-up equity capital of such Indian insurance company. The Indian company can be jointly created with one foreign partner, which must be an insurance company and can own up to 26 percent of the joint venture equity. The local partner can be any qualified

[15]The Insurance Act of 1938 (Amended in 1999), Provision 2AA.

entity. The act bars any insurer other than an Indian insurance company from engaging in insurance business in India. As such, a branch or wholly owned subsidiary of a foreign insurer is not admitted to the Indian insurance market.[16] Even the permitted foreign insurer-partner cannot appoint majority directors on the joint venture board or influence daily business operations of the joint venture. It can affect only special resolutions.

To allow banks to engage in insurance business, the government amended the previous prohibition in the Banking Regulation Act. Subsequently, the central bank—the Reserve Bank of India—announced a set of five criteria that a bank wishing to be in insurance business must meet as of March 31, 2000.[17] They are:

- A minimum net worth of 5 billion rupees;
- A minimum capital requirement of 1 billion rupees;
- A minimum capital adequacy ratio of 10 percent;
- A record of net profits at least for the last three years; and
- A reasonable level of non-performing assets.

For the non-banking financial company wishing to conduct insurance business, the central bank requires it to meet a minimum capital adequacy ratio of 12 to 15 percent —depending on its current area of business— and five-percent threshold for non-performing assets. The central bank later added that the Indian bank-partner could hold up to 50 percent capital equity of the joint venture.[18] This requirement literally asks the bank-partner to locate a third partner for 24 percent of the ownership interest after factoring in 26 percent ownership by a foreign partner. Further, the Indian partner must also dilute its ownership to 26 percent over a 10-year period.

As these criteria are not stringent for large national banks, several banking institutions, especially those with extensive branch networks across the country, have already acquired joint-venture licenses and commenced insurance or bancassurance business. The list of such financial institutions includes, but not limited to, the State Bank of India, the Industrial Credit Investment Corporation of India (ICICI), HDFC, and Vysya Bank.

Several non-banking financial companies also show an interest in insurance business. Co-operative banks, which have extensive networks in the rural sector, might have a strategic advantage over large commercial banks. For example, IFFCO has already created a joint venture with Tokyo Fire and Marine, and several others, possibly including Maharashtra Cooperative, are looking for a foreign insurer-partner.

The IRDA regulates insurance intermediaries—brokerage firms and agencies. A minimum capital of 2.5 million rupees is required for brokerage business either in life or non-life class, or 12.5 million rupees for

[16]The IRDA Act states that the expression "foreign company" has the meaning assigned to it by the Income-tax Act of 1961. In an Indian context, a foreign company refers to a company not incorporated in India or a corporation, association, institution or other body without having its principal office in India. "India Privatizes Insurance: Will It Attract Investor Funds?" *International Financial Law Review* (March 2000), 28-31.

[17]*The Banker*, October 2000; and *Financial Times*, April 28, 2000.

[18]"India: Portfolio Investment," *Oxford Analytica Asia Pacific Daily Brief* (May 10, 2000).

both classes. The IRDA may also control the commission rates that insurance intermediaries can receive. Foreign brokerage firms might be allowed to have equity ownership up to 49 percent of the Indian brokerage firms. The IRDA (Licensing of Insurance Agents) Regulations of 2000 also prescribe the accreditation requirements for insurance agent training institutions.

Solvency Regulation

Every registered insurer in India must at all times maintain a required minimum solvency margin—the excess of the value of its assets over the amount of its liabilities. In the case of a life insurer, its margin must be the greatest of 500 million rupees (one billion rupees for the life reinsurer), a sum not exceeding five percent of the mathematical reserves for direct business and reinsurance assumed (without deducting reinsurance ceded), or a sum not exceeding one percent of the aggregate coverage (sum at risk) for the policies it has underwritten. For non-life insurers, the minimum solvency margin is the greatest of 500 million rupees (one billion rupees for non-life reinsurers), a sum equivalent to 20 percent of premium income, net of reinsurance, or a sum equivalent to 30 percent of incurred losses, net of reinsurance claims.

Additionally, all life insurers must make a deposit with the Reserve Bank of India cash or approved securities amounting to a sum equivalent to one percent—subject to maximum 100 million rupees—of its total gross premiums written in India in any financial year beginning after March 31, 2000. The percentage for non-life insurers is three percent, while the maximum deposit amount remains unchanged. Reinsurers are subject to a flat deposit of 200 million rupees.

Investment and Accounting Regulation

The IRDA (Investment) Regulations of 2000 and the 2001 amendments specify how insurers and reinsurers should apportion their invested assets among the designated asset classes, as the table on the next page shows. These regulations also prescribe investment restrictions according to "exposure/prudential norms" guidelines. (See the Appendix.) Note that reinsurers in India are subject to the guideline for non-life business until a separate guideline for reinsurers becomes available.

Insurers must invest their assets in securities that are actively traded in any stock exchange in India. The IRDA does not allow any unapproved investments, and all investments must be made in securities rated "very strong" by a reputed and independent rating agency (for example, AA rating of S&P). Additionally, the IRDA (Registration of Indian Insurance Companies) Regulations of 2000 and the IRDA (Obligations of Insurers to Rural and Social Sector) Regulations of 2000 define the meanings of "infrastructure and social sector."

The IRDA (Investment) Regulations of 2001 list additional conditions that all insurers must meet. They are as follows:

- Every insurer must maintain a proper balance between the investments made in infrastructure and those in the social sector. The IRDA recognizes only those bonds that are either guaranteed by the government, or are rated not less than "AA' by an independent, reputed agency for this purpose. If, however, no investment meeting this rating requirement is available for a category, the insurer may be allowed to invest that asset in investments carrying a rating of not less than "A+."

Investment Guidelines

	Types of Investments	*Limits (2000)*	*Limits (2001)*
For Life Business			
i)	Government securities	25%	25%
ii)	Government securities or other approved securities including (i) above	Not less than 50%	Not less than 50%
iii)	Approved investments as specified in Schedule I*		
	(a) Infrastructure and social sector	Not less than 15%	Not less than 15%
	(b) Others to be governed by "exposure/prudential norms"	Not exceeding 20%	Not exceeding 35%
	(c) Other than in approved investments to be government by "exposure/prudential norms"*	Not exceeding 15%	Not exceeding 15%
For Pension, General Annuity and Group Life Business			
i)	Government securities	Not less than 20%	Not less than 20%
ii)	Government securities or other approved securities including (i) above	Not less than 50%	Not less than 40%
iii)	Balance to be invested in approved investments as specified in Schedule I and to be governed by "exposure/prudential norms"*	Not exceeding 60%	Not exceeding 60%
For Non-life and Reinsurance Business			
i)	Central government securities	Not less than 20%	Not less than 20%
ii)	State government securities or other guaranteed securities including (i) above	Not less than 30%	Not less than 30%
iii)	Housing loans to state government for housing and fire fighting equipment*	Not less than 5%	Not less than 5%
iv)	Approved Investments as specified in Schedule II*		
	(a) Infrastructure and social sector	Not less than 10%	Not less than 10%
	(b) Others to be governed by "exposure/prudential norms"	Not exceeding 30%	Not exceeding 50%
	(c) Other than in approved investments to be governed by "exposure/prudential norms"**	Not exceeding 25%	Not exceeding 25%

* See the appendix for Schedules I and II and explanation of the "exposure/prudent norms."
** Qualified investments for this category include bonds or debentures issued by HUDCO, National Housing Bank, or its accredited house building institutions for house building activities. Those investments must either be guaranteed by the government, or carry a rating of "AA" or above by an independent rating agency.

- In the case of debt instruments issued by any Indian financial institutions; that is, those recognized by the Reserve Bank of India, the minimum acceptable rating is "AAA." If, however, no investment meeting this rating requirement is available for a category, the insurer may be allowed to invest that asset in investments carrying a rating of not less than "AA."
- No investment should be made in an unrated asset even if potentially it can be rated according to market practice.
- Investments in equity shares listed on a stock exchange should be made in actively traded and liquid instruments, *viz.*, as per guidelines governing mutual funds laid down from time to time by SEBI (e.g., "thinly traded" security).[19]

These guidelines and conditions give insurers and reinsurers little flexibility in deciding where to invest their assets. Life insurers, for example, must invest at least 65 percent of their assets in government securities, other approved securities, or infrastructure and the social sector. For pension, general annuity, or group life business, the minimum of such investments is 50 percent. For non-life insurers, including reinsurers, it is 45 percent.[20] When the IRDA announced its revised investment guidelines in 2001, these limits remained unchanged.

Asset and Liability Valuation. The IRDA has announced specific rules related to asset and liability valuation. The insurer cannot admit, and must record zero value for any outstanding balances, over a certain period, of agent's balances, premiums, and reinsurer's balances. The value of computer equipment, including software, must be recorded according to the depreciation schedule stipulated in the IRDA (Assets, Liabilities, and Solvency Margin of Insurers) Regulations of 2000. And, all other assets must be valued according to the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations of 2002.[21]

For the valuation of liabilities, the IRDA published valuation schedules for life and non-life insurance business. According to those schedules, life insurers must determine their mathematical reserves for each contract prudently and with respect to key parameters such as unearned premiums and benefits payable. The method they use can be a gross premium method or an equivalent one, and include an appropriate margin for adverse deviations (MAD) that may result in an increase of the mathematical reserves. Life insurers are discouraged from changing the premium method from one period to the next. The IRDA permits insurers to discount benefits (including bonuses) payable on death or on policyholder's termination, commissions payable, policy maintenance expenses, and profits allocated for shareholders. If a life insurer has sold unit-linked policies, the

[19]Section 6 of Procedure to Determine the Value of Investments, The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations of 2002 (March).

[20]Bonds issued for development of infrastructure of the social sector can be counted toward investment in infrastructure and the social sector, if they are either guaranteed by the government or rated "AA" or higher by an independent, reputed rating agency.

[21]These regulations, revised from the IRDA's guidelines issued in August 2000, modify the guidelines regarding actively traded securities, loans, and financial statement preparations.

insurer must estimate and maintain two additional reserves—a unit reserve and a general fund reserve. The unit reserve must be calculated for the units allocated to such policies in force at the valuation date. Valuation methods for general fund reserves resemble the methods (such as the gross premium method) for other types of life insurance policies.

Non-life insurers are required to estimate and maintain three types of reserves—an unearned premium reserve (also known as reserve for unexpired risks), a reserve for outstanding claims, and a reserve for claims incurred but not reported.[22] They must use the percentages stipulated in the regulations—based on premiums net of reinsurance, 50 percent for fire business, miscellaneous business, and marine business other than marine hull business (but 100 percent for marine hull business)—for the estimation of outstanding policies (unexpired risks). Non-life insurers must also state the value of provisions for bad and doubtful debts, dividends declared or recommended, outstanding dividends, and foreign exchange reserves.

Finally, the IRDA requires all non-life insurers to have their annual return financial statements certified by an auditor approved by the authority. In the case of a life insurer, such statements must be certified by an IRDA approved actuary. A life insurer cannot conduct business without employing an appointed actuary, and the actuary cannot work concurrently for another insurer.[23]

[22]"Reserve for IBNR claims" include claims incurred but not enough reported. The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations of 2002.

[23]IRDA (Appointed Actuary) Regulations of 2000, IRDA/Reg 25/7/2000.

Market Conduct Regulation

The IRDA has issued regulations on marketing and advertisement activities of all licensed insurers and insurance intermediaries. Additional regulations apply to pricing, terms and conditions in insurance contracts, and compulsory reinsurance cession.

Advertisement and Disclosure Regulations. All insurers in India must comply with the IRDA (Insurance Advertisement and Disclosure) Regulations, notified on July 14, 2000, which require insurers to report all their advertisement activities or means to the IRDA within two business days from the first day of use of such advertisements.[24] The regulations define "insurance advertisement" as "any communication directly or indirectly related to a policy and intended to result in the eventual sale or solicitation of a policy. . . ." These rules apply to any communication means, including e-mails, Internet-based marketing and telephone solicitations "with a prospect or policyholder that urges the person to purchase, renew, increase, retain, or modify" an insurance policy.

[24]The IRDA made it clear that each of the filing must include the following information: (1) the number of the advertisement and the date of issue; (2) the form number of the insurance policy advertised and the date IRDA approved the policy, (3) a description of the advertisement and how it is used, (4) the medium used for dissemination of the advertisement, (5) a certificate of compliance to relevant IRDA regulations as well as the code prescribed by the Advertisements Standards Council of India. IRDA, "Compliance of the IRDA (Insurance Advertisement and Disclosure) Regulations 2000," IRDA/LG/ADVT. REG/2000-2001/AC, January 29, 2001.

Reinsurance and Compulsory Cession. According to the IRDA (General Insurance—Reinsurance) Regulations of 2000, one main objective of a reinsurance program is to maximize retention within the country. There are three specific rules related to this purpose. First, insurers in India are advised to maintain the maximum possible retention commensurate with their individual strength and business volume. Second, each insurer must cede a stipulated percentage—currently 20 percent—of the amount of insurance for policies in India to the Indian reinsurer before it places part of the risk with another reinsurer.[25] Finally, the Indian reinsurer helps all non-life insurers to organize domestic pools for reinsurance surpluses in fire, marine hull, and other classes. The IRDA attempts to maintain the retention of non-life business within India near the level of retention for year 1999-2000.

According to the regulations, the Indian reinsurer is an insurer that carries on "exclusive" reinsurance business, as approved by the government. Thus far, only the General Insurance Corporation of India has been approved as an exclusive reinsurer.[26] The regulations require the Indian reinsurer to retrocede 10 percent of the obligatory cessions—after protecting the portfolio by suitable excess-of-loss arrangements—to the ceding companies in proportion to their original cession. Such retrocession will be at the original terms plus an overriding commission to the Indian reinsurer not exceeding 2.5 percent.

The IRDA permits a direct insurer to engage in reinsurance business, provided that the insurer has a well-defined underwriting policy for reinsurance purposes.[27] As such, non-life insurers are advised to give an opportunity to Indian insurers, including the Indian reinsurer, to participate in their reinsurance programs before a cession is placed outside India. When placing risks outside India, the non-life insurer must limit cession to any reinsurer to 10 percent of its total reinsurance premiums ceded outside India. The reinsurer must also have an S&P rating of BBB (or equivalent) or higher during the recent five years of business. Placement in excess of the 10-percent limit (for certain specialized risks) or with lower-rated reinsurers requires prior approval from the IRDA.

Obligations of Insurers to Rural and Social Sectors

The IRDA Act of 1999 and the IRDA (Obligations of Insurers to Rural Social Sectors) Regulations of 2000, in conjunction with the still effective provisos of the Insurance Act of 1938, impose obligations to serve the rural and social sectors. The rural sector refers to the rural area that has a population of not more than 5,000, a population density of not more than 400 per square kilometers, and a minimum 75 percent of the male population engaging in agriculture. The social sector includes the unorganized sector, the informal

[25]If, however, the Indian reinsurer refuses to assume life reinsurance of "declined lives" (risks declined by any Indian insurer), this compulsory session requirement does not apply.

[26]The GIC has ceased its operation as a non-life insurer and now operates only as a reinsurer. As a result, the market share (measured by direct premiums) of the GIC was mere 1.1 percent for financial year 1997-1998. *The Indian Insurance Industry (Non-Life): 1997-1998* (Mumbai: Interlink Reinsurance Consultants, 1998(?)).

[27]Such an insurer must submit a note on its underwriting policy stating the classes of business, geographical scopes, underwriting limits, and profit objectives.

Obligations of Indian Insurers to Rural and Social Sectors

Financial Year	Rural Sector		Social Sector
	Life Insurers*	Non-life Insurers**	All Insurers**
In the first year	5%	2%	5,000 lives
In the second year	7%	3%	7,000 lives
In the third year	10%	5%	10,000 lives
In the fourth year	12%	5%	15,000 lives
In the fifth year	15%	5%	20,000 lives

* Based on the total policies directly written.

** Based on total gross premiums written. Non-life insurers are permitted to count their business in crop insurance toward meeting these requirements.

sector, economically vulnerable or backward classes and other categories of persons, such as the disabled, in both rural and urban areas. The unorganized sector includes self-employed non-professional workers such as construction workers, fishermen, and other manual workers. The informal sector is not defined in the regulations.[28] In the case of a new insurer, five percent of the total life insurance business during the first year of operation must be from such areas.

This target percentage rises to 15 percent after five years of operation. In non-life insurance, new insurers must generate two percent during the first year of operation and three percent during the second year of their gross premium income from crop, cattle and farm equipment protection insurance. This rises to five percent after three years.

The IRDA reserves its right to revise these guidelines applicable to new insurers. Insurers already in operation on the effective date of the IRDA Act are advised to maintain their portion of business in these sectors at least at the level they reported for the accounting year ended on March 31, 2000. If necessary, the IRDA may revise its policy applicable to incumbent insurers.

[28]IRDA (Obligations of Insurers to Rural Social Sectors) Regulations of 2000, IRDA/Reg/7/2000, July 14, 2000.

Other Regulations

Although fewer lines of insurance will be subject to pricing regulation, the IRDA is still expected to influence premium rates as well as terms and conditions of non-life insurance policies. The Insurance Act of 1938 gives the Tariff Advisory Committee the power to "control and regulate the rates, advantages, terms and conditions that may be offered by insurers in respect of non-life insurance business."[29] The IRDA Act states that the IRDA supervises the functions of the advisory committee and the chairperson of the IRDA serves as the chairperson of the Tariff Advisory Committee.

The IRDA requires that all claims exceeding 20,000 rupees be assessed by a professional surveyor or a loss assessor. A qualified professional can be a practicing surveyor or loss assessor, a holder of an engineering degree from a recognized university, a fellow member of ICAI or ICWAI, or anyone with a qualification in insurance from a recognized university or a government institution.

[29]Section 64U of the Insurance Act of 1938.

Nepal

Located in the snow-capped Himalaya mountains, Nepal is a constitutional monarchy with a democratic, parliamentary form of government that is multiethnic, multilingual, and Hindu. Strikes and demonstrations convinced the king to abolish the former "partyless" council system of government in 1990. A new constitution enshrined fundamental human rights and established Nepal as a parliamentary democracy. The monarchy remained to enhance political stability and provide an important symbol of national identity.

The transition from absolute monarchy to multi-party democracy has given Nepal eleven governments in eleven years. Social and political unrest, including a Maoist insurgency that has claimed nearly 2,000 lives in the past six years, strains Nepal's social fabric. A further shock occurred in 2001 when the Crown Prince shot and killed the King and other family members and then killed himself.

An isolated, agrarian society until the mid-20th century, Nepal remains among the world's least developed countries. Like its neighboring countries, Nepal is slowly opening its economy to foreign investors and is committed to a program of economic liberalization. Since 1981 it has relaxed foreign exchange regulations, reduced foreign investment requirements, and privatized several government enterprises. Privatization plans have had mixed results. Many privatizations were unsuccessful because of inadequate evaluation of the technical expertise of potential investors and the failure of some investors to meet financial commitments. The government recently requested a private firm to evaluate the financial performance of 43 state-owned enterprises. The findings indicated that those enterprises performed poorly due mainly to poor management, lack of competitiveness *vis-à-vis* the private sector, and undue political intervention in operation and management of the enterprises. Based on these findings, the government may further privatize the economy.[30]

Foreign investment is largely a recent development in Nepal. The government now allows foreign investments in every sector of the economy, including the financial services, with the exception of legal services. Foreign firms may purchase shares of an existing company, participate in a joint venture, or establish a wholly owned subsidiary.[31]

As a result of these reforms, a number of private financial services institutions now operate in Nepal. There are 13 commercial banks, two development finance institutions, 44 finance companies, 22 cooperative societies, and 17 insurance companies (including one credit insurer). The Nepal Rastra Bank (the Central Bank of Nepal) is the regulator of banking institutions. It determines foreign currency exchange rates and implements monetary policy. The Insurance Board regulates and develops the Nepalese insurance industry. The board—empowered by the Insurance Act of 1992 and the Insurance Rules of 1993—grants licenses, issues directives, and may take actions on observing any non-disciplinary activity of an insurer. Rastiya Beema, the state-owned insurer, dominates the market. It writes about

[30]The Privatization Cell of the Ministry of Finance [http://www.privat.gov.np/], *Targets and Performances of Public Enterprises FY1999/2000 - 2000/2001.*

[31]Rules and regulations governing foreign investment can be found from the Foreign Investment and Technology Transfer Act of 1992. Nepal's corporate income tax rate is 30% in banking and finance sector and 25% in other sectors.

80 percent of the life insurance business and about15 percent of non-life insurance business.

Market Access Regulation

An applicant of insurance business must apply in writing to the Insurance Board. The application must include a business plan—known as "feasibility study report"—and, in the case of foreign applicant, a certificate from the insurance authority in its country of domicile. If the application is for life insurance business, the applicant must obtain prior approval from the Nepal government. The Insurance Board requires a new insurer to have a minimum paid-up capital of 100 million Nepalese rupees (approximately US $1.3 million) for non-life insurance business or 250 million rupees for life insurance business. The Nepal Insurance Board allows, although it does not strongly encourage, foreign investment up to 100 percent of the paid-up capital of an insurance company.

Other Regulation

All insurers must meet the minimum solvency margin requirements set by the Insurance Rules of 1993. That is, an insurer must deposit a minimum of 50 percent of direct earned premiums into a statutory reserve fund. It must set aside 115 percent of the outstanding claim reserve as a technical reserve and transfer 50 percent of profit to this reserve until the fund amount becomes equal to the paid-up capital. In the case of life insurance, the assets must be greater than the liabilities.

The government recently created a tariff advisory board, over which the chairperson of the Insurance Board presides. Key functions of this advisory board comprise determining policies related to tariff rates, conducting seminars and conferences related to the determination of tariffs, supervising and inspecting insurer compliance with the tariffs already implemented, and submitting suggestions to the Insurance Board not only for matters related to tariff but also for the development and transparent operation of insurance business in Nepal.

Pakistan

Pakistan gained its independence from Britain the same day as India, August 15, 1947. Since then it has experienced intermittent democratic and military governments. On October 14, 1999, General Pervez Musharraf declared a state of emergency and issued the Provisional Constitutional Order (PCO), which dissolved the federal and provincial parliaments, suspended the 1973 Constitution of Pakistan, and designated Musharraf as Chief Executive. Under the Provisional Constitutional Order and its amendments, all power flows from and to the Chief Executive, who also heads the military. The Judiciary is proscribed from issuing any order contrary to the decisions of the Chief Executive, and the President, Cabinet, National Security Council, and Governors serve at his discretion. In practice, Musharraf consults extensively with his civilian appointees and Corps Commanders. In economic policy civilian appointees have exhibited wide latitude. Although the Judiciary was compelled to take an oath to the PCO and the Chief Executive, courts continue to function and exercise that authority which does not conflict with the PCO. Musharraf has promised to return Pakistan to democratic, civilian rule, but the details are unknown.

Pakistan's economy has made some progress in its fifty years of independence, but it continues to face severe challenges of economic growth and human development.

Since the early 1990s, the government has implemented several measures to revitalize its economy. It has privatized some state-owned enterprises and lifted restrictions on the export of agricultural products. The government has plans to deregulate the oil, gas, power, and telecommunications sectors. Further, developments in the wake of September 11, 2001, may give the government a new opportunity to ease tensions with Western governments and to expedite its economic program. Pakistan's current national development agenda focuses on poverty reduction and governance reforms. It includes steps for stabilization of the economy, further deregulation, devolution of power to local governments, accelerated growth, and improved social services.

As a result of Pakistan's banking reforms, the nationalized commercial banks have reduced operating losses and recovered a third of the stock of loan defaults. In 1999, Pakistan repealed the multi-foreign currency exchange system. Also in 1999 it established the Securities and Exchange Commission of Pakistan (SECP) as the regulator of the capital market and the private corporate sector. The SECP introduces new, or revises existing, legal and operational standards to the capital market. These principles apply to the insurance industry as well.

As in neighboring countries, the insurance industry in Pakistan has been subject to stringent government control. In 1972, the government merged 34 out of 50 then existing life insurers into the State Life Insurance Corporation.[32] Other life insurers eventually faded away. The life insurance market is now open again, and four private insurers—Eastern Federal Union (EFU) established in 1992, Metropolitan Life in 1993, American Life Insurance Company (Alico) in 1995, and Commercial Union in 1996—compete with the state-owned insurer. Insurers in Pakistan offer simple life insurance products. Health insurance is relatively new in the country.[33]

The government operates two state-owned non-life insurers, the National Insurance Corporation (NIC) and the Pakistan Insurance Corporation (PIC). The PIC, established under the Pakistan Insurance Corporation Act of 1952, has been the sole reinsurer in the country. The NIC, established under the National Insurance Corporation Act of 1976, operates in direct lines of business and meets all government insurance needs including industrial, real estate, and vehicle coverages.

Unlike the life insurance market, a number of local private insurers serve the non-life insurance market in Pakistan. There were 56 non-life insurers operating in the country in 1998. This non-life insurance market generates premiums amounting to 10 billion rupees per annum. Major lines of non-life insurance are fire, motor, and ocean marine insurance. Crop insurance is also available in Pakistan. Except for a few large insurers, the private firms tend to be small and lack

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[32] This corporation was established under Article 11 of the Life Insurance (Nationalization) Order of 1972 (P. O. 10 of 1972). Besides, the Pakistani government also nationalized all private sector banks in 1974. This sector was liberalized again in the 1990s, and forty-five banks or so—including 21 foreign owned banks—now operate in the country.

[33] Allianz Aktiengesellschaft (Allianz AG) and EFU Group signed a joint venture agreement in March 2000 to form Allianze EFU Health Insurance Company. This is the first specialized health insurance provider in Pakistan.

Securities and Exchange Commission of Pakistan

Securities Division - regulates the securities market. It handles licensing and coordination matters, regulates public offering, the secondary market and market intermediaries, and conducts market surveillance.

Enforcement Division - examines accounts of listed companies—except for certain specialized companies, including insurance companies—and, as and when necessary, investigates their compliance with relevant laws and regulations.

Specialized Companies Division - regulates mutual funds, *modaraba* companies, leasing and other specialized companies. (*Modaraba* companies operate in pursuance of Islamic principles, similar to *takaful* companies in other Islamic countries.) Its functions include licensing, regulatory compliance and enforcement of all applicable laws. Insurance companies are not subject to this division's regulation.

Insurance Division - regulates the insurance industry. It has five sub-divisions: (1) actuarial services, (2) life and insurance prudential supervision, (3) non-life insurance prudential supervision, (4) market conduct supervision, and (5) enforcement and prosecution. This division, in fact the SECP, is empowered to administer the following matters: issuance of directives; registration, licensing and regulation of insurance companies; examination of annual accounts, actuarial reports, solvency margins, reinsurance arrangements, level of management expenses, premium rates and terms and conditions of insurance policies; investigation of insurance companies; inspection of the record of insurance intermediaries; and winding up financially insolvent companies through court orders.

Company Law Administration Division - administers matters related to incorporation of all firms, and enforces the Companies Ordinance of 1984 and other statutes and regulations. It is also responsible for supervision of Company Registration Offices (CRO) located in various cities.

Support Services Division - provides support services to the entire SECP. Those services include legal services, fund and account management, administration of human resources, and development of automation systems.

insurance expertise.[34] Some of them even experience difficulty in meeting newly imposed capital and solvency requirements. Nowadays, a few foreign insurers wait for an opportunity to enter the market. Foreign investors may, however, purchase shares of local non-life insurance companies through the Pakistani Stock Exchange.

[34]The four-firm concentration ratio, measured by written premiums, has been about 80 percent in the non-life insurance market. In particular, Adamjee and EFU together generate about 60 percent of the total premium in the market.

The Securities and Exchange Commission of Pakistan (SECP)

Responding to changes in the capital market and to the need for having a centralized regulatory body, the Pakistan government has introduced several reform measures. Following recommendations of the Asian Development Bank Capital Market Development Program, these measures focus on creating an enabling policy environment, modernizing market infrastructure, and strengthening corporate governance. The culmination of this reform is probably the

creation of the Securities and Exchange Commission of Pakistan (SECP) as the sole regulator of the financial services industry.

The SECP was established under the Securities and Exchange Commission of Pakistan Act of 1997, and become operational in January 1999. As an autonomous and self-funding entity, the SECP administers the Securities and Exchange Ordinance of 1999 and the Companies Ordinance of 1984. Between 1981 and 1998 the duty of regulating the capital market and the private corporate sector had resided with the Corporate Law Authority, a former department of the Ministry of Finance. The SECP is subject to checks and accountability. In particular, it must submit an annual report on its performance to the Parliament, and it is subject to the Securities and Exchange Policy Board's oversight on its operation and advice on policy issues. The board currently consists of seven members, three of them from the private sector.

As the box on the previous page shows, the SECP consists of six divisions. The separate division for "specialized companies" reflects the distinct treatment Pakistani law accords to companies organized according to Islamic principles. They are not treated as insurance companies and therefore are not necessarily subject to the same regulation.[35]

With the enactment of the Insurance Ordinance of 2000 and the implementation of the Securities and Exchange Commission (Amendment) Ordinance of 2000, the SECP assumed the duty of insurance regulator, effective in January 2001.[36] Simultaneously, the former regulatory authority, the Department of Insurance (headed by the Comptroller of Insurance) of the Ministry of Commerce was dissolved, and the Insurance Act of 1938 was repealed.[37] The SECP sets the objectives of insurance regulation as to maintain the confidence of insurance policyholders by protecting their interests as well as and their beneficiaries', to improve existing methods and devise new options for the expeditious settlement of claims and disputes, to promote efficiency in the conduct of insurance business, to promote the establishment and development of professional and educational organizations connected with insurance business, and to promote awareness among consumers about the benefits of insurance.

The Insurance Ordinance of 2000—specifically Section 171 of the law—states that this ordinance does not apply to insurance business carried out by the federal or by a provincial government. An exception to this exclusion is made—thus the corporation is subject to this new insurance law—when a

[35]These functions are being carried out under the following laws and rules: Investment Companies and Investment Advisers Rules of 1971 for closed-end mutual funds; Asset Management Companies Rules of 1995 for open-end mutual funds; Modaraba Companies and Modaraba (Floatation and Control) Ordinance of 1980 and Modaraba Companies and Modaraba Rules of 1981; Leasing Companies (Establishment and Regulation) Rules of 1996; and Credit Rating Companies Rules of 1995. About 65 Modaraba management companies are registered in Pakistan, but only 45 companies or so are in operation. They do business in such areas as leasing, commerce, trade, underwriting, venture capital, and investment in stock market.

[36]The Securities and Exchange Commission (Amendment) defines the law of insurance as the Insurance Ordinance of 2000 or any other law related to insurance.

[37]The department had administered the insurance act since 1948.

federal or provincial government simply holds a controlling ownership interest in a corporate body, as in the case of NICL.

Market Access Regulation

The Insurance Ordinance of 2000 requires all insurers to apply for and obtain a new license by January 2001.[38] The ordinance lists several specific conditions that each applicant must meet. Those conditions include meeting minimum initial paid-up capital, statutory deposit and solvency margin; promising financial soundness and managerial competency; and agreeing to compulsory reinsurance cession (applicable to non-life applicants only). Registered insurers are no longer required to renew licenses annually.

The ordinance gives life insurers a minimum paid-up capital requirement of 100 million rupees (approximately US$1.85 million) by December 31, 2002, followed by a higher requirement—at least 150 million rupees—by December 31, 2004. Non-life insurers must have minimum paid-up capital of 50 million rupees by December 31, 2002, increasing to 80 million rupees by December 31, 2004. Until December 31, 2002, existing insurers are subject to the minimum paid-up capital requirement of 30 million rupees for life business or 40 million rupees for non-life business.[39]

[38]A dozen or so insurance companies failed to meet the registration deadline, but were not blocked from continuing their operations.

[39]The minimum required capital for non-life insurance business was 1.5 million rupees under the repealed Insurance Act of 1938. However, this minimum was increased to 40 million rupees under an administrative order issued in 1997. This order was based on the recommendations of the Task Force on Insurance, sanctioned by the Pakistan government.

The ordinance classifies life insurance business into four lines:

- ordinary life,
- capital redemption,
- pension fund, and
- accident and health.

For non-life insurance business, it introduces the following nine lines:

- fire and property damage;
- marine, aviation and transport;
- motor third-party compulsory;
- liability;
- workers' compensation;
- credit and surety;
- accident and health;
- agriculture insurance (including crop insurance); and
- miscellaneous insurance.

The SECP may restrict an insurer, whether in life or non-life business, from writing specific lines of business within a licensed class. Insurers in Pakistan are not allowed to conduct both life and non-life business.

Registered insurers in Pakistan must maintain at least one statutory fund. If a life insurer offers more than one type of insurance products (for example, term life products and unit-linked products), the insurer, unless otherwise explicitly exempted in the ordinance, must maintain a statutory fund for each type of its insurance business. It must also manage each fund separately from other statutory funds.

Insurers must deposit their statutory funds with the State Bank of Pakistan, either in cash or in approved securities estimated at market value on the day of deposit, or partly in cash and partly in approved securities. The minimum deposit amount for the fund is currently the greater of (1) 10 million rupees or (2) 10 percent of the insurer's paid-up capital. The Insurance Ordinance of 2000, on one hand, gives the SECP the power to change this amount at its discretion. On the

other hand, if the insurer achieves the level of solvency required by the ordinance, the SECP may abolish this requirement: that is, reduce the required minimum deposit to zero. Insurers may include their individual deposit amounts toward asset calculation, but they can only use them as the last resort to discharge their insurance-related liabilities.

Solvency Regulation

The Insurance Ordinance requires insurers to maintain a minimum solvency margin. For the purpose of calculating solvency margins, insurers are not allowed to count certain items as admitted assets. In the case of life insurers, nonadmitted assets include (1) most loans to directors, shareholders, employees or agents, (2) policy loans, (3) premiums in arrears over three months, (4) intangible assets such as good will, (5) vehicles, (6) office equipment and fixtures, and (7) any asset that exceeds the percentage—set by the Commission—of the value of the fund.

For the valuation of assets and liabilities, the law lays down the following instructions. No assets of an insurer can be valued at more than their individual market value, net of transaction costs. No liability of an insurer can be valued at less than its market value, net of expenses. Non-life insurers' liabilities for outstanding claims cannot be valued at less than the expected settlement cost, including settlement expenses, of all future claims. This includes IBNR claims. Non-life insurers cannot value their liabilities for outstanding policies at less than the sum of the unearned premium reserve and the premium deficiency reserve.[40]

To meet the solvency margin requirement, a life insurer must at all times maintain in its shareholders' fund a surplus of admissible assets in Pakistan over liabilities in Pakistan of not less than the required minimum amount. Life insurers are currently allowed to meet the minimum—35 million rupees—set by the repealed insurance act, but are required to meet the new minimum of 75 million rupees by December 31, 2004.

In the case of a non-life insurer, the insurer must at all times have admissible assets in Pakistan in excess of its liabilities in Pakistan of an amount greater than or equal to the minimum solvency requirement. The minimum amount is the greatest of (1) an amount set by the SECP, (2) a percentage of its premiums, net of reinsurance, earned during the preceding 12 months, or (3) a percentage of its reserves for unearned premiums and losses, net of reinsurance up to 50 percent of the gross figure. A few exceptions to this requirement exist.

Other Regulation

The Insurance Ordinance lists several rules that insurers must meet to continue to operate in Pakistan. It also states what powers the SECP exercises to protect policyholders.

As mentioned, the SECP no longer requires registered insurers to renew licenses annually. Under the repealed Insurance Act of 1938, this power served as a market conduct control mechanism when a registered insurer had failed or was likely to fail to comply with the conditions of registration. Under the new insurance law, the SECP may instead rely on

[40]The Insurance Ordinance defines the premium deficiency reserve as "the amount if any by which the expected settlement cost, including settlement expenses but after deduction of expected reinsurance recoveries, of claims expected to be incurred after the balance date in respect of policies in force at the balance date, exceeds the unearned premium reserve."

its new power—issuing a directive to the insurer to cease writing new business.[41] The SECP believes that this new approach can not only minimize adverse consequence to the policyholders of that insurer, but also decrease the likelihood of an insurer's litigation.

The SECP may examine annual accounts, actuarial reports, and management expenses of any registered insurers. Its powers also include any necessary investigation of insurers and winding up financially insolvent companies through court orders.

The SECP regulates terms and conditions of insurance policies. It also has the power to regulate premium rates or to set tariff rates.[42] For example, life insurers must seek prior approval at least thirty days before they offer new insurance products, and then comply with any SECP recommendations with respect to those products.

Direct insurers may cede their risks to overseas reinsurers after placing a compulsory treaty cession to the Pakistan Insurance Corporation. This compulsory cession—subject to the maximum amount of insurance—was reduced to 15 percent as of January 1, 2001, from previous 20 percent. The government plans to reduce the percentage further to 10 percent on January 1, 2003, and to zero from January 1, 2004. This national reinsurer also accepts additional cessions—including facultative cessions—from insurers in Pakistan.

This national reinsurer participates in the reciprocal arrangements under the Economic Corporation Organization (ECO), a regional reinsurance (or retrocession) pool for various non-life lines of insurance excluding aviation, motor, credit, and bond lines. The Pakistan Insurance Corporation, Mimeh Markazi of Iran, and Milli Reasurans, T. A. S. of Turkey founded this organization with two main objectives: (1) to contain reinsurance premium payments within the member countries through reciprocal arrangements and (2) to improve the standard of insurance services in member countries. The ECO is housed at and has been managed by the Pakistan Insurance Corporation since 1996. This regional pool now includes Afghanistan, Azerbaijan, Kazakhstan, Kyrghzstan, Tajikistan, Turkmenistan, and Uzbekistan as well.

In addition to insurers' market conduct, the Insurance Ordinance of 2000 addresses the professional duties, rights, and liabilities of insurance intermediaries. It also establishes an Insurance Ombudsman to investigate complaints of "mal-administration" by insurers, which are not necessarily related to claims disputes.[43] It does not accept any complaints related to reinsurance contracts. An appeal against the Insurance Ombudsman's decision lies with the SECP. All other insurance-related disputes, including claims, fall under the jurisdiction of Insurance Tribunal, which was established under the Insurance Ordinance of 2000. Small disputes and claims—up to 500,000 rupees—can be handled by one of the Small Disputes Resolution Committees that the federal government may establish.

[41] Sections 11 and 63 of the Insurance Ordinance of 2000.

[42] Under the previous regulatory arrangement, it was the Insurance Association of Pakistan (IAP), an industry association comprising representatives of non-life insurers, that regulated insurance pricing and distribution, and maintained tariff structures that non-life insurers in all lines, with a limited exception for those writing marine insurance, must abide by.

[43] Section 127 of the Insurance Ordinance specifically illustrates the scopes of "mal-administration" that can be subject to this investigation.

Sri Lanka

The Democratic Socialist Republic of Sri Lanka is an island in the Indian Ocean approximately 18 miles off the southeastern coast of India. Portuguese traders seized the island's coastal areas in the 16th century. They were supplanted by the Dutch and then the British, who created the Crown Colony of Ceylon in 1815. They established a plantation economy based on tea, rubber, and coconuts. In 1931, the British granted Ceylon limited self-rule and a universal franchise. Ceylon became independent on February 4, 1948, and changed its name to Sri Lanka in 1972.

Sri Lanka is ethnically, linguistically, and religiously diverse. Sinhalese, concentrated in the densely populated southwest, make up 74% of the population. Ceylon Tamils, citizens whose South Indian ancestors have lived on the island for centuries, total about 12%. They live predominantly in the north and east. Another 6% of the population consists of Indian Tamils, brought to Sri Lanka by the British in the 19th century as tea and rubber plantation workers. They remain concentrated in the tea country of south-central Sri Lanka. Both Sinhala and Tamil are official languages. English continues to be spoken by many in the middle and upper middle classes, particularly in Colombo, the capital. Most Sinhalese are Buddhist; most Tamils are Hindu. The 1978 constitution, while assuring freedom of religion, grants primacy to Buddhism.

Historical divisions continue to disrupt Sri Lankan society and politics. From independence, the Tamil minority has feared the country's unitary form of government would allow the Sinhalese majority to abuse Tamil rights. Growing radicalization among Tamil groups has led to separatist violence in the north and eastern provinces and terrorist incidents throughout the country associated with the separatist Liberation Tigers of Tamil Eelam, better known as Tamil Tigers.

Sri Lanka has a multi-party democracy that enjoys considerable stability despite relatively high levels of political violence. The President of the Republic, directly elected for a 6-year term, appoints and heads a cabinet of ministers responsible to Parliament. The president's deputy is the prime minister, who leads the ruling party in Parliament. The Parliament is a unicameral legislature elected by universal suffrage and proportional representation. Sri Lanka's judiciary consists of a Supreme Court, Court of Appeal, High Court, and a number of subordinate courts. Sri Lanka's legal system reflects diverse cultural influences. Criminal law is fundamentally British, while civil law is Roman-Dutch. Laws pertaining to marriage, divorce, and inheritance are communal.

Sri Lanka's economy began to shift away from a socialist orientation in 1977. Since then, the government has been deregulating, privatizing, and opening the economy to international competition. Economic growth has been uneven in the ensuing years, but the private sector, especially the export sector, continues to grow. During the period 1995-1998, Sri Lanka's privatization program made significant progress. Privatization of tea plantations boosted productivity to help Sri Lanka regain its place as the world's leading tea exporter. Garment exports also contribute significantly to the country's economy.

The British first introduced insurance to Sri Lanka in 1833. By the early 1960s, there were approximately 70 insurers, including a few local insurance companies incorporated under the Companies Ordinance of 1938, operating in Sri Lanka. There had been no legislation to regulate the insurance industry until the government introduced the Insurance Corporation Act in 1961. This act nationalized the life insurance industry and created the Insurance Corporation of Sri

Lanka (renamed the Sri Lanka Insurance Corporation, Limited in 1993) to give it a complete monopoly over new insurance business. The government introduced a separate statute, the Control of Insurance Act (No. 25) of 1962, to regulate the servicing of the policies that private insurers had already issued prior to nationalization of the industry.[44] The government nationalized the non-life insurance industry in 1964, and established in 1979 another state-owned insurer, the National Insurance Corporation (renamed the National Insurance Corporation, Limited in 1993).

The Control of Insurance (Amendment) Act of 1986 re-opened the market to the private sector. Today, there are ten composite insurers or so operating in Sri Lanka. Nevertheless, Sri Lanka Insurance Corporation continues to dominate the market, generating about 60 percent of both life and non-life insurance businesses in the country.[45] The National Insurance Corporation writes about five percent of both the life and non-life insurance in Sri Lanka.

During the late 1990s, the Public Enterprises Reform Commission planned a partial privatization of the government's insurance business. This resulted in the sale of 51 percent of the shares of the National Insurance Corporation in June 2001 to Janashakthi Insurance Company, a new insurer formed after the merger of Janashakthi Life Insurance Company and Janashakthi General Insurance Company.[46]

In another major reform, the government announced in March 2001 that it would allow foreign investment in local insurance companies up to 90 percent of the equity. It repealed the Control of Insurance Act of 1962 and introduced the Regulation of Insurance Industry Act (No. 43), which became effective on March 1, 2001. According to this law, the Insurance Board of Sri Lanka, created in March 2001 and headed by the Director General, took over the insurance regulatory function from the Insurance Division, headed by the Controller of Insurance, of the Ministry of Finance and Planning.[47] The Insurance Board is responsible for administering insurer and brokerage firm registrations, advising the government on the development and regulation of the insurance industry, and implementing insurance-related policies.

Market Access Regulation

To commence non-life insurance business in Sri Lanka, an applicant is expected to raise a minimum paid-up capital of 50 million rupees (approximately US $0.65 million). If, however, it raises initial capital of at least 25 million rupees but less than 50 million rupees, the applicant may still get a limited license,

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[44]Ministry of Finance and Planning, "Main Features of Insurance Legislation in Sri Lanka and Recent Development," in *Insurance Regulation and Supervision in Asia* (Paris: OECD, 1999).

[45]Sri Lanka Insurance Corporation, Corporate Profile, March 2002.

[46]Another ten percent of the ownership of the National Insurance Corporation was distributed to the employees of Janashakthi Insurance Company. Public Enterprises Reform Commission of Sri Lanka, *Guidelines for Parties Expressing Interest in Sale of 39 Percent Share Owned by Government of Sri Lanka in National Insurance Corporation, Limited*," March 2002, pp. 3-4.

[47]The Board consists of seven members, including three ex-officio members: the Deputy Secretary of the Treasury, a Deputy Governor of the Central Bank, and the Director General of the Securities and Exchange Commission of Sri Lanka.

meaning that the insurer can write premiums up to three times of its initial capital. This rule also applies to an applicant for life insurance business, except that the minimum paid-up capital is 25 million rupees for a full license and a minimum of 15 million rupees for a limited license.

A new life insurer must make a statutory deposit with the Department of Treasury of 50,000 rupees for each class of insurance business. In the case of a non-life insurer, it must deposit 250,000 rupees. The regulatory authority requires each applicant to submit several other documents, including a three-year business plan, to employ a qualified insurance person and not to hold shares of any insurance brokerage firms. While operating in Sri Lanka, a non-life insurer must maintain a solvency margin of the greater of the statutory deposit or 10 percent of premium income for the preceding financial year.

Other Regulation

The new law requires life insurers and general insurers to invest 30 percent and 20 percent, respectively, of their reserve funds (and probably capital, too) in government securities. The Insurance Board has the authority to determine the institutions or investment instruments to which life and general insurers must invest the balance of their reserves (and capital). This is departure from the previously required investment of 50 percent of life business reserves and 30 percent of non-life insurance business reserves to government securities and the balance in approved securities as defined in the Insurance Act.[48]

The Insurance Board is empowered to set minimum and maximum rates that licensed insurers can charge for their fire, motor, and workers' compensation insurance products. The board may still have the power to review and, if necessary, amend policy wordings.

With the Regulation of Insurance Industry Act, non-life insurers are no longer subject to the compulsory reinsurance cession to the National Insurance Corporation, which is now privatized. They are also free from prior approval requirement for reinsurance arrangements. However, the Insurance Board reserves its right to examine reinsurance arrangements, and, if necessary, prohibit an insurer from dealing with certain reinsurers.

As for brokerage business, the Regulation of Insurance Industry Act prescribes that an insurance brokerage firm must be a limited liability company, and satisfy minimum professional liability insurance requirements. It also states that a licensed insurer can neither hold shares of a brokerage firm nor appoint its nominees to the board of an insurance brokerage firm registered in Sri Lanka. In contrast, an insurance agent must be an individual and can represent only one insurer.

The Social Securities Board, the Export Credit Insurance Corporation, and the Agricultural Insurance Board are exempted from complying with the requirements of the new law. Finally, the Insurance Board plans to create a policyholder protection fund to protect insureds and claimants of insolvent insurers. Once created, the fund is expected to be under the control of the Insurance Board.

[48]The main areas of approved investment are shares in listed companies, deposits in banks and government-approved project in which the government is a joint participant. G. D. Chandra Ekanayake, "Investment Regulation: The Regulatory Framework in Sri Lanka," in *Insurance Regulation and Supervision in Asia* (Paris: OECD, 1999).

Summary of Regulatory and Supervisory Structures

All five countries examined in this study nationalized the insurance industry and created wholly state-owned insurers in the 1970s. Even today, national insurers still dominate the local markets. No local private reinsurers are allowed, and they are not likely to be allowed in the near future, except perhaps in India.

Each of the five countries has imposed new measures to reform and revive the insurance industry. Bangladesh amended the Insurance Corporation Act and the Insurance Act in 1990. India passed the Insurance Regulatory and Development Authority Act of 1999 and amended the Insurance Act of 1938. Nepal adopted an insurance law in 1992. Pakistan repealed the Insurance Act of 1938 and enacted the Insurance Ordinance of 2000. Sri Lanka introduced a new insurance law in 2001. These reforms serve either to privatize the insurance industry or to open the market for foreign insurers.

Along with these legal reforms, India and Pakistan created a new regulatory authority. The Insurance Regulatory and Development Authority (IRDA) of India is a stand-alone regulatory body, officially separated from the government. The regulatory power in Pakistan now resides with the Securities and Exchange Commission of Pakistan (SECP), which is also functionally separated from the government. In Nepal it is the Insurance Board, probably an independent body, that regulates the insurance industry. Sri Lanka introduced a new regulatory body—the Insurance Board. In Bangladesh, the Department of Insurance of the Ministry of Finance continues to regulate the insurance industry.

Although all five countries have liberalized their markets, these reforms vary in scope. Thus dissimilar market environments and insurer operations exist in these countries. This section encapsulates these findings.

Market Access Regulation

The insurance markets in all five countries are open to the private sector. Foreign investment in insurance companies—for example, purchasing shares of local stock insurers—is also permitted. However, only limited access is available for foreign insurers wishing to operate in any of those countries. Bangladesh currently does not admit new foreign insurers. India has licensed private insurers only since October 2000. Pakistan has just restructured its insurance market, and time will tell whether it will again become attractive to foreign insurers. The markets in Nepal and Sri Lanka remain less attractive for foreign insurers. In Muslim countries like Bangladesh and Pakistan, a few insurers offer products in compliance with Islamic principles, which are known as *mudaraba* or *takaful* insurance policies. No government in the region has admitted private reinsurers, and is unlikely to privatize the reinsurance market in the near future.

A related issue is whether the market is large enough to accommodate the existing insurers, especially when state-owned insurers dominate the market and a large number of small insurers compete in the same market. The Indian insurance market is potentially large enough to accommodate more (financially sound) insurers. However, it is

Licensing Regulation

	Foreign ownership	*Minimum capital*	*Economic needs test*
Bangladesh	Not allowed	Different amount between life and non-life insurers	Not known
India	Joint venture with 26% foreign ownership limit	Different amount between life and non-life insurers	Probably not
Nepal	100% foreign ownership allowed	Required equally to all applicants	Not known
Pakistan	Allowed	Different amount life insurers, non-life insurers, and foreign insurers	Not known
Sri Lanka	Not allowed	Different amount between life and non-life insurers	Not applied

debatable whether the market in Bangladesh, which generates premiums of US $150 million, is big enough to sustain all 13 life insurers and 43 non-life insurers. This matter should be further investigated, and, if necessary, merging small insurers with limited financial capacity might increase insurer efficiency and market stability. A similar debate can be made regarding the market in Pakistan, which is currently served by six life insurers and 56 non-life insurers. The market in Nepal is currently too small to house a large number of insurers: thirteen or so insurers generate premiums amounting only to about US $20 million in the country. In contrast, only a handful number of insurers generate about US $200 millions of premiums in Sri Lanka. With political stability, Sri Lanka can be an attractive place for new private insurers and foreign insurers to operate. Finally, whether private insurers, both local and foreign, will be treated equally with state-owned insurers remains a question in most countries.

Solvency Regulation

Differences exist among the countries when it comes to solvency margin requirement. Bangladesh currently maintains a simple philosophy that licensed insurers should meet their insurance liabilities, and does not impose, especially on life insurers, any specific solvency margin guidelines. The Securities and Exchange Commission of Pakistan has similar rules, but prescribes asset and liability valuation methods. India recently introduced a guideline that requires every insurer to maintain a required minimum solvency margin—the excess of the value of the insurer over the amount of its liabilities. Non-life insurers in Nepal are required to earmark minimum percentages of their direct earned premiums and outstanding claims. In the case of life insurers in Nepal, their assets must be greater than their liabilities. Insurers in Sri Lanka are subject to rules similar to the ones imposed on insurers operating in Nepal.

The solvency margin requirements in all five countries are based primarily on premiums. The formulae currently used do

Ongoing Regulation

	Solvency margin requirement	Regulation of		
		Pricing	Contract wording	Investments
Bangladesh	Weakly imposed	Not known	Not known	Stringent
India	Required	Tariff rates for non-life insurance	Exists for non-life insurance	Stringent
Nepal	Required	Not known	Not known	Not known
Pakistan	Required	Not known	Not known	Stringent
Sri Lanka	Required	Tariff rates for motor, fire, and employer's liability	Exists	Stringent

not fully reflect differences in size among insurers operating in the same class, in risk and investment portfolios of individual insurers, and in other insurance business-related risks, thus resulting in potentially inadequate solvency buffers for those insurers operating in volatile lines of insurance business. Except for India, none of the countries have well-articulated methods enabling insurers to estimate their unearned premium reserves and loss liabilities, IBNR claims in particular.

To address these issues, the existing solvency margin formulae need modification to reflect asset risk, pricing risk, underwriting risk, and business risk. When local insurers start to offer insurance protection regionally and internationally, regulators should also consider foreign exchange risk in formulating solvency margins. An alternative approach could be adopting risk-based capital models or more advanced solvency margin formulae conforming to international standards.

Whether all insurers are financially sound enough to weather catastrophic losses and, more importantly, to compete with well-capitalized regional and foreign insurers is another issue. This might be comparatively of less concern for India, where most new insurers are affiliated with a large, potentially financially strong, domestic commercial bank or an internationally well-known insurer. However, the viability of many small insurers in Pakistan and Bangladesh is dubious. They are likely to seek mergers with larger insurers or be forced to consolidate into a fewer number of insurers. The regulatory authorities should also consider increasing the minimum capital requirement to a meaningful amount.

Financial and Accounting Regulation

In the new regulatory environment where *ex post* regulatory measures are increasingly emphasized, prudent financial and accounting regulation is critical. Without prudence in such regulation, the supervisor may not be able to monitor effectively signs indicating financial difficulty of insurers. Regular collection and analysis of material financial and accounting information from licensed insurers is a useful tool for this purpose. It is more useful if consistent guidelines prescribe reasonable, but somewhat conservative, valuation of insurers' assets and liabilities.

Permitting insurers to invest their assets in a diverse array of investment instruments commensurate with their liability exposures is also important. South Asian regulators seem

to pay more attention to portfolio limits than to appropriate matching and risk management practices. They commonly prescribe the permitted areas of investment. An insurer will report fewer admitted assets if it invests in instruments outside the guidelines. Regulators also specify the percentage of insurer's capital and premiums earned to government securities or designated sectors of the economy. Those stringent investment guidelines, coupled with insurers' investment limited to the local economy, may not only hinder insurers from investing prudently consistent with their risk portfolios and business philosophy, but also affect the cost of insurance that their policyholders pay.

A related question is whether the capital markets in those countries are mature enough to offer a wide range of investment opportunities for insurers. It appears that the choices are somewhat limited in those countries. When facing a limited investment choice on top of stringent investment guidelines, insurers might not be encouraged to develop new, sophisticated insurance products. Indeed, simple insurance products such as term life, whole life, and fire insurance policies or compulsory insurance coverages are the predominant products. (Many insurers also offer marine insurance coverages in those countries.) A non-diversified investment portfolio, especially one heavily skewed toward low-risk investment areas, could also be a result of a government's policy to safeguard policyholders' funds against volatile investment results of their insurers. These inferences lead to a conclusion that regulators in those countries may need to review the existing investment guidelines so that more diversified investment choices are available to insurers; otherwise the local market may become or remain less attractive both to the private sector and to foreign insurers. The capital market must be further developed, too.

Market Conduct Regulation

Regulators in all five countries tend to maintain, even under the revised regulatory guidelines, tariff-rating systems for non-life insurance. They also tend to prescribe insurance policy forms and rates, or require prior approval for rate changes for existing policies from both life and non-life insurers.

Compulsory reinsurance cession to the national reinsurer is also an issue. In all countries, insurers are required to cede a minimum percentage—usually 20 percent—of their direct non-life business to the national reinsurer. Only then, they may be allowed, subject to prior approval in selected countries, to place risks with overseas reinsurers. It is often contended that the national reinsurer functions as a risk sharing/pooling mechanism for local insurers and that a compulsory reinsurance requirement reduces foreign currency outflows. However, few studies have examined whether national reinsurers in those countries have the capacity of handling an ever-increasing amount of risk, whether they offer pricing, underwriting, and other ancillary services to local insurers that are comparable to the services professional international reinsurers often offer, or whether they operate efficiently or are managed prudently.

Conclusions and Recommendations

The insurance markets of South Asia have opened significantly in recent years. These reforms not only mirror other reforms of the economy, including other sectors in the financial services industry, but also they reflect governments' efforts to meet international best practices in insurance regulation and supervision.

All countries have eliminated the national monopoly in insurance. However, other protectionist measures—including limitations on foreign ownership of local insurance companies and compulsory reinsurance cessions—are still in place. Some social insurance needs might be better met by local or national entities. That said, however, prolonged protection of the local insurance industry might prevent the market from operating efficiently. It can delay the development of a sound insurance industry led by insurers equipped not only with expertise in insurance pricing, marketing, underwriting, and claims handling but also with financial capacity to underwrite large risks and compete in the regional and international markets.

The insurance markets in South Asian countries are significantly underdeveloped, just one indication of the need to strengthen the financial infrastructure. Thus this paper concludes with some recommendations to that end and an enumeration of the prerequisites for the further development of the insurance industry in South Asia.[49]

[49]The International Association of Insurance Supervisors (IAIS) also identified similar common problems facing insurance markets in emerging economies. Those problems are: lax management within insurance companies; weaknesses in the legislative framework; weak corporate governance; ineffective market discipline; and inadequate information flows due to a lack of transparency or undeveloped accounting systems.

Preserving Well-defined Regulatory and Supervisory Guidelines

With an insurance law, the regulator can set the appropriate level of regulation, and the insurance provider can identify the scope of operations that best meet its stakeholders' interests. In pursuant to supplementary guidelines to the law, the regulator imposes specific regulatory measures, and the insurer can find ways to increase its operating efficiency even within the boundary.

Mere presence of a law or guideline is necessary but not sufficient for the development of a financially sound insurance market. The law should be clear about market accessibility and the scopes of insurer operations. It should encourage insurers to diversify their risk and investment portfolios while requiring insurers to abide by well-defined accounting standards. It should address the supervisory roles of the regulator, and encourage self-regulation among insurers. It should promote fair competition in the market. Administration of the law should be transparent. Lastly, the law should best protect policyholders' interests.

Widening the Scope of Insurer Investments

Insurers in the region are subject not only to stringent investment regulation but also to limited investment opportunities. Compared to the industry in economically advanced countries, banks in South Asia are weakly capitalized and lack expertise. Bond and securities markets scarcely exist except in

India. Capital movements into and out of the country are closely monitored. Without the presence of a financially sound and strong capital market, insurers face difficulty in diversifying their investment risks. Neither can they match the duration, risk, and investment return of their assets to those of their liabilities.

Any restriction on investment can increase the cost of insurance. For instance, when insurers are required to invest a certain percentage of their assets in rural and social sectors that often bring negligent investment returns, they may then attempt to use a low rate of investment return for pricing insurance coverage. This will result in higher premium rates. Artificially suppressing premium rates is not a solution to this dilemma but further damages the insurance market. Similarly, when insurers are required to charge lower premiums to certain policyholders, other policyholders of those insurers are forced to subsidize part of the resulting premium deficiencies.[50] These restrictions deviate from international best practices, thereby raising questions regarding the viability of the regulatory framework.

Additionally, unless a reasonable justification exists, South Asian countries should consider removing foreign equity ownership limits. Such a limit can reduce insurer underwriting and large-line capacity. This limit, when coupled with a lack of management control by foreign partner, can discourage further foreign direct investment in the country, especially in its financial services industry.[51]

Developing Human Resource and Insurance Expertise

There is a widespread shortage of qualified insurance professionals—actuaries, underwriters, claims adjusters, investment specialists and market specialists—in most countries. Causes include decades of national monopoly, tariff rating, little new product development, and few training institutes or universities offering insurance programs.[52] As the insurance industry develops, it certainly needs more local expertise in insurance business. Developing and updating mortality and morbidity tables is also urgent in all five countries. These needs cannot be met effectively via skills-oriented training programs only. The insurance industry undoubtedly needs well-educated professionals specializing in insurance and actuarial science. A long-term solution would be promoting collegiate insurance and actuarial science education and encouraging academic research in insurance and related areas. With the convergence of financial services, such expertise should also include other areas of financial services industry—banking and investment services. Several international organizations—APEC, IAIS, and a group of Asian regulators—have initiated training programs for insurance regulators in the Asia-Pacific region.

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[50] In India, this requirement is also derived from the country's experience of the closure of countless rural branches of banks after the government adopted in the early 1990s more commercial principles in the banking industry. At present, nearly one-half of LIC's policies are issued to rural dwellers. Oxford Analytica Asia Pacific Daily Brief, July 30, 1999.

[51] In fact, some of the early joint-venture initiatives in India failed due in part to one or more of these reasons. Examples of such failures are Dabur-Allstate, Chubb-Kotak Mahindra, UAP-Integrated Finance, Royal & Sun Alliance-DCM Shriram, and Allianz-Alpic.

[52] See Kwon (1999a and 1999b) for a discussion of the current status of insurance and actuarial science education and training institutes in Asia.

Educating Consumers

Insurance is probably the lowest-cost and most systematic risk management mechanism that protects individuals and businesses from scores of risks. It is also an effective mechanism to preserve and accumulate wealth for holders of life insurance and their beneficiaries. These benefits of insurance and its advantages compared to other investment mechanisms as a wealth protection mechanism are not widely known in South Asia. The infinitesimal amount of insurance consumption—measured by per capital premiums—as well as extremely low insurance penetration ratios in those countries reflects this lack of knowledge. Thus, regulators and insurance providers in those countries should place more emphasis on educating the general public about insurance. Such a campaign will encourage insurance consumption when the market is served by operationally and financially prudent insurers, and when rigorous regulatory mechanisms are in place to protect policyholders' interests. Education can also discourage policyholders from exercising adverse selection against insurers or committing fraud.

Making more widely available insurance products following Islamic principles can be an excellent approach to encourage insurance consumption in Muslim countries. Those products are typically based on an *al-takaful* (meaning "co-sharing" or "helping the destitute") concept or an *al-mudaraba* (meaning "pre-arranged profit sharing') concept. These concepts can be applied not only to both life and non-life insurance but also to proportional reinsurance arrangements. Several conditions exist to make prosperous an Islamic principle-based insurance market. It requires sound regulatory measures specifically designed for those products and the presence of target investments that share the same religious principle.

Further Liberalization of the Insurance Market

For further development of the insurance market in South Asia, regulators should minimize any unnecessary constraints in the insurance market, while closely monitoring all the activities in the market, especially those related to financial stability of insurers. Of course, a perfectly competitive market could only be observed in theory, but a freer market environment may induce insurers to increase their efficiency and be more competitive. Insurers in a competitive market will focus their *modus operandi* on developing expertise in all areas of insurance operations, thus being able to offer a wide array of insurance products. When the market is liberalized, even if not fully, foreign capital and expertise will flow in to the local market and all the participants in the market can receive the benefits resulting from scale- and scope-economy effects of insurance operations.

The insurance industry plays an important role in an increasingly liberalized and competitive economy. The industry is a vital source of capital for economic development. More importantly, it makes indirect, but significant, contributions to the economy in the form of providing effective and low cost means of protecting wealth of individuals as well as letting businesses use their resources to enhance their firm values.

The more widely open an insurance market, the more the market, as well as the economy, benefits from scope- and scale-economy effects. Liberalization of the market improves financial intermediation and resource allocation in the economy. Liberalization of the market induces inflows of foreign capital and technical expertise, thus resulting in an increase in productivity and in the types of products available in the market. In fact, numerous studies have found a

positive correlation between openness of the financial services market and economic growth in developing countries.

Liberalization encourages insurers to develop more specialized products that meet ever increasing and broadening needs of policyholders. Competition leads to improved management and service quality, allowing cost-savings to policyholders. A competitive market tends to be stable and is less vulnerable to abnormalities in the market. A competitive market—an open market with national treatment and regulatory transparency—is attractive to both the local private sector and foreign insurers.

Inefficient insurers cannot survive long in a competitive market. However, regulators and other stakeholders in closed markets often misinterpret the causes of the failure of those insurance firms, sometimes even the mere possibility of such a failure, and prefer retaining protectionism or upholding tight regulation. Even when a market in a developing economy is in the process of liberalization, the regulatory authority may insist on safety nets—for example, tight access and exit regulation, price regulation, investment regulation, as well as compulsory reinsurance cession—to minimize the risk of market distortion and insurer insolvency. Such safety nets should not always be avoided and might be working when the market is in transition. However, they should be of short-term measures and eventually be removed. Otherwise, the market continues to operate less efficiently than a fully liberalized, competitive market. The same logic applies when the insurance market is more tightly regulated than other industries. Insurance regulation must do its best to keep the insurance industry equally attractive as other industries; otherwise, the capital can be diverted to other industries within the financial services sector or to other sectors with better potential returns.

The insurance markets in Bangladesh, India, Nepal, Pakistan, and Sri Lanka are becoming freer. To create a more efficient market and a competitive market environment, all interested parties must be actively involved. The regulators should impose only the rules and regulations that promote fair competition within the market, and must not attempt to use the insurance industry as a simple means to support another industry or purely as a source of capital for economic development. Insurers should be financially sound, technically competent in insurance matters, and prudent in management and operation. Consumers must enhance their understanding of insurance, and seek insurance products that meet their risk protection needs. Political stability is also essential. As these prerequisites are met, the insurance industry will increasingly contribute to the economic development of South Asia.

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Appendix: India's Investment Regulations

Schedule I: List of Approved Investments for Life Business

[IRDA (Investment) Regulations, Regulation 3]

All approved investments specified in Section 27A of the act except:

- clause (b) of sub-section (1) of section 27A of the Act;
- first mortgages on immovable property situated in other country as stated in clause (m) of subsection (1) of section 27A of the act;
- immovable property situated in other country as stated in clause (n) of subsection (1) of section 27A of the act

In addition the authority under powers given vide clause (s) of sub-section (1) section 27A of the act declares the following investments as approved investments:

- All secured loans, secured debentures, secured bonds, other secured debt instruments, shares and preference shares and debt instruments issued by all India financial institutions recognized as such by Reserve Bank of India – investments to be made in terms of investment policy guidelines, benchmarks and exposure norms/ limits approved by the board of directors of the insurer.
- Subject to norms/ limits approved by the board of directors of the insurers deposits with banks (e.g. in current account, call deposits, notice deposits, certificate of deposits etc.) included for the time being in the Second Schedule to Reserve Bank of India Act, 1934 (2 of 1934) and deposits with primary dealers duly recognized by Reserve Bank of India as such.
- Commercial papers issued by a company or all India financial institution recognized as such by Reserve Bank of India having a rating by a reputed and independent rating agency under the category of 'very strong' or more;
- Treasury bills issued by RBI, Inter-bank Repos of RBI, and bills rediscounting.

For this purpose any investment in the short or medium or long-term loans or deposits with private limited companies shall not be treated as "approved investments."

Schedule II: List of Approved Investments for General Business

[IRDA (Investment) Regulations, Regulation 4]

All approved investments specified in Section 27B of the act except:

- clause (b) of sub-section (1) of section 27A of the act;
- first mortgages on immovable property situated in other country as stated in clause (i) of subsection (1) of section 27B of the act;
- immovable property situated in other country as stated in clause (n) of subsection (1) of section 27A of the act

In addition the authority under powers given vide clause (j) of sub-section (1) section 27B of the act declares the following investments as approved investments:

- All secured loans, secured debentures, secured bonds, other secured debt instruments, shares and preference shares and debt instruments issued by all India financial institutions recognised as such by Reserve Bank of India – investments to be made in terms of investment policy guidelines, benchmarks and exposure norms/ limits approved by the board of directors of an insurer.
- Subject to norms/ limits approved by the board of directors of the insurers deposits with banks (e.g., in current account, call deposits, notice deposits, term deposits, certificate of deposits etc.) included for the time being in the Second Schedule to Reserve Bank of India Act, 1934 (2 of 1934) and deposits with primary dealers duly recognized by Reserve Bank of India as such.

Commercial papers issued by a company or all India financial institution recognized as such by Reserve Bank of India having a 'very strong' or more rating by a reputed and independent rating agency;

Treasury bills issued by RBI, Inter-bank Repos of RBI, and bills rediscounting.

For this purpose any investment in the short or medium or long-term loans or deposits with private limited companies shall not be treated as "approved investments."

Exposure/Prudential Norms

[IRDA (Investment) Regulations of 2001, Regulation 5]

Type of Investment	Limit for Investee Company	Limit for the entire group to which the investee company belongs	Limit for the industry sector to which the investee company belongs
(a) All investments in equity / preference shares of the company (b) Debentures (convertible / partly convertible/ non-convertible) (c) Short/ medium/ long term loans (d) Any other permitted investments as per the act/regulation	In the case of Indian insurers, exposure at any point of time not to exceed 10% of the subscribed share capital, free reserves and debentures/ bonds of the investee company or the 10% of the insurer's total assets in case of non-life insurers and 10% of the controlled funds in case of life insurers, whichever is less. In the case of existing insurers, the limits mentioned above as applicable to the Indian insurance companies, shall stand modified as under:- a) exposure at any point of time not to exceed 20% of the subscribed share capital, debentures/ bonds of the investee company or 5% of the controlled funds of the life insurer or 10% of the general insurers total assets.	Exposure at any point of time not to exceed 10% of the aggregate subscribed share capital, free reserves and debentures of all the group companies in which investments including investments under considerations, have been or proposed to be made by the insurer or the 10% of the total assets in case of non-life insurers and 10% of the controlled funds in case of life insurers whichever is less. The percentage of 10% of the total assets in the case on non-life insurers and 10% of the controlled fund in case of life insurers can be raised to 15% in each case subject to specific approval of IRDA.	Investment by the insurer in any industrial sector would not exceed 10% of its total investment exposure to the industrial sector as a whole. (classification of Industrial sector to be done on the lines of classification in industries done by CMIE (Centre for Monitoring Indian Economy)

1. Subject to exposure limits as per the Insurance Act of 1938, investment in equity including preference shares, investment in equity convertible part of debentures should not exceed 50% of the above exposure norms as mentioned in the table. A similar 50% of exposure norms limit would also apply to investment in immovable property.
2. Subject to exposure limits mentioned in the table above, an Insurer shall not have investments of more than 5% in aggregate of its controlled funds in the case of a life insurer or 5% in aggregate of its assets in the case of non-life insurer in the companies belonging to the promoters' groups. For the purposes of this regulation "group" will have the same meaning as in the MRTP Act of 1969. All investments in this category would specifically be referred to the authority.