DEPARTMENT OF ECONOMIC AFFAIRS-
INSURANCE DIVISION

CHAPTER : X

National Insurance Company Limited
Oriental Insurance Company Limited

Special contingency policies on mobile handsets.

Highlights

Two insurance Companies suffered heavy losses in the issue of tailor made insurance policies because of non-compliance to technical parameters and non-evaluation of risk factors involved.

(Para 10.4)

The failure on the part of the Management to obtain reinsurance protection, ensure the compliance of Insurance Regularity and Development Authority (IRDA)/ General Insurance Public Sector Association (GIPSA) guidelines as well as non-inclusion of the loading clause deprived the Company of the opportunity to reduce its losses in all the Special Contingency Policies (SCPs) issued during 2002-03 to 2004-05.

(Paras 10.5.2, 10.5.3, 10.5.4 and 10.5.6)

In handsets all risk cover issued under SCP on 18 December 2002 to Reliance Industries Limited (RIL), National Insurance Company Limited (NIC) received claims for Rs.91.23 crore upto October 2004 against the premium of Rs.27.39 crore (excluding service tax) realised during December 2002 to October 2004. Out of these, it settled claims for Rs.24.69 crore and the balance claims for Rs.66.54 crore were pending settlement.

(Para 10.5.6)

In the default policy issued to RIL on 25 June 2003, NIC received claims for Rs.152.34 crore against the premium of Rs.55.71 crore realised upto October 2004. Out of these it settled claims for Rs.120.60 crore and the balance claims for Rs.31.74 crore were pending.

(Para 10.6.3)

In the default policy issued to Tata Tele Services Limited on 1 April 2004 NIC received claims of Rs.9.54 crore against the premium of Rs.6.20 crore realised upto October 2004. Out of these, it settled claims for Rs.3.42 crore and the balance claims for Rs.6.12 crore were pending.

(Para 10.7)

In the default policy issued by OIC in August 2003 to RIL for handsets the insured reported 61193 claims for Rs.63.53 crore. The Company had so far settled 18706 claims for Rs.19.64 crore and balance claims involving estimated outgo of Rs.13.81 crore, after taking into consideration repudiated claims, were pending.

(Para 10.8)

NIC failed to arrange the reinsurance protection. With a view to finance the huge flow of claims, it obtained Alternate Risk Transfer (ART) cover from foreign reinsurer and paid Rs.13.38 crore as one time upfront fee. This upfront fee further reduced the already low premium income.

(Para 10.9)

10.1 Introduction

General Insurance business is traditionally divided into Fire, Marine and Miscellaneous. Miscellaneous insurance includes in its scope Special Contingency Policy (SCP) or tailor-made policy. The risks associated with 'Mobile handsets', which could not be covered under the standard policies, were covered under SCP. SCP covers were issued to dealers and manufacturers.

The Mumbai Divisional Offices of the National Insurance Company Limited (NIC) issued two policies in 2002-03 and 2003-04 respectively to the Reliance Industries Limited, Reliance Infocom Limited and its associates (hereinafter referred to as RIL) and one policy to Tata Tele Services Limited during the year 2004-05 and the Mumbai-based Divisional Office of the Oriental Insurance Company Limited (OIC) also issued a policy during the year 2003-04 to RIL to underwrite the risks associated with mobile handsets without careful evaluation of the risk involved and other technical aspects, which resulted in heavy losses to these companies.

10.2 Scope

The review of the insurance cover issued by the Mumbai-based Divisional Offices of NIC and OIC during the years 2002-03 to 2004-05 to cover the risks related to mobile handsets under SCPs was conducted during the period from September 2004 to November 2004.

10.3 Audit Findings

An analysis by Audit of the insurance policies under SCPs revealed that they were devised primarily to suit the requirements of the insured, without safeguarding the insurers' interest owing to non-adoption of the prudent underwriting guidelines as brought out in the succeeding paragraphs.

10.4 Non-evaluation of technical aspects

Before issuing the SCPs, all the operating offices were required to comply with the following technical parameters to ensure that the risk would not make the rating unviable:

(i) Prior sanction of the Reinsurance Department of the Company to be obtained before acceptance of risks beyond the prescribed limits, as advised by Reinsurance Department from time to time.

(ii) The excess clause[♣] must be clearly indicated against each item or section.

(iii) Basis of sum insured i.e. whether market value, reinstatement, replacement, non-recoverable cost etc. as applicable, to be indicated to avoid disputes.

[♣] ***Excess clause means that part of loss, which would be borne by the insured in order to avoid high frequency low value losses/claims to be paid by the insurer.***

(iv) In case of non-standard products/risks like financial risks, asset protection and stock exchange risks, the pricing, terms and conditions should be in line with the requirement of reinsurer as contemplated in the Company's reinsurance programme.

However, an analysis in audit revealed that during the course of finalisation of terms and conditions of policy documents for the issue of insurance cover for SCP for the mobile handsets by the operating offices of NIC and OIC, the above-cited instructions were not complied with as brought out in paragraphs 10.5.2 to 10.5.4, 10.6.1 and 10.6.3.

10.5 Handsets all risks cover with RIL

The Kalyan Divisional Office (D.O) under the Mumbai Regional Office (R.O)-I of NIC, issued a SCP for mobile handsets on 18 December 2002 to RIL, which was valid for three years, based on a Memorandum of Understanding (MOU) signed on 6 December 2002 with RIL. It covered the risk of physical loss or damage to the mobile handsets necessitating repair and fraudulent use consequent upon misplacement/theft, suffered by the persons to whom the mobile handsets were sold by the insured, subject to a maximum of Rs.12,000 per accident. Premium at the rate of 0.25 per cent per annum was charged on the declared sum insured.

The salient features of the MOU were as under:

(i) The policy was issued with the concept of periodical increase in sum insured by progressive coverage.

(ii) Either side (insurer or insured) might cancel the policy by giving seven days notice in writing.

(iii) The insured would undertake periodic declaration of invoice number, date of sales, value, and details of customer (name, city) to the insurer;

A review of the MOU referred to above revealed that the following important guidelines were not followed by the operating offices:

10.5.1 Approval from Head Office:

As per NIC's guidelines issued in March 1999 the power to develop a new product under SCP was retained with the Head Office of the Company. The Kalyan D.O. based on MOU dated 6 December 2002 with RIL, devised a new SCP to cover the loss or damage to the mobile handsets involving repair and fraudulent use. Being a new product, it required approval of headquarters before its implementation. However, this was not obtained before its implementation.

Besides this, as per Company's guidelines all fresh proposals under SCP where the sum insured exceeded Rs.50 lakh were to be referred to Head Office for approval. However, Kalyan D.O issued the above-cited SCP for mobile handsets for the sum insured of Rs.6.50 crore with a clause that sum insured would increase with subsequent sales of mobile handsets upto the expiry of period of the policy i.e. 17 December 2005. As the sum insured had far exceeded the prescribed limit of Rs.50 lakh, the Kalyan D.O, by not obtaining prior approval of Head Office, had exceeded its powers.

10.5.2 Re-insurance protection:

The Company every year draws up its reinsurance programme for various classes of risks in order to fix retention limit of risks commensurate with its financial strength. Insurance Regulatory and Development Authority (IRDA) guidelines also stipulate that the maximum loss retention should not exceed five per cent of the networth of the Company. However, the D O did not make any reference to Re-insurance Department for taking reinsurance cover. In the absence of this, the risk retention limit could not be calculated. The sum insured as on 31 October 2004 was Rs.3850 crore (and would increase further as validity of the policy was upto 17 December 2005). Thus, there was no reinsurance to protect the Company's risk except 20 per cent obligatory share of risk accepted by the General Insurance Corporation (GIC). The GIC allowed 25 per cent commission on premium received on account of obligatory reinsurance.

10.5.3 Absence of risk analysis

As per IRDA guidelines NIC was to indicate how the products would be priced, the database that would be used to determine the premium basis and the terms and conditions and the statistical system that would be established to review the adequacy of rates. NIC did not make any exercise based on statistical data of similar industry to evaluate the adequacy of rating and risk involved.

10.5.4 Absence of viable clause of loading.

As per General Insurance Public Sector Association (GIPSA) guidelines circulated by the Company in June 2001, the rates quoted were to be suitably loaded based on claims experience of each year so as to bring the incurred claim ratio to 70 per cent in case of adverse claims. However, the policy was issued on long-term basis for three years without inclusion of above-cited clause, which ultimately made the rating of the policy unviable.

10.5.5 Inaccurate pricing

In March 1996 the Company formulated a scheme for wholesalers/dealers/manufacturers for normal coverage of damage and theft of mobile phone on trial basis for a period of one year at a suggested rate of 0.25 per cent per annum. Although the scope of risk involved in the SCP for handsets policy issued to RIL was increased to cover the new element of loss due to fraudulent act in addition to normal losses on account of damage and theft of mobile phone, the Divisional office of NIC did not charge any premium for the additional coverage of risk. This resulted in extending undue benefit to the insured.

10.5.6 Non-invoking of cancellation clause

As per clause eight of the MOU entered into between NIC and RIL there was a provision for cancellation of policy by giving seven days notice to the insured. Despite the number of deficiencies in the implementation of the terms and conditions of the MOU, NIC did not invoke the cancellation clause. The reasons to justify the non-invoking of the cancellation clause were not available in the records made available to Audit.

The technical department of Head Office observed in February 2003 that the operating office should have included a suitable clause for rapid obsolescence of the equipment and fall in its market price, unexplained losses/malicious act and settlement of claims on market value basis after deduction of depreciation. By not referring the above policy to

Head Office for their technical concurrence, the above-cited aspects were left out of the policy conditions.

The failure on the part of the Management to obtain reinsurance protection as well as non-inclusion of the loading clause deprived the Company of the opportunity to reduce its losses. As a result of this, against the premium of Rs.27.39 crore (excluding service tax) realised during December 2002 to October 2004, it received claims for Rs.91.23 crore upto October 2004. Out of these, claims for only Rs.24.69 crore were settled and the balance claims for Rs.66.54 crore were pending settlement. On the basis of paid/outstanding claims after taking into account premium ceded and commission received on account of reinsurance the Company had suffered a loss of Rs.63.84 crore (NIC Rs.49.70 crore and GIC Rs.14.14 crore).

10.6 Default policy issued to RIL

Based on another MOU entered into between NIC and RIL on 25 June 2003, the Kalyan DO issued an SCP to RIL to cover the default liability risk in respect of mobile handsets for the period from 25 June 2003 to 24 June 2006. The premium rate per handset/connection was charged at Rs.100 (including eight per cent service tax). The scope of cover included net ascertained financial losses arising out of telecom services of the insured and/or cost of the handset from default due to fraudulent activity of the subscriber subject to a maximum loss of Rs.11,000 per handset. The fraudulent activity included default of periodical payment/dues by the subscriber for any reasons whatsoever. Further, the parties had no option to cancel the policy during the validity period of the policy.

A review of records relating to the underwriting of the risk under this default policy revealed the following deficiencies that led to huge losses to the Company:

10.6.1 Non-conventional Policy

The SCP for handsets issued in 2002 covered the risks of damage/theft suffered by the users on account of fraudulent use of the handsets consequent on misplacement/theft. The Kalyan D.O, based on the MOU signed in June 2003, devised a new product enlarging the scope of risk. The cover was given to RIL with sum insured of Rs.5500 crore to indemnify their financial loss on account of default of periodic payment/ dues by the subscribers for any reasons including fraudulent activity. This type of non-conventional policy covering financial risk was issued for the first time in the Indian market. Despite the substantial increase in the amount of the sum insured over the prescribed limit of only Rs.50 lakh, the Kalyan D.O in this case also did not obtain the approval of Head Office before issue of SCP for default cover for handsets. Thus, the same D.O exceeded its powers in issuing the above-cited cover.

In this context the Head Office of NIC also observed while reviewing the policy in March 2004 that any non-conventional, tailor-made or contingency proposal should not have been committed without its authorisation and more serious thought should have been given and prudence should have been observed in ascertaining the aggregate risk exposure.

10.6.2 Absence of reinsurance protection

As already mentioned as per IRDA guidelines and the Company's reinsurance programme, the Company, before undertaking any cover, must obtain reinsurance

support. However, the Kalyan D.O. in the instant case of 'Default cover policy' also did not take any reinsurance protection before issue of the policy, even though the aggregate sum insured was Rs.5,500 crore.

10.6.3 Deficiencies in MOU

(a) No clause for cancellation

In the earlier MOU (December 2002) entered into between NIC and RIL, there was a clause for cancellation of policy by giving seven days notice in writing by either side. In the MOU dated 25 June 2003, however, this condition was excluded. Thus, the Management had forgone the right to take any remedial action. As a result, the Company would be bound to accept claims under policy endorsements issued upto 24 June 2006.

(b) No provision for loading and periodic review

Despite the Head Office specific instructions of February 2003 that the SCP in any case should be renewed on yearly basis, this provision was not considered in the MOU entered into with RIL in June 2003. The default policy was issued to RIL for three years without any provision for periodic review of premium including loading factor for adverse claims.

(c) Risk coverage beyond the scope of MOU

The D.O. had also extended the risk coverage to coloured handsets by charging premium of Rs.140 per set (including service tax) with a sum insured of Rs.24,000 per set and thereby increased the total sum insured from Rs.5,500 crore to Rs.6,150 crore, even though no such provision existed in the MOU.

(d) Absence of excess clause

No excess clause to limit the overall loss amount was included in the MOU in order to minimise/restrict the loss of the Company.

In view of the deficiencies narrated above, NIC received claims for Rs.152.34 crore against the premium of Rs.55.71 crore upto October 2004. The Company settled claims for Rs.120.60 crore and the balance claims for Rs.31.74 crore were pending. Though the currency of policy was three years, the liability of the Company would extend beyond the stipulated period as each policy endorsement carried coverage period of three years from the date of issue. As such the Company would be liable for any future default/claims upto June 2009. On the basis of paid/outstanding claims after taking into account premium ceded and commission received on account of reinsurance the Company had suffered a loss of Rs.96.63 crore (NIC Rs.74.51 crore and GIC Rs.22.12 crore) upto October 2004.

The request of the Management to RIL for enhancement of premium in April 2004 stating that pricing done was not proper considering the nature of risk and that the magnitude of loss would reduce the networth, substantiated the audit findings.

10.7 Default Policy with TATA TELE Services Limited

While the Company had already suffered huge loss in underwriting the default cover of RIL at a very low premium as mentioned above, the Mumbai based Divisional Office under the same Regional office entered into MOU on 1 April 2004 for a three year period with TATA TELE Services Limited for giving default cover similar to the cover given to RIL. The premium rate was Rs.92 (excluding service tax at fixed rate) for one year

instead of three years in the case of RIL. In the issue of insurance cover to TATA TELE Services Limited also NIC committed the deficiencies as brought out in paragraphs 10.6.2 and 10.6.3 (a) and (d).

NIC had received claims of Rs.9.54 crore, against the premium of Rs.6.20 crore realised upto September 2004. The Company had settled claims for Rs.3.42 crore upto October 2004 and the balance claims for Rs.6.12 crore were pending, based on settled/outstanding claim position after taking into account premium ceded and commission received on account of reinsurance the Company had suffered a loss of Rs.3.34 crore (NIC: Rs.2.37 crore and GIC: Rs.97 lakh) on this policy. This indicated that the company had been venturing to underwrite risks even though it was clear that this would be a loss-making portfolio.

10.8 Default Policy issued by the Oriental Insurance Company Limited

The Oriental Insurance Company Limited (OIC) also agreed (August 2003) to underwrite the default insurance policy covering the period from 1 August 2003 to 31 July 2006 with RIL at the agreed rate of Rs.92+ Service Tax of eight per cent. In the issue of default policy cover to RIL, OIC committed the same deficiencies as brought out in paragraphs 10.6.1, 10.6.2 and 10.6.3 (a) and (b) viz. not obtaining approval of H.O., absence of reinsurance protection, non-inclusion of cancellation clause and non-provision for periodic review.

The gist of OIC replies (December 2004) to paragraphs 10.6.1, 10.6.2, and 10.6.3 (a) and 10.6.3 (b) and the audit comments thereon are given below:

(i) While accepting the fact that such cover was issued for the first time OIC stated that the policy was issued by the Regional Office (RO) after exercising due diligence and the detailed information was sent to Head Office for information and necessary action

The above contention of OIC is not tenable as many claims were subsequently found to be false and were repudiated due to non-existence of the subscribers at the given addresses. Inclusion of persons who had not subscribed to Reliance mobile services substantiated the fact that due diligence was not exercised by the Company before the issue of the policy to the insured.
Further, the contention of OIC that the detailed information was sent to Head Office for information and necessary action is also not acceptable as in the absence of the details as to when the matter was referred by the R.O. to the Head Office (H.O.) and the action by the H.O. thereon before the issue of the policy, the correctness of the facts stated in the Management's reply could not be verified in Audit. Some suggestions sent by the H.O. after the issue of the policy i.e. on 9 August 2003 on inclusion of the cancellation/claim procedure clauses were also found not complied with.

(ii) The contention of the Management with regard to para 10.6.2 that the Company did not take reinsurance protection before the issue of the policy cover as it treated each connection as an independent risk and not as an aggregate risk is not tenable because sum insured under SCP for 'Default Insurance Cover' issued to RIL-Mumbai for Rs.6150 crore covering 50 lakh mobile handsets substantiated that the risk was treated as an aggregate risk and not as an independent risk. Further, the total risk under the policy which is spread all over the country is similar to floater policy where-under aggregate of risk is considered as a single risk irrespective of their location. On the analogy of floater

policy approval from competent authority should have been taken, considering need for reinsurance and underwriting the aggregate risk.

(iii) In reply to para 10.6.3. (a), the Management stated that they had included the cancellation clause to protect their interest. The above contention of the Management is not correct because as per terms of the cancellation clause included in the insurance policy the insurer and the insured had agreed to waive any right of cancellation of the insurance agreement for a period of three years. Thus, the option for cancellation could be exercised only after expiry of three year period of the policy. It shows that the Management cannot cancel the insurance policy during the currency of policy to protect its interest.

(iv) In reply to para 10.6.3. (b), the Management stated that since it was the first policy of its kind underwritten by them it did not have the features like review, which was normally incorporated on renewal of a policy if claim experience was adverse. The above contention of the Management is not acceptable because as per the general rules and regulations of insurance no insurance may be granted for a longer period than one year. Thus, the Company should have included the provisions for review of the premium/ adverse claim ratio on yearly basis instead of for three years.

The business results available upto December 2004 indicated that the Company could get premium of Rs.17.02 crore (excluding service tax). The insured reported 61193 claims of the total handsets for Rs.63.53 crore covered under the default cases upto November 2004. Out of 61193 claims reported, verification of 53670 claims was carried out by the investigator appointed by the Company upto February 2005 by incurring an expenditure of Rs.3.76 crore. Based on verification report of the 53670 claims given by investigator, the Company repudiated 29,334 claims for Rs.30.08 crore on the grounds of (i) non-existence of addresses (3278 claims) (ii) non-existence of persons at the given address (16289 claims), (iii) persons not subscribed to Reliance Mobile (5438 claims), (iv) persons moved away from the given address (3345 claims) and (v) continuance of mobile service even after default (984 claims) and settled 18706 claims of Rs.19.64 crore in aggregate. The balance 13,153 claims of Rs.13.81 crore were outstanding for want of further verification.

Based on the current claim settled/outstanding after taking into account premium ceded and commission received on account of reinsurance, OIC has suffered a loss of Rs.16.05 crore (including investigation charges) and GIC a loss of Rs.4.14 crore.

10.9 Alternate Risk Transfer

The Alternate Risk Transfer (ART) cover is generally taken where substantial losses are apprehended. The main object of ART cover is risk financing and not risk-sharing. The default cover policies were given to RIL without any reinsurance protection. After steady flow of claims, the Company searched for reinsurance protection but could not arrange any conventional reinsurance. Ultimately, through broker, it could obtain non-conventional risk financing under ART protection from foreign reinsurer. Under the ART cover, insurer (NIC) would require to pay back the entire amount received from reinsurer to settle claims within two to three years to smoothen the effect on balance sheet.

NIC paid Rs.13.38 crore to the reinsurer as one time upfront fee. This upfront fee further reduced the already low premium income. In ART, the caps for number of mobile phones and recoverable loss were kept at 50 lakh and Rs.482.03 crore respectively. So, the

probable loss, which the company would suffer as per its own estimation under this policy, worked out to Rs.482.03 crore.

The Chairman and Managing Director of NIC in reply to the Ministry mentioned (April 2004) that the Company was facing loss in the default liability policy (Reliance Infocom Limited). He added that the claims might far exceed the premium collected. Since no traditional cover was available in the international market, the Company opted for a non-traditional cover known as ART. Efforts were being made to impress upon RIL for additional premium for ART cover.

The lapses in the policy are further substantiated by the fact that the concerned Regional Office approached the Head Office for conventional reinsurance protection after experiencing huge flow of claims. The Company, as per guidelines, should have undertaken the risk only after obtaining the conventional reinsurance protection.

Thus, failure on the part of NIC/OIC to extend SCPs on mobile handsets without risk analysis and reinsurance protection resulted in loss of Rs.65.79 crore (including investigation charges) and liability of Rs.118.21 crore on account of pending claims. On the basis of paid/outstanding claims and expenses, NIC and OIC had so far suffered loss of Rs.142.63 crore (NIC Rs.126.58 crore and OIC Rs.16.05 crore) and made GIC suffer loss amounting to Rs.41.37 crore.

10.10 Inadequate internal control system

As per IRDA guidelines the Company was required to formulate the procedure and norms with regard to underwriting and policy issue for the pricing of new products, claims processing and settlement. The Financial Advisor of NIC observed (September 2004) that the system of internal control existing in the Company was ineffective and inadequate and needed to be strengthened.

In reply NIC while admitting the facts and accepting the deficiencies as pointed out in Audit stated (March 2005) that the new default liability cover of RIL was perceived by them as an opportunity to get into the big account of Reliance Group. The Management agreed with all the recommendations made by audit and assured that the authority to issue SCP, Tailor made policy and long term policy would be centralised at Headquarters to safeguard the interest of the Company.

10.11 Conclusion

While underwriting the non-conventional policies, which had serious financial implications, the operating offices did not exercise due diligence and caution and did not ensure the compliance of guidelines issued by IRDA, GIPSA and H.O of NIC/OIC which resulted in huge loss amounting to Rs.142.63 crore (NIC Rs.126.58 crore and OIC Rs.16.05 crore) and made GIC suffer loss amounting to Rs.41.37 crore. No responsibility has been fixed for the Regional/Divisional Offices having exceeded their powers and exposing the Companies to such heavy risk and loss.

10.12 Recommendations

(a) There is urgent need to ensure that all the instructions issued by IRDA, GIPSA and Head Office are complied with by all the operating offices through better Management Information System.

(b) The terms and conditions of the insurance policies for the new products should be formulated by incorporating suitable clauses for premium loading and for periodical review of policy so as to ensure that rating of the policy does not become unviable.

(c) The internal control system needs to be strengthened in order to ensure that the recurrence of such cases is avoided.

(d) The matter needs to be investigated thoroughly and appropriate departmental and legal action taken.

The para was issued to Ministry in December 2004; its reply was awaited (March 2005).