

Investment Audit of Life Insurance companies

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Setting the Context

Regulatory framework governing Investment Audit coverage, frequency and reporting

**IRDA (Investment)
(Fifth Amendment)
Regulations, 2013
and circulars issued
by IRDA w.r.t.
investment limits**

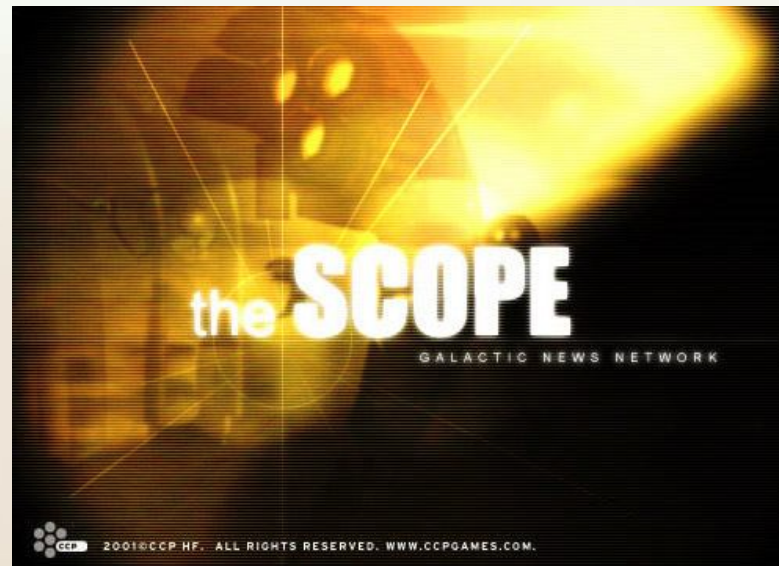
**IRDA Circular
INV/CIR/023/20
09-10 dated
August 4, 2009**

- **Technical Guide on
Internal / Concurrent
Audit of Investment
Functions of Insurance
Companies” issued by
ICAI in consultation with
IRDA**

General function of Investment Activities

ACTIVITIES	Board /Investment Committee	Front Office	Mid Office	Back Office	Finance & Accounts
Investment Policy framing and Review					
Investment Analysis					
Investment Decision					
Deal Execution					
Limit Monitoring					
Monitoring of Investments					
Settlement of Investment					
Investment Accounting					
MIS & Reporting					
Integration of Investment Accounts with Company Financials					

Audit Scope and Process



Preparing for Investment Audit

- IRDA Investment Regulations and various Circulars issued there under.
- Technical Guide issued by ICAI on Internal/Concurrent Audit of Investment Function
- ULIP F&Us to gain understanding on Investment Pattern proposed for the respective ULIP fund
- Understanding of
 - Valuation principles for NAV computation of Units of ULIP
 - Individual ULIP fund though in the stable of same Insurer, it is completely different than the other ULIP fund of the same insurer.

Concurrent/Internal Audit

Regulatory

- Investment Policy
- Compliance of IRDA (Investment) (Fifth amendment) Regulations 2013, Insurance Act 1938 and various circulars and guidelines issued by IRDA from time to time
- Investment Committee constitution and function
- Segregation of Front Office, MID Office and Back Office
- Minimum Risk management system and process
- Segregation of funds
- Reconciliations
- Outsourcing of Investment related function

Internal controls/Best practices

- Compliance of internal policies
- Standard Operating Processes
- Verification of Net Asset Value on daily basis for unit linked schemes
- Dealing with Brokers
- Counter party exposure
- Accounting of Investments

Investment Committee

Quarterly

SCOPE [Governed by Regulation 13A]

■ Constitution of IC

Minimum 2 non-executive directors, CEO, CIO, CFO and appointed actuary

■ Role and Functioning of IC

- Number of IC meetings
- Placement of IRDA circulars in Investment committee meetings
- Suggesting norms for making "*other investments*"
- Approving classification of risks for investment impact reporting
- Quarterly investment performance review
- Review of exception reports and issuing directions thereon
- Compliance of decisions taken in the IC meetings
- Delegation of authority and amendments thereon
- Approval of IP and SOP and any changes thereto
- Review of internal audit reports and actions taken

AUDIT PROCESS

- Review agenda and minutes of Investment Committee meetings

Board of directors - Quarterly



SCOPE

- Approval of Investment Policy
- Review of investment policy at least on a half yearly basis
- Lay down internal norms for making “other investments”
- Review implementation of the Investment Policy
- Review of performance of the funds on quarterly basis
- Review whether funds are generating adequate returns
- Approval of model code of conduct and review of compliance of the same
- Review of internal audit report to review exceptions to Regulations, IP and SOP
- Approval of derivative policy and policy for exercise of voting rights

AUDIT PROCESS

- Review agenda and minutes of Board of Directors meetings

Investment Policy

Half-yearly

SCOPE [Governed by Regulation 13B]

- Review of Investment Policy to confirm it contains the aspects such as
 - Liquidity, prudential norms, exposure limits, asset liability management, stop loss limits including securities trading, management of investment risks, internal controls of investment operations, scope of internal/concurrent audit, investment statistics and all other internal controls of investment operations,, the provisions of the Insurance Act, 1938 and IRDA (Investment) Regulations

AUDIT PROCESS

- Review of Investment Policy

Standard Operating Processes

Quarterly

SCOPE

- Standard Operating Processes (SOPs) are formulated to cover the whole gamut of investment operations
- Mapping of processes followed vis-a-vis SOPs
- Review of authority matrix, delegation of authority and maker/checker controls stated in SOP

**STANDARD
OPERATING
PROCEDURE**

Review of SOPs

AUDIT PROCESS

- Whether SOPs are in place covering all investments and activities of investment, treasury, back office and fund accounting department such as
 - Dealing, Settlement of trades
 - Cash Flow preparation
 - NAV computation
 - Valuation
 - Reconciliations
 - Risk Management
 - Broker empanelment
 - Compliance with IRDA Regulations
 - Preparation of IRDA returns
 - Review of service providers
- SOPs are approved by the Board/IC
- SOPs contain authority matrix, delegation of authority and maker/checker controls for every operations
- Verify frequency of updation of SOPs
- Through transaction audit, map the processes followed are in accordance with the SOPs laid down and if any modifications re required.

Compliance of internal policies

Quarterly

SCOPE

- Compliance with Prohibition of Insider Trading Policy
- Broker empanelment process and Business concentration amongst brokers
- Adherence to counterparty limits
- Adherence of the internal investment limits specified in IP (within the IRDA Regulations)

Review of internal policies

AUDIT PROCESS

■ Prohibition of Insider Trading Policy

- Insurance company has framed Insider trading policy in line with SEBI Regulations
- It has been approved by the Board
- It covers the employees of investment operations
- Check the records maintained for pre-approval of trades, life of approval, declarations provided on periodic basis, comparing matching of employee trades with the trades by the insurance companies etc.
- There exists mechanism to monitor the compliance of Employee dealing policy including system control

IRDA has not laid down any guidelines and every insurance company needs to frame its own policy on the basis of SEBI (Prohibition of Insider Trading Policy).



Review of internal policies ...

AUDIT PROCESS

■ Broker dealings

- ⦿ All the brokers are empanelled as per empanelment norms and standard Agreement
- ⦿ Is there concentration of business among few brokers (more than Specified % business through single broker) – **Combined limit**
No limit specified by IRDA. BOD needs to specify the same.
- ⦿ Reasons for concentration are recorded for reporting to IC

Limited risk due to settlement process.



Review of internal policies ...

AUDIT PROCESS

■ Counter party limits

- ⊙ Process is in place for approval of counter parties and setting limits
- ⊙ Review system control to monitor the same
- ⊙ Transaction verification, to check adherence to the limits

Limited relevance due to settlement process of equity, Debt and G Sec trades. Covers failed trade risk rather than credit risk

■ Review of internal investment norms

- ⊙ Internal limits are approved by the IC/Board of Directors
- ⊙ Limits are inbuilt in the front office system
- ⊙ Audit trail is maintained for relaxation of these limits, if any
- ⊙ Exception reports placed to IC

Operations / Transaction audit

Daily

SCOPE

- Verification of all Investment deals
- Recording of investment decisions
- Voice recording
- Verification of Primary Market Transactions
- Cash flow preparation particularly for ULIP funds

AUDIT PROCESS

- Verification of deals for ensuring compliance with prescribed procedures by the company covering authorisation, price verification and documentation w.r.t. Deal slips, Counter party confirmation, Contract notes;
- Procedure followed for investment/disinvestment is as per SOP
- Verifying Primary Market Transactions are within laid down procedures including authorization and **apportionment between schemes**
- In case of Secondary market trades, allocation of deals across funds on **weighted average basis**

AUDIT PROCESS

- Recording of rationale – system support
- Preparation of detailed research report for first time purchases as per the format approved by Board/IC
- Verification of timely settlement of trades
- Categorisation of security as approved/other investments and whether appropriate catcode has been assigned.
- Credit rating is as per document provided by Credit Rating Agency
- Creation of master in Front Office and Fund Accounting system and CRISIL Bond Valuer, if security is to be valued.

AUDIT PROCESS

- In case of investment in debt instruments,
 - ⦿ Information Memorandum (IM)/subscription Agreement, Term Sheet, Latest Credit Rating its rationale have been obtained and rating has been taken into account
 - ⦿ Security has been created in favour of lender. If not, whether any penal charges have been stipulated as per the policy of the Company.
 - ⦿ Hard copy and soft copy of IM /subscription agreement and other documents are available and kept in safe custody
 - ⦿ Wherever Security Trustee has been appointed for creation of security, whether necessary security is created

AUDIT PROCESS

- Review cash flow preparation vis-a-vis system support
- Observe and comment on Idle balances in Investment bank accounts and its impact on the fund performance
- Overdrawn bank balances and treatment for the interest
 - ⦿ In case of ULIP, the Fund management is the function of the Insurance company and for which fees are also charged and thus interest should not be charged to the ULIP fund.

Compliance of IRDA Regulations and Insurance Act 1938 Daily

SCOPE

- Review of category of investments – Approved/unapproved (daily for new securities and quarterly for all the securities)
- Reg. 4 Investment exposure limits for Life Business, Pension and Annuity and Unit Linked Life Insurance
- Reg. 9 Exposure / Prudential Norms
- Reg. 15 and circular issued by IRDA - Dealing in financial derivatives
- Various guidelines / circulars issued till date by IRDA pertaining to investment operations e.g. mutual fund investments including equity ETFs, venture fund/AIF investments, IPO investments, Asset Backed securities, PTCs and SRs, perpetual debt instruments, long term bonds for investment in infrastructure and affordable housing, on-shore rupee bonds
- Compliance to fund's investment objective specified in F&U
- Segregation of policy holders and shareholders funds and investments as envisaged under Regulations and circulars
- Verification of Inter-fund transfer of securities
- Compliance to internal limits specified in IP such as credit exposure limits, sector limits etc.

Compliance with Investment Limits

AUDIT PROCESS

- Verify all regulatory/internal limits including fund investment objectives are fed in Front Office System – hard limits as well as alert limits
- Verification of regulatory limits under Reg. 4 and exposure/prudential norms under Reg. 9 and IRDA circulars for all transactions
- Review of exception reports generated by Front Office system
- Exception Reporting to IC
- Interpretation issues in Limit monitoring
 - Treasury Bills to be considered as G. Sec. or Money Market instruments
 - Liquid MF to be classified as money market or debt security
 - Whether investment in MF to be included in computing group company exposures

Compliance with Investment limits...

- Segregation of policy holders and shareholders funds
 - ⦿ Review the investments held, income accounted for policy holders and shareholders funds to ascertain these funds are segregated not only in books of account

Compliance with Investment limits...

■ Compliance with IRDA Guidelines for inter-fund transfers

- ⊙ Transfer from policyholder fund to shareholder fund not allowed
- ⊙ For Transfer from share holders fund to policy holders fund
 - ◆ at lower of cost or market value in case of equity and at amortised cost in case of debt security when AUM is not less than Rs. 50 Cr.
 - ◆ equity and debt at market price in case of AUM is less than Rs. 50 Cr.
- ⊙ Transfers among unit linked funds to be carried out
 - ◆ At market price (to be ascertained on the basis of same or similar security traded before inter-fund transfer)
 - within market hours and
 - Settlement on **spot basis**

Review of custody operations

Quarterly

SCOPE

- Custodian is not associate or group company of the Insurer
- Review internal controls in place at the Custodian vis-à-vis
 - Transaction processing
 - Segregation of assets
 - Safe keeping
 - Corporate actions
- Review of reports sent by the custodian

AUDIT PROCESS

- Visit to custodian on periodic basis for reviewing internal controls in place for receipt of deals and settlement of deals
- Physical verification of investments if held in physical form
- Review of correctness of various reconciliations and reports provided by custodian
- Review internal audit / systems functionality reports of custodian

Front, Mid and Back Office Segregation

Quarterly

SCOPE

- Investment functions are clearly segregated between Front Office, MID Office and Back Office w.r.t.
 - Separate access to the system
 - Restricted access to dealing room
 - Duties and responsibilities are clearly segregated
 - Separate skilled manpower for front office and mid office/back office
 - Separate reporting i.e. Front office reporting to Investment head and MID office/ Back office reporting to head operations/CFO.

AUDIT PROCESS

- One time review of the investment department
- On an ongoing basis, aforesaid aspects can be examined through transaction audit

Launch, merger or split of a fund

Quarterly

SCOPE

- In case a new fund is launched, have the directions in respect of Fund Approval procedure and Guidelines on NAV Process as per Circular IRDA/F&I/CIR/INV/173/08/2011 Dt. 29th July 2011 been complied with
- In case of merger/split of a fund, confirm about transfer of securities to resulting funds to be verified

AUDIT PROCESS

- Confirm that IRDA has approved the fund
- Confirm that all fund details have been updated in Front office and back office system
- Confirm that F&U limits (investment objectives) of the fund have been correctly set in the system
- Obtain the demat statements of the resulting funds and compare with the holding statement to confirm that all securities have been correctly transferred to the resultant schemes.

Review of Accounting

Quarterly

SCOPE

- Accounting of all investment transactions w.r.t.
 - Compliance with general accounting principles
 - Adherence to accounting policy of the insurer
 - Recording of corporate action on the ex-date in case of traded security
 - Transactions are recorded on the trade date and not on the settlement date
 - Income allocation, investment allocation across funds and schemes
 - Review of expense accounting (Fund management charges)

AUDIT PROCESS

- One time review of accounting policy for investment transactions
- Transaction verification and NAV verification would facilitate the verification of ongoing compliance of all the aforesaid areas.

Verification of NAV for ULIPs - Daily



SCOPE

- Trade verification
 - Verifying that all the trades executed are correctly captured in the system for NAV computation
- Interest Accruals
 - Verifying correctness of interest accruals and amortization captured in the NAV computation for the various Unit linked insurance funds/plans
- Valuations
 - Verifying correctness of quoted/unquoted prices of securities
- Expense Ratio
 - Verifying the accrual of expenses in the NAV computation for the funds to ensure that it is accrued in accordance with the Offer Document of Unit Linked product.

Verification of NAV for ULIPs ...

Daily

- Mark ups / downs
 - Verifying Mark ups / downs, if any, are correctly captured in the system for valuation of non G-sec debt instruments
- Corporate Action
 - Verifying the correctness of corporate actions captured in the system on the ex-date
- Unit Capital
 - Verifying the correctness of unit capital captured by in the system
- Disclosure of NAV on website
 - Verifying that life insurer has disclosed correct fund wise NAV (SFIN wise) on the Insurer's website and life council website on the same day

Verification of NAV for ULIPs ...

■ Attributes of Valuation

- All such securities/entitlements needs to be valued if on the date of valuation they are accrued to scheme, has embedded value
- Always check if the valuation is fair and **equitable** for the incoming unit holders, continuing and exiting unit holders
- Unlike accounting, conservatism is not a virtue in valuation and particularly in case of open ended scheme
- Readymade models are not available and thus need to evolve valuation methodology and arbitrariness is at times inevitable
- Involve valuation committee to take such calls
- Simplistic approach of valuing, such as at cost, would not be correct

Verification of NAV for ULIPs ...

AUDIT PROCESS

- Detailed review of the valuation policy to ensure its completeness and correctness e.g. it covers
 - ⊙ Corporate actions - Merger / de merger
 - ⊙ Preference Shares
 - ⊙ Warrants, convertible bonds
- One time review of NAV computation process and system support for the same
- Obtain data independently as far as possible e.g. market price file, data from custodian, security masters data
- Track corporate actions independently (using the feeds from Custodian).

Verification of NAV for ULIPs ...

- Confirm change in the rating for debt securities are tracked and effected in the master on immediate basis as it impacts valuation.
- Mark-up/mark-downs in the yields for debt valuation –
 - ⊙ Is in accordance with the Valuation Policy
 - ⊙ Reasons for mark-up/mark-down are recorded with appropriate reasons,
 - ⊙ Presenting the same to investment committee on periodic basis

Verification of NAV for ULIPs ...

■ **Mistake prone area**

- ⊙ Missed trade
- ⊙ Incorrect valuation of non traded security
- ⊙ Corporate action recording missed on ex date
- ⊙ Corporate actions not valued
- ⊙ Rating change in security not updated

Areas require special Attention -

■ Valuation –

- Securitised debt – particularly when there is change in the cash flow
- Thinly traded equities
- Valuation post merger/de-merger

Verification of NAV for ULIPs ...

- Income accrual on non-performing assets by mistake
- When new security masters created in the System and CRISIL Bond Valuer and any modifications to the existing security masters
- Change in the rating of debt Security
 - Verify the change in the rating of the non G Sec debt security is correctly captured in the security master of CRISIL Bond Valuer (CBV) as well as accounting software
- Valuation of non investment grade Debt security

Corporate Actions

- These are unilateral actions by the issuer and no action is required on the part of the investor company.
- Considering this nature it is possible to miss the corporate action all together for accounting and valuation
- Need to understand the impact of corporate action on the market value of the security
- This impact needs to be compensated by the corporate action accounting and valuation.
- Entitlements vary in nature and therefore need to understand the embedded value of the entitlement.

Accounting of Corporate Actions ...

WARRANTS

- A share warrant entitles the holder to buy specified number of shares at specified future date at a specified price
- Whenever company announces a warrant entitlements, those needs to be recognized in books at Zero cost.
- If warrants gets traded on exchange, it needs to be valued at traded price. Else by a formula (Ex-right price – warrant exercise price)
- As warrants are exercisable at future date, appropriate discount to be applied to the market value of the underlying share.

Case Study - valuation of non traded warrants

Sadbhav Engineering Ltd. declared corporate action of 3 warrants for every 20 shares held. Warrants were exercisable after 3 months at Rs. 425/- to receive one share each. Shares of Sadbhav Engineering Ltd. were traded at around Rs. 1,240/- on June 16 i.e. on Ex date . Market price was around Rs. 1,360/- on June 15.

Suggested Valuation

Market price – exercise price i.e. - (Rs. 1,240/- less Rs. 425/-) = Rs. 815/-

Appropriate discount is to be applied to recognize the lock in of 3 months for realizing the embedded value of warrant (i.e. market price less exercise price). Say 5% - 10%. The valuation would be in the range of Rs. 730.

Review of Reconciliations

Daily and fortnightly

- Investment reconciliation between records of the insurer and the custodian records
- In case of unit linked schemes, Unit reconciliation between accounting records and the policy admin system, on daily basis
- Reconciliation of investment bank accounts on daily basis
- Reconciliations of corporate actions and review of follow up for recovery of over dues on fortnightly basis

Identification of Non-Performing Assets and Provisioning

Quarterly

SCOPE

- NPAs are correctly classified and provisioning has been made on the basis of norms prescribed by IRDA vide circular No. 32/2/F&A/Circulars/169/Jan/2006-07 dated January 24, 2007

AUDIT PROCESS

- Review the process at insurer for recognition of NPA and system support for the same
- Review of outstanding interest and redemptions
- If the security has become NPA, verify the provision made as per IRDA norms
- No further income has been accrued on the security
- Reporting to IC
- Correct reporting in Form 7 to IRDA

Addition to the scope as per IRDA (Investment) (Fifth Amendment) Regulations, 2013

Reconciliations of premium received as per UIN and SFINs Daily

SCOPE

- To verify if the insurer has reconciled through the system the premium received (net of charges and benefits paid) under each product (Unique Identification Number – UIN wise) with value of all the segregated fund(s) (Segregated Fund Identification Number – SFIN wise) net of fund management charges, held under a single UIN, on a day to day basis, during the quarter

AUDIT PROCESS

- Confirm that the reconciliation is carried on daily basis
- Confirm that the reconciliation is carried out through system
- Any differences in reconciliations have been duly addressed

Reconciliation of units as per PAS and IAS Daily

SCOPE

- To verify whether w.r.t. each Segregated Fund [including Discontinued Policy Fund (DPF)], reconciliation of “Units” has been made between Policy Admin System (PAS) and Investment Accounting Systems (IAS) through a fully automated system using process integrators to ensure seamless data transfer without manual intervention.

AUDIT PROCESS

- Confirm that the reconciliation is carried on daily basis
- Confirm that the reconciliation is carried out through system
- Any differences in reconciliations have been duly addressed.

Discontinued policy funds

Monthly/Quarterly

SCOPE

- To verify whether the Insurer's Policy Admin System (PAS) is 'automated' for tracking 'policy-wise', information of discontinued policies along with the information of the particular ULIP fund to which the same pertains .
- Is there any shortfall/deficit in meeting the Discontinued Policies Fund (DPF) liabilities. If yes, has the Insurer provided for such shortfall /deficit on a quarterly basis
- DPF to be formed and managed as ULIPs and investment to be made only in G.Sec. and money market securities

AUDIT PROCESS

- Confirm that policy-wise details of DPF provided by PAS match with Investment Accounting system
- In case DPF is for traditional fund, ALM report to be seen to confirm if there is a shortfall. In case it is a ULIP fund, confirm that NAV is more than face value.
- For newly discontinued policies, insurers have formed new DPF which is a ULIP fund

Review of IRDA returns

Quarterly

- Following returns are filed with IRDA by Life Insurance companies

Form 1	<i>Statement of Investment and Income on Investment</i>
Form 2 Part A Part B Part C	<i>Statement of Downgraded Investments, Details of Rated Instruments, Investment assets & infra investments- rating profile (Life fund)</i>
Form 3A Part A Part B Part C Part D Part E	<i>Statement of Investments Assets (Life Insurers) Compliance to investment pattern at SFIN level Statement of NAV of Segregated Funds Statement of Accretion of Funds Statement of Investment Details of ULIP Products to Segregated Funds</i>
Form 4 (Part A)	<i>Exposure/Prudential and other investment norms –compliance certificate</i>
Form 4 (Part B)	<i>Internal / Concurrent Auditor's Certificate on Investment Risk Management Systems - Implementation Status</i>

Review of IRDA returns ...

Quarterly

- Following returns are filed with IRDA by Life Insurance companies

Form 4A (Part A, B and C)	<i>Statement of Investment Subject to Exposure Norms – Investee Company, Group, Promoter Group, Industry Sector</i>
Form 5	<i>Statement of Investment Reconciliation</i>
Form 5A	<i>Statement of Mutual Fund investments</i>
Form 6	<i>Certificate under sections 28 (2A), 28 (2B) and 28B (3) of the Insurance Act, 1938</i>
Form 7	<i>Statement of Non performing Assets</i>

Review of IRDA Returns

AUDIT PROCESS

- Refer IRDA Guidance Note on preparation of investment returns to confirm that all the computations have been made in the manner specified in IRDA guidance note
- Confirm that all returns are prepared through system
- Independently compute all the components of the returns and compare the same with the returns provided by the insurer
- Generally this verification is carried out before submission of the forms to IRDA i.e. within 45 days of the quarter end.

Follow up of earlier reports

Quarterly

- Follow-up actions/corrective actions for the following reports to be tracked as per the timelines stated therein and commented
 - IRDA Inspection Reports
 - Previous Internal/Concurrent Auditor's Report- for the first time
 - Certification of implementation of investment risk management systems and processes.
 - Implementation of directives of Board, Audit Committee, Investment Committee and IRDA
 - Audit observations of previous audit period

Outsourcing of Investment related functions One time

SCOPE

- Outsourced activities relating to investment operations is in accordance with IRDA circular INV/CIR/08/2008-09 dated August 22, 2008.

AUDIT PROCESS

- One time review of the investment function to assess whether any investment related activity has been outsourced by the Insurer (other than custody). If NAV accounting or Investment advisory services are outsourced then verify that -
 - ⊙ AUM is not more than 500 cr. and it has not completed 2 years of operations from the date of Registration by issue of R3 by IRDA.
 - ⊙ Fees charged are not borne by policy holders funds

Audit Report



REPORTING

- Impact of observations at system level, if any
- Gaps and Inconsistency observed, if any, in SOPs & suggested amendments
- Regulatory & Internal breaches

SPECIFIC CONFIRMATIONS FOR

- Adherence to outsourcing norms
- Primary data centre for investment management system is in India
- Automated systems are in place for complying with exposure norms
- IP has been approved by the Board and reviewed periodically
- Risk parameters are identified and reported
- Compliance with derivative guidelines
- Review of performance of the products by the Board
- UIN-SFIN reconciliations has been carried out on daily basis through the system
- Disclosure of NAV on insurer and Life Insurance Council website
- Books have been maintained at SFIN level

Audit Report

- Reconciliation of units as per PAS and IAS is carried out on daily basis through the system
- Segregation of Front Office, Mid Office & Back Office
- PAS is automated to provide policy-wise details of discontinued policies
- Compliance with Act and Regulations w.r.t. investments
- IRDA returns have been prepared through system as per Guidance Note on preparation of Investment Returns" issued by IRDA
- Bank and securities reconciliations have been prepared on day to day basis
- Compliance with model code of conduct to prevent Insider/personal trading
- Compliance with inter-fund investment norms
- Deficit/shortfall in DPF has been dealt with
- Progress on implementation of Investment Systems & Processes as committed to IRDA by the Insurer

Thank You