CHAPTER VI

INVESTMENT OF LIFE INSURANCE FUNDS

General Principles: Investment principles in the case of companies carrying life business is little bit different from the other financial institutions engaged in investment activities. The life insurance companies act as trustees on behalf of millions of policy-holders whose large funds are collected by them by way of premiums. Such large funds mobilised through premiums are not required to meet any liabilities immediately, hence they are invested in certain securities which may give better return on such investment.

The basic principles underlying the investment of life insurance funds may be enumerated as under:

(i) Safety of capital:

The primary duty of the life insurance companies is to pay the claims, as and when they become due. Therefore, safety of capital should receive utmost importance by an insurer while investing life fund. The speculative activities in investing the life insurance fund is not at all desirable and the life insurance companies have to act as conservative investors. The prudent insurers prefer safety of capital even at the cost of yield[1]. Keeping in view the problems of investing life insurance funds, the Government of India, has, therefore, imposed a number of restrictions on the portfolio behaviour of the life insurance funds.

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1. Khan, M.A. : Theory and Practice of Insurance, 1977, Educational Book House, Aligarh, p. 457.

(ii) Sufficiency of yield: The investment policy of a life insurer should maintain a proper co-ordination between safety and yield. The premium rates are fixed taking into account a definite rate of interest on the investment of funds, hence the fund should be invested in such a way that it would get at least that rate of interest which has been assumed in ariving at the premium rate. Earning good profit on investment means decrease in the rate of premium and increase in the rate of bonuses to be paid to the policyholders[1].

The income earned on investment of life funds plays a very important role in determining the rate of premium charged to the policyholders. For instance, an increase in interest yield by 1 to 1.5 percent on its investments reduces the premium rates by 16 to 20 percent on Endowment Assurance, and by about 20 to 30 percent on Whole Life Policies thereby making life insurance cheaper[2].

(iii) Liquidity: Liquidity principle refers to the convertibility of investment into cash without loss of capital and without such difficulties. Notwithstanding, current incomes, from interest, dividend and premiums are sufficient to meet the liabilities arising out of claims, but the current incomes in case of large scale catestrophe may prove insufficient to meet heavy liabilities of surrender values, loans and the claims (death as well as maturity). In such circumstances convertibility becomes indispensible. In principle, however, a case can be made out for the proper scheduling of the maturity of investments so as to coincide with the maturing obligations.

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1. Ibid, p. 458.
2. Govt. of India, Report of the working group on Life Insurance Administration, Vol. I, October, 1968, p.74, para 3.6.2.

(iv) <u>Diversification:</u> The diversification of investment of life funds is a pre-requisite of investment policy of any life insurance company. "Life insurance applies the principles of diversification of investments not only in the number of different investments it holds, but also in geographical distribution of those investments, their distribution by types of enterprise, by types of companies, by types of securities, by maturity dates and by time of purchases"[1]. The diversification of investment should be made on geographical as well as securities pattern. Reliance on a single pattern of securities is not a sound principle of investment for a life insurer. The distribution should be spread with reference to redemption dates, industries, degree of risk involved etc. This necessiates the assistance of financial experts having sound knowledge of stock exchange activities and general economic trend of the country as a whole. The LIC has a separate Investment Department Comprising of persons having profound knowledge in this connection.

<u>Channels of Investments:-</u>

Life insurance companies throughout the world have some definite channels through which they channelise their investible funds. We propose to discuss their relative merit and demirits and their individual importance in the LIC's investment portfolio.

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1. Meher, R.I. Osler, R.W., Modern Life Insurance, The Macmillan Company, U.S.A., 1970, p. 25.

1. <u>Government Securities:</u>

Like many other life insurance companies abroad, LIC also invests its sizeable portion of investment in central and State Government securities. The preference of government securities over other securities is partly due to statutory control imposed by the Government of India over the investment policy of the LIC and, partly due to superiority of government securities over other securities in respect of safety, marketability and freedom of wide diversification, government has unlimited credibility in meeting its obligations due to power of imposing taxes and raising funds from the public. The most important merit of the government securities is that there is no fluctuation in the market value of such securities. In view of its non-fluctuating nature, the Govt. securities are most readily convertible securities. Marketability of such securities becomes easier also due to presence of large number of institutional investors in government securities.

Keeping in view the requirements of institutional investors, the central as well as state governments issue various kinds of securities in a variety of combinations. The number of securities in the investment portfolio of the LIC is increasing year after year. For instance, the number of types of securities of the public sector (including purely government securities) in the portfolio of LIC was 20 as on 31st.March,1976[1] which rose to 34 as on 31st.March,1985[2]. Besides safety of capital, investment in government securities also enhances the volume

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1. LIC's Annual Reports and Accounts for the year ended 31st.March, 1976, p. 3.
2. LIC's Annual Reports and Accounts for the year ended 31st.March, 1986, pp. 77-79.

of life insurance business since most of the amount invested in government securities is spent on public welfare programmes which in turn increases the income of the people and their saving capacity.

Inspite of the above mentioned merits of government securities, the main defects of these securities is that they yield lower return on investment. In view of this serious defects, the life insurers abroad invest their major investible funds in securities other than government. However, the LIC's major funds are invested in government securities.

2. Corporate Securities:

The Corporate securities occupy an important position in the investment portfolios of life insurance companies. However, the proportion of corporate securities to total investments of the life insurance companies differs from country to country. The proportion of corporate securities is much higher in the industrially advanced countries than wwhat we find s in the case of LIC. The percentage of LIC's investments in corporate securities has sharply declined since nationalisation of life insurance business. For instance, investment in corporate securities formed about 16.0 percent of the total investments of the Corporation in the year 1962-63[1] which came down to 11.8[2] percent in 1975-76 and further declined to 10.5 percent in the year 1985-86[3]. These corporate

1. LIC's Annual Reports for the year ended 31st.March,1963.
2. LIC's Annual Reports and Accounts for the year ended 31st.March,1976.
3. LIC's Annual Reports for the year ended 31st.March,1986,p.20.

securities comprise of debentures, preferences shares and equity shares of the public limited companies. Suitability of such corporate securities is briefly discussed as under:

(a) Debentures

Debentures of public limited companies enjoy certain advantages over preference and equity shares as these offer considerable safety of regular income as well as safety of capital. However, these securities are not free from drawbacks. First, they do not guarantee whatsoever safeguard at the time of inflation since the value of money decreases during the inflation but the contractual obligation remains the same. Secondly, most of the debentures of the public limited companies have optional dates of redemption which reduce their attractiveness to longterm investors. Lastly, they are not frequently transacted in the stock exchanges except at the time of their issues[1]. The debentures accounted for only 3.1 percent of LIC's portfolio in the year 1985-86[2]. The percentage was even lower in the earlier years.

(b) Preference shares

The preference shares do not occupy any significant role in the investment portfolio of the LIC as these suffer from a number of disadvantages. They are often called as 'friendless orphans of stock exchange'.

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1. Clayton & Osborn: Insurance Company Investment, Allen and Unwin Co. Ltd., p. 118.
2. LIC's Annual Reports and Accounts for the year ended 31st.March,1986 (computed).

Preference shares are generally undated and often carry no date of redemption which may be utilised to the disadvantage of the investors. This uncertainty combined with narrowness of the market, leads to considerable fluctuations in capital value. At the same time, security of regular income is not so fair as in the case of government secuBities and debentures of the corporate sector[1]. In light of the above mentioned factors, the LIC does not prefer to invest its funds in this type of corporate securities. The resent trend in the investment policy of the LIC indicates that the Corporation has almost stopped a fresh investment in the preference shares of public limited companies. For instance, total investment in preference shares was Rs. 40.70 crores as on 31st.March,1976 which came down to Rs. 27.56 crores as on 31st.March,1986[2]. Its percentage to total investments is very negligible.

(c) Equity Shares

Notwithstanding, the equity shares of public limited companies are the main commodity of buying and selling in any stock exchange throughout the world, these shares are not free from some inherent drawbacks. The most important demerit of these shares is that there is violent fluctuations in their value. But there is no unfavourable effect of inflation on such shares, as a matter of fact they gain at the cost of contractual income securities. In the investment portfolio of the LIC, equity shares occupy second place among corporate securities, next to debentures. It has shown an increasing

1. Clayton & Osborn. op.cit. p.120.
2. LIC's 29th. Report and Accounts for the year ended 31st.March, 1986, p. 78.

trend in recent years. The percentage of such shares to total investments of the LIC as on 31st.March,1986 was about 2.0(percent) and about 35 percent of the ≡ total investments, in corporate securities. The LIC's investment in equity shares is both in the interest of policyholders as well as national economic development. However, investment in equities should be made in diversified companies of repute.

(3) Investment in Mortgage Loans:

Life insurance companies, throughout the world, keep fair amount of their funds invested into mortgage loans. Investments in mortgages guarantee the safeguard of capital as well as fair return on investment. Diversification of investment becomes easier. In addition, investment in high class securities are always ready for its maketability[1]. They are highly suitable to the investment portfolio of the LIC provided that the properties so mortgaged are kept under constant supervision and continued appraisal. Mortgages are specialised form of investment which demand better skill and experience of investing institutions. Since management of mortgage investments are more expensive than the other investment, a part of interest earned x on such investment should be treated as the management expenses of the investment department.

(4) Loans to Policy Holders

The LIC grants various facilities of loans to its policy-holders on the security of unencumbered policies. These loan facilities fall under to heads viz., general purpose and specifically for housing.

1. Sharma, R.S; Insurance Principles and Practice, Vora & Co., Bombay, 1960, p. 76.

<u>General Purpose:</u> At present loans are granted on unencumbered policies upto 90 percent of Surrender value under policies which are in force for full sum assured and upto 85 percent of Surrender value on policies which are paid-up for reduced sum assured. The minimum amount for which a loan can now be granted under any policy is Rs. 150. The rate of interest charged at present is 10.5 % per annum and it is payable half yearly. Loans are not granted for a shorter period than six months.

<u>Housing Loan:</u> Any person holding an unencumbered policy or taking out a new policy on his life and who satisfies the LIC about his repaying capacity, is eligible to get the loan subject to certain terms and conditions. Loan is advanced on the First Legal Mortgage by deposit of title deeds of the property to be constructed or purchased with the life insurance policy assigned as collateral security to the extent of the loan amount. Loan is granted to the extent of a minimum Rs. 10,000 and a maximum of Rs. 2,50,000. For those in the service, the period of loan may be extended upto superannuation age but not beyond 65 years of age. For other applicants period shall not be extended beyond, the age of 65 years. However, the repayment terms shall not exceed 30 years in any case.

(5) <u>Investment in Real Estate:</u>

Investment in real estate, which includes land and buildings, requires expert knowledge and skilled supervision and aministration. This type of investment involves huge cost of administration and is subject to high depreciation and severe incidence of fluctuations in value. Such investments are the least liquid and money invested is blocked up due to complete dearth of organised market for such investments. Hence, investment in real estates does not find much favour with the life ~~sim~~ insurance companies. In spite of the above constraints of investment in the real esti mate, it provides, a good hedge against inflation[1]. Increasing urbanisation and growth of population have pushed up the values of sites in major cities of India to a great extent a and this requires a change in the traditional outlook in the investment policy of the LIC. Investment in real estates has become more profitable, but the LIC, like other life insurance companies, invests in real estates for housing its head office, branches, sub-branches and to some extent residential accomodation for its employees.

It is evident from the above analysis that safety, yield and marketability which are accepted principles of investment of the life insurance funds are not fully and simultaneously satisfied by any one form of investment. Each investment presents a peculiar type of risk. To ensure against the risk-inherent in investment, the LIC has no other alternative except to diversify its investment in fixed earning securities and equity shares so that the mobility of one may be compensated against the ~~mx~~ stability of the other. During the period of inflation, the market value of fixed income investments tend to decline and that of equity shares, to appreciate.

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1. Clayton & Osborn: op.cit. pp. 118-19.

STATUTORY CONTROL ON INVESTMENT OF LIFE INSURANCE FUND

Genesis

The life insurance companies act as trustees of general saving community, desirous of life cover. Hence, safeguarding the interest of the numerous policy-holders is the main motto of imposing legal restrictions on the investment of life insurance funds. If such statutory provisions are not imposed on the life insurance companies, there is always a possibility of the funds being misused by unscruplous companies or used in speculative avenues. The past experiences throughout the world confirm this suspicion. Therefore, "the financial management and condition of a life insurance company are a concern of the law, which not only sets rigid standard for company's investments and disbursements but which also makes its transactions subject to constant review by State regulatory authorities[1].

On the basis of the past experiences and future security of the vast number of policyholders, the governments of different countries have imposed certain legal restrictions on the investment of life insurance funds. However, such statutory control over investment of life funds differs from country to country in degrees and dimensions. The degree of control in relatively free economies is quite lower than the countries following the principles of mixed or semi-regulated economy. The vigilance and control over the investment pattern of life insurance companies have created a fresh confidence in the minds and hearts of millions of small savers throughout the world.

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1. Meher, R.I., Osler, R.W., Modern Life Insurance Macmillan Company, U.S.A., p. 555.

Safety of the policy-holders' funds is not always the only criterion for statutory control over the life funds of the life insurers. Sometimes, the government control is to direct the investment of funds into more desirable channels than to leave it alone to the management of life insurance companies. Such huge funds are mainly channelised into government and semi-government securities for the overall development of the society as a whole. This in turn raises the employment opportunities, production, national income and thereby the standard of living of the people. In such cases, the interest of policy-holders remain secondary, of course their savings remain safe as most of such government or semi-government securities are gilt-edged securities. The salient features of statutory control over the investment policy of the LIC can briefly be discussed as follows:-

<u>Insertion of Sec. 27 of Insurance Act, 1938 in the LIC Act, 1956.</u>

The investment policy of the LIC was to be guided by a special Investment Committee constituted under section 19(2) of the Life Insurance Corporation Act, 1956 at the time of nationalisation which provided that "the Corporation would be following the principles laid down in 1938 Act in respect of its investments till the matter was further examined"[1]. However, the provisions contained in section 27 of Insurance Act, 1938 with regard to investment policy was not given in immediate effect.

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1. Estimate Committee Report (1960-61), 134th., p. 39.

The year 1957 can be regarded as a landmark in the history of life insurance business in India. This was the year in which the government introduced a Bill in the Indian Parliament to formulate a viable investment policy of the Life Insurance Corporation of India and at the same time this was the year of the infanous "MUNDHRA SCANDAL" posing a big question mark on the investment policy of the LIC. The intension of the Bill introduced in Parliament was to provide for "a Board consisting of the Governor of the Reserve Bank of India as its Chairman, the Chairman of the Central Board of State Bank of India and the Chairman of the LIC as its members. The Bill contemplated to take away the function of investment from the Corporation and to entrust that function to a separate body on which the Corporation would have been represented by its Chairman"[1].

However, the 'Mundhra Scandal' shunted this move of the government in cold storage to be freezed forever. This scandal generated an acrimonious debate in the Indian Parliament. The hero of this debate was no less a person than the veteran Parliamentarian, Feroze Gandhi-son-inlaw of the then Prime Minister. On demand of the members of Parliament a Commission of Enquiry was set up under the Chairmanship of Mr. Justice M.C. Chagla of Bombay High Court to look into the affairs of Mundhra Episode. This issue did not remain confined to the walls of the Parliament but it also attracted the comments of leading economists, politicians and academicians throughout the length and bread of the country. This

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1. Ibid, p. 40.

in turn, gave a blow to the government's move to constitute a new "Investment Board" for LIC and instead, the decades old provisions of section 27A of the Insurance Act, 1938 was inserted into LIC Act, 1956 to guide its investment policy on August 25, 1958 with certain modifications.

The investments of the LIC after insertion of section 27A was broadly divided into three categories[1]. Category one consisting of 'Government and approved securities representing mainly giltedged securities, category two comprising of investments approved under section 27A' and third category representing other investments'. According to section 27A at least 50 percent of the total funds should be invested in government and gilt-edged securities and not less than 35 per cent in approved investments while not more than 15 per cent should be held in the other form of investments.

With the pressing need of funds for the development of basic infrastructure of the economy, the government was left with no alternative but to turn towards the giant financial institutions like the L.I.C.

Amended Pattern of Investment

The present statutory framework governing investment pattern of the LIC is based on the recommendation of the R. Jagannathan Committee. Effective from April, 1975, the details of the investment pattern runs as follows:[3]

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1. Lok Sabha Debates: Second Series, Vol. XIX, August 25, 1958, Columns 2674 to 2678.
2. Ibid, Column 2675.
3. LIC's Annual Reports and Accounts, 1974-75, para 34, p.7.

Category	'Percentage of accretion x to the controlled fund to be invested in the category mentioned in the first column
(1)	(2)
1. In Government of India marketable securities	Not less than 25%
2. In Government of India and State Government securities including government x guaranteed marketable securities including (i) above and	Not less than 50%
3. In socially-oreinted sector x including public sector, Co-operative sector, House Building by Policyholders, OYH schemes including(ii) above.	Not less than 75%

The balance 25 percent of the accretion to controlled fund, according to government should be invested as follows:-

(a) About 8 percent of the controlled funds to be invested in the loans to policy-holders againsts policies within their surrender values.

(b) About 2 percent of the controlled fund to be invested in immovable properties of the Corporation, and

(c) About 10 percent of the accretion to the controlled fund may be invested in private sector industries.

The remaining 5 percent of the controlled fund, may not be available for investment in any form and to remains as reserve fund in the pipline to meet any exigency arising out in future. It may be mentioned here in this connection that at the time of introducing section 27A to Life Insurance Corporation Act,1956, it was felt that the funds left over after investment in government and other approved securities had to be invested in scheduled investments. While investing the LIC's funds in either socially-oriented sector or in the private sector or in the landed properties, the stipulation about scheduled investments should be satisfied subject to relaxation permitted as per main tenets of the investment policy of the LIC as under:-

(a) The keynote of the Corporation's investment policy should be that the funds should be invested in such a manner as to safeguard and promote the maximum extent possible the interest of the policyholders. The larger interest of the country, should not, however, be ignored.

(b) Investment should be dispersed over different classes of securities, industries and regions. The Corporation's policy has been not to acquire more than 30 percent of the outstanding equity shares of the company.

(c) The Corporation should act purely as on investor and not assume the role of anx operator or speculator and try to take advantage of temporary fluctuations in the market prices.

(d) The Corporation would underwrite security issues after careful investigation of project from financial, economic, technical, managerial and social angles. Another notable feature of underwriting policy of the LIC is the Corporation's participation in underwriting is in the form of 'firm' underwriting in the sense that it underwrites issues of capital invariably by way of firm commitment. Through underwriting it purchases large ~~bx~~ block of sound securities for its investment portfolios. The approach of LIC in this regard is that of an investor and not that of catalytic agent to generate public subscriptions.

Further, it is the policy of the Corporation to lay relatively more emphasis on senior securities because fixed return and preferential claims on income and assets fit into the cannons of sound investments for an insurance organisation like LIC.

(e) The Corporation should review its investment portfolio from time to time and make changes in its composition as may be warranted under the circumstances.

(f) The Corporation would not acquire control or participate in management of any concern in which it has interest as an investor unless exceptional circumstances warrant such participation.

As regards assistance policy of LIC, the Corporation assists public sector undertakings and public limited companies and abstain from assisting private limited companies.

The Corporation assists industrial enterprises directly by underwriting of capital issues, subscriptions to shares and bonds and long term loans to enterprises. Besides, the Corporation finances the private industries indirectly through subscriptions to the shares and bonds of the special industrial financial institutions such as IDBI, IFCI, SFCs and so on. In sanctioning loans, the Corporation accords priority to generation and transmission of electricity, housing schemes, water supply and drainage system, road transport development and financing of industrial development.