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SUPPLEMENTARY GUIDANCE NOTE ON THE IMPACT OF COVID-19 AND FUTURE STRATEGIES FOR INTERNAL AUDIT OF GENERAL INSURANCE COMPANIES

THE INSTITUTE OF COST ACCOUNTANTS OF INDIA

Statutory Body under an Act of Parliament

Behind every successful business decision, there is always a CMA

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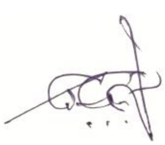
PREFACE

The Institute of Cost Accountants of India had brought out the Guidance Note on the Internal Audit of General Insurance Companies and the same was released in January 2020 at the Global Summit. The same was well received by Industry and members of the Institute. In March 2020 the World Health Organization (WHO) declared the spread of Corona Virus or COVID-19 as a pandemic spread. In India due to spread of COVID-19 Pandemic and resultant LOCKDOWN of nearly 8 weeks, the economic activities in the country had come to agrinding halt and meanwhile the world economy also faces a decisive recession due to COVID-19 and growing unemployment. The value of investments began shrinking. To contain the economic slowdown, the Government of India had taken a number of steps. IRDA also quickly acted and issued various orders and guidance to the Indian Insurance Industry for operation post Covid.

In view of this lockdown and commencement of new normal economy, it was felt that a Supplementary Guidance Note: may also be added to the existing one, taking into consideration the latest developments in the economy, for the benefit of the members doing Internal Audit of General Insurance Companies. While preparing this supplementary guidance note, the latest guidelines of the IRDA and GoI are taken into account. Hope the Insurance Industry and Members will receive these supplementary guidance note overwhelmingly as done to the main guidance note.



CMA Chittaranjan Chattopadhyay
Chairman
Banking and Insurance Committee
The Institute of Cost Accountants of India

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CHAPTER 1

INTRODUCTION

1.1 BRIEF OF THE SCENERIO

The COVID-19 pandemic was inflicting high and rising human costs worldwide. Protecting lives and allowing health care systems to cope have required isolation, lockdowns, and widespread closures to slow the spread of the virus. The health crisis is therefore having a severe impact on economic activity. As a result of the pandemic, as well as recessionary trends in world economies, IMF (April 2020) predicted that the global economy is projected to contract sharply by (–)3 percent in 2020, much worse than during the 2008–09 financial crises. In a baseline scenario, which assumes that the pandemic fades in the second half of 2020 and containment efforts can be gradually unwound, the global economy is projected to grow by 5.8 percent in 2021 as economic activity normalizes, helped by policy support. There is extreme uncertainty around the global growth forecast. The economic fallout depends on factors that interact in ways that are hard to predict, including the pathway of the pandemic, the intensity and efficacy of containment efforts, the extent of supply disruptions, the repercussions of the dramatic tightening in global financial market conditions, shifts in spending patterns, behavioral changes (such as people avoiding shopping malls and public transportation), confidence effects, and volatile commodity prices. Many countries face a multi-layered crisis comprising a health shock, domestic economic disruptions, plummeting external demand, capital flow reversals, and a collapse in commodity prices.

1.2 EFFECTOF COVID-19

In India, following the COVID-19 outbreak, the economic activities of the country came to a standstill and almost 8 week Lockdown was implemented. Road, Rail and Air Transports were stopped. The values of risk assets collapsed and market volatility spiked. Expectations of widespread unemployment, reverse movement of labor, liquidity crunch, virtual absence of economic activities, forced wages without productivity, loss of tax revenue to government due to the above effects are some of the threats to the Indian Economy. Several factors amplified asset price moves: previously overstretched asset valuations, pressures to unwind leveraged trades, dealers' balance-sheet constraints, and deterioration in market liquidity. Emerging market economies experienced the sharpest reversal of portfolio flows on record. As a result, financial conditions tightened at an unprecedented speed. It is expected that there would be a lot of issues on non-life insurance sectors which also suffered due to these financial effects. In the present chapter it would be discussed what are the threats post COVID-19 Lockdown and how they can be overcome with opportunities and it is for the Insurance Companies to utilize them. In the following chapters it is discussed the specific segments in which more issues would arise and how the internal audit would tackle the same and advise the companies.

1.3 POST COVID-19 LOCKDOWN SCENARIO:

1.3.1 THREATS

Post COVID-19 Lockdown, in India, it is expected that the economic activity would pick up from scratch. On the one side there would be reduction in Income at the same time there would be a lot of opportunities availablein the new normal economy especially in Insurance Sector. It is expected the new normal life would change the economic activities as a lot of enterprises would force their existing work-force to do Work Form Home (WFH) for many time thus paving way for lesser transport cost. The unproductive human cost for all most 8 weeks had spiked the economic growth. There was virtually no production in the entire months of April 2020 and to a major extent in May 2020. The working capitals of most of the enterprises were already spent on idle wages/salaries in these days. Moreover, there is huge carrying cost of inventory for almost 2 months apart from lot of work-in progress in various industries lying idle. It is feared that some stock/ goods (both raw material as well as under process) may detoriate in quality and cannot be utilised. Fear of cancellation of export orders are also there.

The Net Asset Value of their Investment funds had already shrunk due to volatility in stock and bond markets and some of the investments would be downgraded due to revised corporate rating of bonds and debentures in which these Insurance Companies had invested the shareholders as well as policy holders' funds. Some may also lose their solvency margins also.

1.3.2 OPPORTUNITIES:

As state above, though there were threats to the Insurance Industries, there is vast scope that these threats can be converted into opportunities by them in this new normal economy. In the new normal economy there bound to be pick up of economic activities as it is expected some industries may relocate from China to India which would further employment. There would be demand for inclusion of unspecified diseases in the treatment portfolio in the health insurance sector and the premium may go up. The fear of footing bills for treatment of hitherto unknown diseases like COVID-19 would force many to opt for Health Insurance. This would increase the coverage of health insurance from the present 100 million families to atleast 150 million families. Apart from the Union Govt.'s coverage of health sector, the States would also increase their share in spending in health sector which would promote more number of institutions offering health care which would increase the competition. Similarly, in other Insurance products, there would be scope for more coverage.

In the following chapters the risks involved due to COVID-19 and LOCKDOWN to Insurance Industry policies especially under Fire, Engineering, Health, Motor Marine, Investments and Reinsurance along with the checks an Internal Auditor has to do and report would be discussed.

CHAPTER 2

GENERAL INSURANCE

2.1 INTROUDCTION

The details of how the non-life Insurance policies were managed and the checklist for auditor to examine the items to be verified in audit were discussed in the Guidance Note of Internal Audit of General Insurance Companies. Due to Lockdown, IRDAI had issued directions to the life Insurance companies that any premium due in March 2020 would automatically be extended upto 3 May 2020. As far as non-life insurance policies are concerned IRDA issued specific orders for some type of policies to regulate them. Therefore the claims may arise even the original normal date of expiry. In this chapter, the additional areas where the Internal Auditor's exercise on COVID-19 and LOCKDOWN claims to be checked are discussed below.

2.2 STANDARD FIRE & PERILS

Normally the following claims are admissible in a Fire Insurance Policy if add on premium was paid. The circumstances are

a. Terrorism
b. Removal of debris
c. Spoilage and Material Damage
d. Leakage and contamination
e. Earth quack.

Similarly, the claims of following types are not admissible in Fire & Perils policies.

a. Spontaneous combustions fermentation
b. Burning of property by public authority
c. Explosion of boilers
d. Total or Partial cessation of work
e. Permanent and temporary dispossession by order of Government
f. War and warlike operations

The above are only illustrative.

A detailed audit approach was discussed in Chapter 5 of the Guidance Note. The auditor should verify the following claims relating to COVID and Lockdown period which may arise to which the insurance companies can regulate.

a) As per policy conditions, the spoilage or material damage to the raw material/process stock was allowable or not?

b) If so whether add on premium was received to cover the peril

c) (The claims may arise due to raw materials spoilage due to long storage or detoriation in quality). The insured had taken adequate care in storage of raw materials both at storage as well as at shop floor or not. If not the claim is not admissible.

d) (The cessations of operations were due to Government order). Therefore, the claims on detoriation in stocks due to stoppage could not be entertained.

e) Similarly, no loss of profit for the stoppage period could be entertained as the stoppage was not of any insured perils.

f) After stoppage, and restart of manufacturing facilities, certain breakdown may occur and combustion may also occur as in case of some chemical companies. Therefore while regulating the claims, Audit would examine, whether proper operating procedure was followed by the insurer to restart the facilities.

g) The insured assets were not utilised during the lockdown period. Therefore, the policy normally lapses if an asset is not utilised for more than one month. But the same were exempted by insurers. Hence Auditor should check the admissibility of the claims if any.

2.3 INDUSTRIAL ALL RISK POLICIES

These policies are normally covered under Fire policies. The Scope of the Policy are under two sections Section 1 covers Fire, Burglary, theft Machinery Breakdown, Boiler explosion etc., Section 2 covers consequential Loss (Fire Loss of Profit) and Machinery Loss of Profit. However, the inadmissible claims are as detailed below.

- Interruption loss due to failure of gas, electricity and water supply

- Collapse or cracking of buildings
- Larceny fraud or dishonesty
- Wilful negligence on the part of the insured
- War group of perils
- Nuclear group of perils and
- Destruction of property by public order
- Faulty design of materials, workmanship and construction

The following losses would not be covered in the Industrial all risk policies.

- Lack of sufficient capital with the Insured
- Any restrictions imposed by public authorities
- Loss of business due to cancellation of order/Lease
- Damage of boilers machinery etc.,

Loss of profit claims should exclude indemnity for lockdown period

2.4 MACHINERY BREAKDOWN POLICIS.

The losses arising of Machinery Breakdown were insured normally. The replacement cost is also covered in these policies.

Partial Loss: Full cost of parts plus labour charges plus to and fro charges including duties and taxes if any for dismantling, repairs and reerection charges for the affected machinery

Total Loss: Actual value of items before the occurance of loss less appropriate depreciation. If under insured, they may be regulated by applying average clause.

Against this, the following claims are not admissible.

- Fire and allied perils
- War and warlike operations
- Wilful act or gross negligence, existing defects, normal wear and tear and consequential loss and
- Loss or damage under manufacturers' warranty.

A detailed audit approach was discussed in Chapter 4 of the Guidance Note. Normally the following types of claims are admissible for Machinery Breakdown policies. The auditor should verify the following claims relating to COVID and Lockdown period which may arise to which the insurance companies can regulate.

a) Due to prolonged non-operation and non-maintenance, the Machinery after lockdown may on start would breakdown and production may affect. The insured should take adequate pre-operation protectiveness like overhauling the machinery, lubrication, maintenance etc., before commencement of operations as well as to follow the standard operation procedure issued by Ministry of Home Affairs. Therefore the Auditor would check for any such claims, whether the insured had followed proper procedure before commencement of operations which resulted in breakdown.

b) The above same procedure may also be adopted for checking the LOP claims for Machinery Breakdown.

2.5 HEALTH INSURANCE POLICIES

The detailed audit methodology for Health Insurance Policies was discussed in Chapter 6 of the Guidance Note for Internal Audit of General Insurance Companies. Due to outbreak of COVID-19, IRDA had issued guidelines (24^{th}March 2020) and in its subsequent guidelines directed that all the health insurance policies should cover the treatment under existing Health Insurance Policies. Also these policies were validated till the end of Lockdown. This means that all the policies which should have been terminated on due dates from 24 March 2020 till the end of the Lockdown is extended to be live. Though the treatment of COVID is done mostly at government health centres/ hospitals, very few private hospitals were added for treatment of COVID. Therefore the auditor has to verify the following

a. Auditor should examine whether the policy is in force at the time of issue of IRDA order or not to allow the claims.

b. Wherever the claims on COVID treatment is there, it should be verified whether the hospital was authorised by the Government to treat COVID and the rates charged are as per Governments' fixed rates.

c. Also the auditor has to verify whether the claims were honoured quickly as per the directions of IRDA.
d. Auditor can verify the reasonableness of premium rates fixed for new policies covering COVID like health issues.

2.6 MARINE INSURANCE

The Marine Hull Policies Marine Cargo (International) policies are regulated not only by Indian Insurance Act, IRDA guidelines, but also on International laws. The detailed audit methodology for Marine Insurance Policies was discussed in Chapter 8 of the Guidance Note for Internal Audit of General Insurance Companies. Hence no separate additional guidance is issued here for Marine Hull Policies. But for the Marine inland Cargo they were mostly affected due to Lockdown. Normally marine cargo is of two type namely open cover and open policy. Open cover is used in international trade. Our concentration for additional guidance note is for open policy. It was underwritten with a condition that the total annual value of goods transported would be of a specific value and distance and for each consignment the maximum value of goods and distance to be transported were specified. Marine policies with specific destination with period and value are also issued.

As per Media reports, it was feared that goods worth nearly Rs. 15000 crore were loaded into the trucks before lockdown for transportation and nearly 30 to 40 per cent of them were either not started from their place of origin or place of destination. Rest were on road. The media reports confirmed that most truck drivers have left the vehicles unattended and returned to their home. So the safety of the goods as well as the vehicles is in question. Some goods might have been lost due to theft, evaporation, detoriation of quality, damaged goods etc., and the claims have to be acknowledged. Therefore, the auditor has to examine the following:

a. For claims in all types of policies, it has to be examined whether the policy was in force or extended to be in force.
b. If any claim had occurred, it has to be examined whether the claims were reported in time with proper police FIR, Etc.
c. There may be constrains in appointing Loss assessors due to LOCKDOWN. Hence the auditor has to examine how the loss was assessed and claim paid.

d. Auditor should also examine whether the Insurance Company had taken over the damaged goods exercising right of subrogation and also made claims with the transporter.
e. The claims on the transporter by that Insurer would be dealt in Motor Policy guidelines.

2.7 MOTOR INSURANCE:

The detailed audit methodology for Motor Insurance Policies was discussed in Chapter 7 of the Guidance Note for Internal Audit of General Insurance Companies. In the following paragraph, the audit approach on the claims arising out of outbreak of COVID-19, and its after effects of LOCKDOWN were discussed. This is mainly restricted to Four Wheelers and Goods Transport Vehicles. For all kinds, Government of India vide gazette notification dated 1 April 2020, ordered as follows.

"The policy holders whose motor vehicle third party insurance policies fall due for renewal during the period on and from the 25th March, 2020 up to the 14th April, 2020 (which was subsequently extended) and who are unable to make payment of their renewal premium on time in view of the prevailing situation in the country as a result of Corona Virus disease (COVID-19), are allowed to make such payment for renewal of policies to their insurers on or before the 21st April, 2020 to ensure continuity of the statutory motor vehicle third party insurance cover from the date on which the policy falls due for renewal.".

Therefore the Auditor has to examine the following.

a. In case of renewal during this period, whether subsequent renewal was made by the vehicle holder after lockdown to renew the policy was made or not to be studied
b. IF any claims arising during these periods, it has to be checked whether the claim was only for Third party.
c. If any own claim was admitted for this period, it has to be checked whether the policy was in force or not.
d. Similarly, in case of Goods Transport Vehicles, any claims arising out during this period has to be regulated according to the policy conditions only.

2.8 REINSURANCE

The detailed audit methodology for Reinsurance Policies was discussed in Chapter 10 of the Guidance Note for Internal Audit of General Insurance Companies. World economic outlook (April 2020) predicted a worldwide recession in the world economy and estimated a negative GDP growth between 6 to 16 per cent. But it predicted a positive growth of less than one per cent for India. Due to recession, the value of financial assets is losing value and investments were downgraded. In the light of the above, it is feared many Reinsurers especially CBRs may lose their solvency margins or capital adequacy to participate in the Reinsurance Programs. Also it is feared that some of them may fail in their obligation to honour claims on them. In view of the above, the audit approach on the claims arising due to the economic situation in the world financial markets is prescribed as additional guidance note.

a. In case of new treaties, audit would examine whether the CBRs are adequate solvency margins or capital adequacy
b. Audit would examine whether the Insurer had adequate knowledge of the past history of the CBRs.
c. Audit would examine the history of past receivables from CBRs
d. Audit would examine the monthly/quarterly review of the financial positions of the CBRs to cede
e. As per IRDA'S (Assets & Liabilities, Solvency Margin) Regulations 2016, the Insurance companies are allowed capital gearing treaties in various forms including Quota Share Reinsurance Treaty. Since based on the examination by IRDA, it was found that these treaties were of financial arrangements and not a primarily risk transfer arrangement as reinsurance. Therefore IRDA banned such arrangements w.e.f. 28-3-2020. Therefore, Auditors have to examine such treaties and how they are detrimental to the reinsurance arrangements have to be brought out.
f. Audit would examine the steps taken by the Insurer to improve its solvency and capital adequacy to increase their retention.

2.9 INVESTMENTS:

The detailed audit methodology for Investments by Insurance companies was discussed in Chapter 10 of the Guidance Note for Internal Audit of General Insurance Companies. In view of a shocking world economic survey by IMF in April 2020 and IRDA's directions in March and April 2020, it was felt that the following additional areas the Auditor has to examine.

a. IRDA had authorised the Insurance Companies to give three months moratorium for term loans advanced by them. Audit would examine whether the Insurance Companies have charged Interest for these moratorium period
b. Audit would further examine whether these term loans were rescheduled for the three months period and asset classification was done accordingly
c. Due to adverse stock market conditions, the value of investments would be down. Audit would examine the effect of such reduction in value and how they were classified between shareholder funds and insurance funds.
d. Due to reduction in Market value of Bonds as well as value reduction in equity, Audit would examine the capital adequacy of the Insurance Company and its retention capacity.
e. IRDA has advised all the Insurance companies that in view of the prevailing financial market conditions, it is advisable not to declare dividends for the year 2019-20 and increase the reserves to shore up the capital adequacy in the declining value of Investments. The audit would therefore examine in case of dividend declared, the adequacy of capital of the company is sufficient to meet future obligations.

The above additional points are only indicative and based on the latest circulars issued by IRDA in March and April 2020 and the Auditor has to update his checklist depending upon the operations of the respective companies as well as further guidelines by IRDAI.

CHAPTER 3

CONCLUSION

Audit is not complete unless it brings out any suggestions/recommendations for value addition to the organisation. Therefore, at the end of each audit, the Auditor has to give a workable suggestion as value additions based on his observations. The following are some of the areas where auditor can play a vital role in value addition.

1. Strengthening the internal control system
2. Standardisation of terms and conditions of different types of policies
3. Robust methodology in fixation of premiums for various policies
4. Standardisation of discount policy
5. Strengthening claims management and control
6. Strengthening Receivables Management in Reinsurance
7. Robust methodology in selection of TPAs
8. Robust methodology in selection of Investment Managers and Brokers
9. Robust methodology in selection of Reinsurers
10. Appropriateness in fixation of Retention money.

It is pertinent to mention here that the Insurance Industry is a dynamic one and the Internal Auditor has to update his knowledge with change of time as well as update his databank of IRDA orders and circulars issued from time to time to update his checklist and risk assessment.

References

1. ***IMF's Global Economic Outlook (April 2020)***
2. ***Circulars and guidance issued by IRDA during March and April 2020***

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