Fund Of Funds: A Source Of Investment For Insurance Companies
written by Akshay Ramesh | July 12, 2021

Fund Of Funds: Finance is, undeniably, the life and blood of business. What is also undeniable is the fact that finance or money is dynamic and fluid in nature. And while it is important to keep your assets active, it is equally important to do so in a careful manner. Money uninvested is idle money but money invested improperly courts the risk of financial loss. Every business entity must focus on good financial management in order to achieve the optimum utilization of its resources.

Money’s dynamic nature is what fuels the business of banks, insurance companies and other such entities in the investment sector since they can pursue capital market investment interests with the aid of financial assets invested by customers. Broadly speaking, banks and financial institutions do not have any restrictions or specifications regarding the instruments in which they must invest their financial resources. This is not the case with insurance companies. They can invest only in approved sources of investment as specified in Sections 27A, 27B and 27C of the Insurance Act 1938. However, there has been a recent update to this Act which modifies this restriction slightly. The Insurance Regulatory Development, vide its notification April 8th 2021[1], has allowed insurance companies to invest in a “fund of funds”. To understand this notification and what it means, it is important to first understand the mechanisms of the insurance sector.

Mechanism Of Insurance Sector

As we all know, insurance is a contract where the insurer undertakes to indemnify the loss or damages incurred by the insured in return for a consideration called a premium. The premium can be on a monthly or yearly basis depending on the subject matter of insurance.

This leads us to another question: how can insurance companies make a profit if they are indemnifying losses suffered by insurers? Is such a profit based on the premium amount itself or something else?

As mentioned earlier, money ought never to be static and the entities which run the business of dealing with money must constantly invest it in some or the other. The same applies to insurance businesses. As such, insurance companies cannot make profits just by collecting premiums from the insured and keeping it in safe custody. Thus, to answer the question asked above, insurance companies tend to invest in various kinds of investments to compensate for the loss or damages suffered by the insured.

Laws Governing Investment In Assets By Insurance Companies

Generally, insurance companies are governed by the provisions of Sections 27A, 27B and 27C of the Insurance Act 1938. Sec 27A provides the exhaustive list of investments in assets permitted to be made by insurance companies. whereas Sec 27B and Sec 27C provide for restrictions on the assets to be invested in by the companies.

However, vide a circular dated August 14th 2000[2], the Insurance Regulatory Development Authority of India enacted IRDAI (Investment) Regulations 2000 regarding the sector in which an investment can be made.

Further amendments were made to the above notification vide a master circular dated May 5th 2017[3], wherein there was an expansion to the scope of investment as the circular allowed for investments in Alternative Investment Funds (AIF).

The circular did not include any information regarding 'fund of funds' within the ambit of Alternative Investment Funds at that point in time but, in the recent circular dated April 8th 2021[4], IRDAI has allowed the investment in a fund of funds.

What Are Alternative Investment Funds And Fund Of Funds?

Alternative Investment Funds, as the name suggests, do not refer to conventional financial assets such as stock, equity, debt etc., however, the funds are pooled in from various investors and are invested into diverse financial resources such as real estate, hedge funds, private equity, debt securities and so on. Alternative Investment Funds have been defined under SEBI (Alternative Investment Funds) Regulations 2012 as below[5]:

"An Alternative Investment Fund or AIF means any fund established or incorporated in India which is a privately pooled investment vehicle that collects funds from sophisticated investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors."

Alternative investment funds are divided into the following categories[6]:

- Category-I AIF: These include Venture Capital Funds, SME Funds, Social Venture Funds, and Infrastructure Funds.
- Category-II AIF: These include Real Estate Funds, Private Equity Funds, Funds for distressed assets, etc.
- Category-III AIF: These include Private Investments in Public Equities, Hedge Funds, etc.

On the other hand, a 'fund of funds' refers to a form of investment strategy wherein the funds are invested in various portfolios of financial assets such as stocks, bonds, and other securities. A fund of funds may be "fettered", i.e., it invests only in funds managed by the same investment company, or "unfettered" i.e., it can invest in external funds run by other managers.

What Are The Possible Impacts Of Allowance Of Fund Of Funds In The Insurance Sector?

IRDAI's move in allowing investments in a fund of funds ought to indeed boost the investment in private equity sectors and aid the growth of small business entities.

Further, it should help insurance companies diversify their risk in the investment of assets. This diversification allows insurance companies to retain a certain amount of money invested in other financial assets since the risk factor differs for various financial assets.

With this move, insurance companies have also been provided with an investment opportunity for insurance apart from conventional sources of investment. This should also increase the market value of insurance companies since the fund of funds is a source of investment well-known to the general public.

Endnote

A fund of funds is indeed one of the more reliable sources of investment for the general public as the investment amount does not need to be too high – unlike other conventional financial resources such as equity, debt, etc.

From the perspective of insurance companies, it also enables diversification and risk mitigation to a certain extent, which is always desirable to such entities and other related parties.

One cannot also deny the demerits involved in investing in fund of funds such as the lower returns on investment, the lack of transparency and the high expenses incurred for professional fees. These might turn out to be unfavourable to insurance companies since they will be obliged to bear greater responsibility towards the insured as they occupy the role of risk mitigators towards the insured, as compared to other financial institutions such as banks.

As such, insurance companies will need to make careful, informed decisions and strike a good balance when it comes to the percentage of the amount to be invested in a fund of funds. If the amount of money invested in a ‘fund of funds; is too high, insurance companies could be negatively affected by the demerits mentioned above. On the other hand, if the amount of money invested is too low, the percentage of return will not be satisfactory. So, the investment should be made by the insurance companies taking their financial position and risk factor into serious and prudent consideration before making any investments in a fund of funds.

- [1] https://www.irdai.gov.in/admincms/cms/whatsNew_Layout.aspx?page=PageNo4441&flag=1
- [2] https://www.irdai.gov.in/ADMINCMS/cms/frmGeneral_Layout.aspx?page=PageNo63&flag=1
- [3] http://www.dhc.co.in/uploadedfile/1/2/-1/IRDAI%20-%20INVESTMENTS%20%20MASTER%20CIRCULAR%20IRDAI%20(INVESTMENT)%20REGULATIONS, %202016.pdf
- [4] https://www.irdai.gov.in/admincms/cms/whatsNew_Layout.aspx?page=PageNo4441&flag=1
- [5] https://www.sebi.gov.in/sebi_data/attachdocs/1471519155273.pdf
- [6] https://www.sebi.gov.in/sebi_data/attachdocs/1471519155273.pdf

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