

43rd India Fellowship Seminar

Date: 13th-14th Feb 2025

When numbers tell a different story

(Investment Case Study : Professional)

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Agenda

- Synopsis
- Applicable PCS/APS/Regulations
- Professional Issues observed in the case study
- Recommendation
- Conclusion

SYNOPSIS



Synopsis

- Mr. X (Current CIO) is an Investment Actuary with extensive experience in equity and bond investment. A big life insurance company appointed him as Chief Investment Officer.
- Mr. Y (Previous CIO) just retired from the job of CIO after serving more than a decade in that position in the company. During his tenure, he made the company 'No 1' in investment performance as compared to the competitors, based on an internal comparison chart.
- During the review of the company's internal investment performance comparison chart, Mr. X discovered that the data is not entirely accurate. Some adjustments were made to make company's performance look better and competitors' performance look worse.

Synopsis



- When Mr. X confronted Mr. Y, he defended the adjustments, claiming they were necessary to present the company in a positive outlook, which contributed to the company's business growth and there was nothing wrong with some minor adjustments in the interest of the company. Also, CEO was cognizant of these adjustments.
- Mr. X discussed the issue with the CEO, who confirmed his awareness of these adjustments. He justified them by arguing they were needed to secure business and ensure good bonuses for senior management, and that no harm was done to policyholders, as all benefits are paid as per policy documents.

Key Points to Address

- Ethical dilemma faced by Mr. X i.e. whether to continue using the adjusted comparison chart or not
- What are the various professional issues observed ?
- Recommended Actions with possible implications, if any

Applicable PCS/APS/Regulations



Applicable PCS/APS/Regulations

- **Professional Conduct Standards (PCS)**
 - Integrity
 - Impartiality
 - Report of misconduct
- **Actuarial Practice Standard (APS) 34: General Actuarial Practice**
 - Materiality
 - Disclosure
 - Process Management
- **Master Circular on Corporate Governance for Insurers, 2024; *read with* Schedule-III of IRDAI (Actuarial, Finance & Investment Function of Insurers) Regulations 2024**
 - Investment Committee (IC)
 - Nomination & Remuneration Committee (NRC)

Professional Conduct Standards (PCS)



➤ Professional Standard (PCS 2.1)

- The actuarial profession has an obligation to serve the public interest within the context of building and promoting confidence in the work of actuaries and in the actuarial profession.
- Collectively it seeks to do so by informed contribution to debate on matters of public interest and by influencing those with power to protect and enhance the public interest.
- Individually members must maintain and observe the highest standards of conduct.
- The standing of the actuarial profession depends on the judgement of the individual members.

Professional Conduct Standards (PCS)



➤ Professional Standard

- PCS 2.2: Members have a duty to the actuarial profession and clients and must always act honestly and with integrity.
- PCS 2.3: Clients are entitled to have absolute confidence in the skill, objectivity and integrity of any member.
- PCS 2.4: Healthy debates and expressing different opinions on matters of professional interest are good for the betterment of the actuarial profession. However, such debates and opinions must demonstrate due respect and must not bring disrepute to the actuarial profession or other members or the professional body. Members must be aware of the requirements of confidentiality and must respect the same.

Professional Conduct Standards (PCS)



➤ Confidentiality

- PCS 3.2.2: Free to disclose confidential information if it is in the public interest to do so, in some circumstance, if it is for the actuary's own protection.

➤ Standards of Advice

- PCS 4.1: An actuary is expected to use best judgement in formulating advice and must have proper regard to any relevant professional guidance or other guidance.

Professional Conduct Standards (PCS)



➤ Compliance with standards (PCS 5.3): Misconduct

Actions to be taken on discovering a misconduct by another member

- PCS 5.3.1: On becoming aware of any misconduct by another member, a member must take appropriate action at the earliest opportunity.
- PCS 5.3.2: If the member decides that the nature of the misconduct is such that action is called for, the member could, in the first instance, consider discussing the apparent misconduct with the other member. Possible objectives of having such a decision include:
 - PCS 5.3.2.1: Seeking more information about the matter, so as to form a view whether there has actually been a misconduct; and/or
 - PCS 5.3.2.2: To explore whether the matter is one where the misconduct can either be mitigated or be rectified entirely by the other member taking remedial action.

Professional Conduct Standards (PCS)

➤ Compliance with standards (PCS 5.3): Misconduct

- PCS 5.3.3: If the member does not consider a discussion to be appropriate, or if the matter is not resolved to the satisfaction of the member as a result of such discussions, then the member must refer to the professional body as prescribed by the applicable rules.

Professional Conduct Standards (PCS)



➤ Impartiality

- PCS 6.1: Actuaries must ensure that their professional judgement is not compromised, and is not seen to be compromised, by any bias, conflict of interest or the undue influence of others.
- PCS 6.7: Financial rewards which are large in relation to the professional time spent, including success related or contingency fees, can threaten objectivity and thus contravene the general requirements of the Professional Conduct Standards. Accordingly, actuaries are advised to exercise extreme care in determining whether to accept such rewards or fees and must ensure that they are appropriate in the circumstances of the advice given and that there is no conflict with the requirements for professional objectivity.

APS-34 : General Actuarial Practice



- **2.2 Knowledge of Relevant Circumstances** - The actuary should have or obtain sufficient knowledge and understanding of the data and other information available, including the relevant history, processes, nature of the business operations, law, and business environment of the subject of the actuarial services, to be appropriately prepared to perform the actuarial services required by the assignment.

APS-34 : General Actuarial Practice



➤ **2.4 Materiality** - In case of omissions, understatements, or **overstatements**, the actuary should assess whether the effect is material. If the effect of any of these is material, **the actuary should disclose this in any report to which it is relevant**. The threshold of materiality under which the work is being conducted should be determined by the actuary unless it is imposed by another party such as an auditor or regulator or the principal. When determining the threshold of materiality, the actuary should:

- **2.4.1: Assess materiality from the point of view of the intended user(s), recognizing the purpose of the actuarial services; thus, an omission, understatement, or overstatement is material if the actuary expects it to affect significantly either the intended user's decision-making or the intended user's reasonable expectations**

APS-34 : General Actuarial Practice



- **2.5.3 Sources of Data for Assumptions** - To the extent possible and appropriate when setting assumptions, the actuary should consider using data specific to the organization or the subject of the actuarial services. Where such data are not available, relevant, or sufficiently credible, the actuary should consider industry data, data from other comparable sources, population data, or other published data, adjusted as appropriate. The data used, and the adjustments made, should be described in any report.
- **2.5.4 Data Modification** - The actuary should disclose any modification of data before its use (such as interpolation, extrapolation, adjustment, or discarding of outliers) in any report.

APS-34 : General Actuarial Practice

➤ 2.7.1 Selection of Assumptions and Methodology

- The actuary should consider to what extent it is appropriate to use assumptions or methodology if they have a known significant bias to underestimation or overestimation of the result.

➤ 2.11 Process Management

- 2.11.1: Process Controls - The actuary should consider to what extent, if any, the procedures used to carry out the work should be controlled, and if so, how.
- 2.11.2 Reasonableness Checks - The actuary should review the results produced by the selected assumptions and methodology for overall reasonableness.

APS-34 : General Actuarial Practice



➤ 2.14 Retention of Documentation

- 2.14.1: The **actuary should retain**, for a reasonable period of time, **sufficient documentation** for purposes such as peer review, regulatory review, **audit**, compliance with law and assumption of any **recurring assignment** by another actuary
- 2.14.2: Documentation is **sufficient** when it contains enough detail for another actuary qualified in the same practice area to understand the work and **assess the judgements made**.

➤ 3.2.2 Disclosure The actuary issuing a report should **disclose in that report**, if applicable:

- (d) Any data validation (2.5.2.), **adjustments** (2.5.3.), modification (2.5.4.), and deficiencies (2.5.5.)

Master Circular on Corporate Governance for Insurers, 2024 *to be read with* Schedule III of IRDAI (Actuarial, Finance & Investment Function of Insurers) Regulations, 2024



- Corporate Governance is understood as a system of financial and other controls in a corporate entity and broadly defines the relationship between the shareholders, Board of Directors and management.
- In case of the financial sector, where the entities accept public liabilities for fulfillment of certain contracts, the relationship is fiduciary; with enhanced responsibility-
 - to protect the interests of all stakeholders (i.e. policyholders, shareholders and public) with a high level of care, loyalty, and prudence
 - to ensure that entities' actions are guided by integrity, transparency, and accountability

Investment Committee

- The Board can consider setting up of various Committees (such as mandatory Investment Committee (IC), Nomination & Remuneration Committee (NRC) etc.) by delegating daily functions. However, overall corporate responsibility for directing the affairs of the insurers shall be with the Board.
- Every insurer shall constitute mandatory (IC) which shall consist of a minimum of two non-executive directors of the Insurer, the CEO, CFO, CRO, CIO and the AA.
- IC shall be responsible for implementing the Board approved Investment Policy and laying down operational framework for investment operations; encompassing various aspects such as liquidity, compliance with investment prudential regulatory norms, risk management/mitigation strategies to ensure commensurate yield on investments but above all protection of policyholders' interests.

Continued....

- The Investment Committee shall:
 - formulate an effective reporting system to ensure compliance with the policy set out by it
 - meet at least once in a quarter to review investment operations and submit a report to the Board on the performance of the investment portfolio with regard to its safety and soundness.
- The Board shall review on quarterly basis the monitoring of fund wise and in respect of each life-insurance product the following minimum:
 - i. new business scale planned versus actual at the end of the period1 to maturity
 - ii. expenses projected versus actual
 - iii. persistency / renewal premium streams projected versus actual
 - iv. claims - projected versus actual
 - v. actual yield versus projected yield or returns
 - vi. action plan and follow up status

Remuneration of Key Management Persons



- **NRC** shall formulate and adopt a comprehensive Board approved remuneration policy ensuring that:
 - All KMPs are covered (CEO/MD, AA, CIO, CRO, CCO, CFO etc.) and annual pay structure is divided into Fixed + Variable
 - KMPs are not encouraged to take inappropriate/excessive risks for their performance based variable remuneration
 - Remuneration is adjusted for all types of risk; and payouts are sensitive to time-horizon of risk and symmetric with risk outcomes
- Various minimum parameters prescribed in Circular for determination of performance assessment of KMPs for variable incentives such as net-worth position (NWP), solvency, growth in AUM, EV, VNB etc.
- These parameters constitute significant weightage in performance assessment matrix; at least 60% for CEO/MD and 30% for other KMPs

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- The **deterioration** in the financial performance of the Insurer and the **other defined parameters** shall lead to a contraction in the total amount of **variable pay which may even be reduced to zero**.
- The NRC framed remuneration policy is required to:
 - put in place appropriate modalities **to incorporate claw-back mechanism** in respect of **Variable Pay**, taking into account relevant statutory and regulatory stipulations as applicable.
 - confirm **existence of Claw-back clauses** in the employment contract of **all KMPs**
 - identify a representative set of situations, which require insurers to invoke the claw-back clauses which may be applicable to the entire Variable Pay
- **Gross negligence, integrity breach, materially inaccurate financial statements due to the result of misconduct including fraud, poor compliance in respect of corporate governance and regulatory matters, etc.**, by the KMPs shall invite immediate and prompt action of the board and the management

Professional Issues Observed in the Case Study



Issue 1: Adjustments in comparison charts

Issues



Some ‘adjustments’ were made to show the company’s investment performance look better and other companies’ performance look bad. But Mr. Y believed that the adjustments were minor.

Applicable standards



- As per APS 34 (2.4), Mr. Y should have assessed any understatement/ overstatement of the adjustments to validate their **materiality**. The adjustments are not actually ‘minor’ as it made other companies’ performance look bad.
- As per APS 34 (2.5.4), Mr. Y should have **disclosed** any modifications of data in the internal comparison chart.
- As per PCS 2.2, Mr. Y has a duty to the profession and the Company; and must have acted **honestly with integrity**.

Issue 2: Justification of Adjustments by Mr. Y

Issues



Mr. Y stated that the adjustments had shown the company in a better light which also increased the business. He also believed that the adjustments were minor, not wrong and in the interest of the company. The CEO was cognizant of the adjustments.

Applicable
standards



- As per PCS 2.1, Mr. Y has an obligation to serve **the public interest**. Individual members must maintain and observe **highest standards of conduct**.
- When Mr. Y was confronted, instead of a **healthy debate** he justified these adjustments for the interest of the company which contravenes the PCS 2.4.
- Mr. Y has been compromised in his **professional judgement by bias/influence** to increase the business or get influenced by any other stakeholder (in this case the CEO) which contravenes PCS 6.1

Issue 3: Bonuses of Senior Management

Issues



The CEO confirmed that he was aware of the adjustments. He said that those adjustments were needed to get business and good bonus to Senior Management (KMPs)

Applicable standards



- Mr. Y was part of KMPs and was influenced by **financial rewards** (i.e. good bonuses) rather than public interest; which contravenes the general requirements of PCS 6.7
- As per the Corporate Governance guidelines, **variable remuneration** of CEO and other KMPs should be made dependent on various performance metrics (including NWP, VNB, AUM etc.) so that genuine efforts are made for ensuring business growth and returns to shareholders.
- But manipulating these metrics to incentivize KMPs is **against the good corporate governance practices** expected by IRDAI

Issue 4: No harm to Policyholders

Issues



Applicable
standards



The CEO said that no harm was done to policyholders as Company would pay all the benefits to policyholders as per the policy document

- The adjustments have led to an increase in business so, they seem to be **material** enough for significantly affecting the **intended user's decision-making or reasonable expectations**[APS-34 (2.4.1)]
- Justifying the adjustments by saying that *policyholders are not financially harmed* is not completely correct; as reasonable expectations must have been formed about company's outstanding investment performance by both existing and prospective policyholders
- As per Corporate Governance guidelines, the relationship in financial sector is fiduciary so **interest of all stakeholders** should be protected (not just existing policyholders)

Display of Adherence to Standards by Mr. X

- As per APS34 (2.2), Mr. X has **obtained the knowledge and understanding** of the data/adjustments to perform the actuarial services he has been appointed for.
- As per PCS 2.1, Mr. X has shown **integrity** and taken effort to serve the **interest of the public** when he was aware of the adjustments
- As per PCS 5.3.1, on becoming aware of a **potential misconduct**, Mr. X has taken **appropriate actions** at the earliest.
- As per PCS 5.3.2, he **sought more information** about the adjustments and discussed the misconducts with Mr. Y and the CEO
- As per PCS 6.1, Mr. X has demonstrated his **impartiality** and not be biased by the influence of Mr. Y and the CEO

Applicable
standards



Ethical Dilemma for Mr. X

Using Adjusted Charts

Long Term Risks :

- Loss of Trust
- Ethical breach:
Compromises
Professional Integrity
- Legal Risks
- Reputational Risks
- Regulatory Scrutiny

Short Term Benefits :

- Maintains top ranking in investment performance
- Attracts Business
- Increases Bonuses



Using Unadjusted Charts

Long Term Benefits :

- Ensures Transparency
- Builds Trust
- Avoids Legal and Reputational Risks
- Strengthens Credibility

Short Term Challenges:

- Possible drop in ranking
- Resistance from Leadership
- Temporary Business Impact

Recommended Actions



1. Independent verification by Mr. X

- Conduct an in-depth review of the investment comparison chart.
- Analyzing the validity of adjustment calculations
- Compliance with the guidance in any applicable actuarial standard.
- Quantify the impact on financial position if this adjustment is completely removed
- Assess whether the effect is material: if it's affected significantly either the intended user's decision-making or the intended user's reasonable expectations
- **Provide an opinion** - highlighting in the report about the discrepancies i.e. adjustments -flagging the point of disagreement with sufficient evidence.

2. Communication with Investment Committee (IC)

- As per Corporate Governance guidelines; formulating an effective reporting system; ensuring safety & soundness of investment performance and its regular monitoring is a **joint responsibility of all IC members**; not just CIO and CEO.
- So, Mr. X should initiate written communication with all IC members indicating the concerns with adjustments in investment comparison chart.
- Adjustments misrepresent actual results and do not align with ethical and actuarial standards.
- While this adjustment may help the business in short term, it is important to **emphasize the potential risks** and need for transparency.
- Mr. X should discuss how accurate and ethical reporting can improve **long-term business prospects and trust with stakeholders**.

3. Transition to an alternative measure

Proposing an alternative (proxy) adjustment measure which meets following criteria:

- Clear, robust and benchmarked as per Industry-standards
- Ensures fair and reliable comparisons across competitors
- Provides more **accurate and true** reflection of company's performance, ensuring fairness without any distortions.
- Full & transparent **disclosure of the adjustment** measure at places where it can get adequate attention of the intended user [APS-34 (2.5.3, 2.5.4, 3.2.2)]; e.g. as a footnote to the chart.

4. Improvements in Process Management



- **Process controls** to be put in place so that final adjustments are reviewed and approved by *Investment Committee* and *Audit Committees* on a regular basis [APS-34 (2.11.1)]
- Overall **reasonableness checks** around assumptions and methodology should be exhaustive and justified; so that inappropriate adjustments are flagged at validation stage [APS-34 (2.11.2)]
- Sufficient **documentation** to be retained for future audit purpose and assessing the judgements made behind adjustments [APS-34 (2.14)]

5. Reporting of misconduct [PCS 5.3]



- Mr. Y (previous CIO) is guilty of professional misconduct due to breach of PCS (2.1, 2.2, 2.4, 6.1, 6.7 etc.) and APS-34 (2.4, 2.5, 3.2.2 etc.)
- So, the misconduct can be **reported to the professional body** as prescribed by the applicable rules i.e. The President of Institute of Actuaries of India. [PCS 5.3.3]
- The report can include:
 - Detailed documentation of incorrect adjustments and undue influence with supportive evidence, even if it's confidential (PCS 3.2.2).
 - Impact assessment - How these adjustments misrepresent the company's position
 - Steps taken internally to rectify the issue before escalation.
 - Request for guidance on ethical compliance and corrective actions

6. Report to Nomination & Remuneration Committee (NRC)



- Concern regarding the company's performance-based variable remuneration structure for Key Managerial Personnel (KMPs).
- Identified potential misrepresentation of investment performance to achieve bonus-linked targets.
- Corporate Governance: KMPs are not encouraged to take inappropriate or excessive risks for their performance based variable remuneration
- **Proposed Actions :**
 - Should we revise KMP remuneration to mitigate undue risk-taking?
 - Introduction of deferral and claw back mechanisms.
 - Independent validation of investment performance metrics before disbursing variable remuneration

7. Whistle Blower Policy: Last Resort

- As per Corporate Governance guidelines, insurers shall put in place a “whistle-blower” policy, where-by:
 - mechanisms exist for employees to raise concerns internally about possible irregularities, governance weaknesses, financial reporting issues or other such matters.
 - any employee can report in confidence directly to the **Chairperson of the Board** or of a Committee of the Board or to **the Statutory Auditor**.
- If concerns raised by Mr. X with the members of IC and NRC do not lead to appropriate solutions, escalation can be done through the Company’s Whistleblower Policy to Auditors and Chairperson of Board.
- *Because Statutory/ internal auditors* also have the duty to ‘whistle blow’, i.e., to report in a timely manner to **IRDAI** if they are aware that the insurance company has failed to take appropriate steps to rectify a matter which has a material adverse effect on its financial condition.

Conclusion



- Insurance is a business of trust and fiduciary relationship amongst all stakeholders, hence regulatory and professional compliance extremely important.
- But when compliance ends, ethics take over - the difference lies in knowing what you have a right to do and what is right to do
- Given the circumstances of the case study:
 - Mr. Y (Previous CIO) is guilty of professional misconduct due to breach of PCS and APS-34 at multiple points
 - Mr. X should independently assess the real need to make adjustments
 - If needed, Mr. X should get a consensus from all members of IC on alternative adjustment measure which shows true and fair picture to all stakeholders; and should be adequately disclosed
 - NRC/Board should be approached to design Variable pay structure of KMPs to avoid incentives from such unreasonable adjustments in future

THANK YOU

