5 June 2014

Circular No. 1 of 2014

Insurance Council of Zimbabwe (ICZ)

Zimbabwe Association of Reinsurance Offices (ZARO)

All Short Term Insurance, Reinsurance Companies and Insurance Brokers

Zimbabwe Insurance Brokers Association (ZIBA)

Guidance on Calculation of Capital and other Related Issues for Short Term Insurers and Reinsurers

1 Preamble

1.1 This Circular is issued in terms of *section 6(c)* of the *Insurance Act [Chapter 24:07]*, which empowers the Commissioner to formulate standards for the conduct of insurance business with which registered insurers may be required to comply.

1.2 The issue of this Circular is pursuant to the need to protect the rights, benefits and other interests of policyholders in terms of *section 5(a)* of the *Insurance Act [Chapter 24:07]*. In addition, this Circular seeks to give guidance on the nature of capital that will be used for the purposes of application of *section 8(2)* of the *Insurance Act*.

1.3 This follows findings by the Commission to the effect that some insurers are "window dressing" their capital positions for the sake of complying with minimum capital requirements, yet the quality of their capital is such that the said capital cannot effectively play its role as required by the Commission as detailed in item 3 below.

1.4 This Circular shall, supersede Circular No. 8 of 2008 and Circular 5 of 2009, and apply to all short term insurers **with immediate effect** pending the development of a robust risk based capital framework.

2 Definition of Terms

Admissible Assets: Assets that shall be considered for the purposes of calculating the solvency of an insurance company.

Capital: The amount of the insurer's total admissible assets in excess of the amount of its liabilities.

Commission: Means the Insurance and Pension Commission established in terms of the *Insurance and Pensions Commission Act [Chapter 24:21]*.

Encumbered Assets: Assets that are owned by one entity, but subject to a legal claim by another. For example assets that will have been pledged as collateral

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security for a loan, assets that are held in an entity under curatorship or under liquidation and an asset which the insurer is suing a counterparty for its recovery.

Inadmissible Assets: Assets that shall not be considered for the purposes of calculating the solvency of an insurance company.

Related Party: Means a person who is not independent, thus he/she -

a) has significant interest directly or indirectly in a class of shares of an insurer;

b) is an entity in which a director or officer of the insurer or person that controls the insurer has a significant investment;

c) is an entity in which a close relative of a person described in (b) has a significant investment; and

d) is an employee of the insurance company in question.

Short Term Insurance/Reinsurance Company – any underwriter who carries any class of insurance business other than life and funeral insurance business.

3 Roles of Capital

3.1 The roles of capital are as detailed hereunder:

a) **Loss-absorbing Function** - An insurer must have adequate unencumbered and admissible capital reserves to cushion policyholders against unexpected losses. Capital must be commensurate with the level of risks assumed and be enough to weather financial storms, which can at times be severe and of considerable duration.

b) **Cushion Against Risks** - An adequate capital base serves as a safety net for a variety of risks to which an insurer is exposed such as underwriting, credit, market and liquidity risks.

c) **Confidence Function** – The higher the capital base the higher the confidence in the insurer by all stakeholders including facultative reinsurers and the public.

d) **Capital as a Regulatory Tool** - One of the key mandates of regulators is to ensure financial stability. Capital allows an insurance company to absorb losses, and in a worst case, allows it to wind down its business without loss to policyholders and without disrupting the orderly functioning of the financial system, thus ensuring financial stability. Solvency ratios have long been a valuable tool for assessing the "stretching" of the business, safety and soundness of insurers and as a floor or benchmark below which there will be significant risks to the policyholders.

e) **Scope for Innovation and Expansion** - Capital ought to provide insurers with financial flexibility. Insurers that are strongly capitalized can take advantage of growth opportunities. Strongly capitalized insurers are better placed in terms of promoting innovation, and providing new products, new services or new distribution channels.

f) **Scope for Higher Retention and Profitability** - A large capital base enables the insurer to retain most of the premium for its net premium account which facilitates the organic growth of the company, the industry and retention of premiums in the country.

4 Qualities of Capital

4.1 For the capital of an insurance company to be effectively used to play the above mentioned roles and thus be considered as being of high quality, it should have the following characteristics:

a) it must substantially be of a permanent nature such as ordinary shares and share premium;
b) it must not impose mandatory fixed charges against earnings;
c) it should not be in the form of borrowed funds;
d) it must be unencumbered;
e) it must allow for legal subordination to the rights of policyholders;
f) The investment of that capital must predominantly be in liquid assets such as money market, treasury bills or other near cash assets; and
g) The capital of an insurance company must not be concentrated in one asset class or issuer. All insurance companies should work towards complying with the investment guidelines stipulated in Circular No. 2 of 2013 which are effective 30 June 2015.

5 Admissible Assets

5.1 For the purposes of calculating capital for an insurance company, as a going concern, admitted assets shall consist of all the insurer's assets, but not including:

a) Operating assets such as motor vehicles, furniture and fittings, and Information Technology (IT) hardware. As an exception, owner occupied properties shall be considered subject to conditions highlighted in 5.3 and 5.4 below. However, in the event where the insurer is winding up operating assets shall be considered in meeting the insurers' liabilities;

b) Intangible assets such as goodwill and software;

c) guarantees given to the insurer and all other off-balance sheet items, other than guarantees given by a reinsurer in the course of reinsurance business;

d) Encumbered assets including assets which are under legal disputes;

e) Assets on which the insurer in question does not have legal title e.g. those assets pledged by shareholders and yet legal title is yet to be transferred to the regulated entity;

f) Premium debtors aged more than **ninety (90) days** from the date when the premiums were debited by non-life insurers. In the case of reinsurers premium debtors aged more than **one hundred and twenty (120) days** shall not be considered;

g) unsecured loans or loans which are, in the Commission's opinion, inadequately secured;

h) Exposures to related parties in form of loans, debentures, or unquoted shares;

i) prepaid preliminary or prepaid organizational expenses such as deferred tax assets and deferred acquisition costs;

j) any admissible assets which shall form an excess over the threshold for a given asset class, as stipulated in Circulars No. 1 and 2 of 2013 when the circular becomes effective, or as prescribed from time to time. In the case of a "gone concern" some of these excess assets shall be considered where possible; and

k) any other assets as may be determined by the Commission from time to time.

5.2 The assets mentioned above are non-admissible for the purposes of calculation of capital since they are not easily and readily available to be used to back insurance liabilities for an insurer on a going concern basis.

5.3 Treatment of all admissible assets shall be as detailed hereunder:

a) **Cash and Money Market Instruments:** For the purposes of calculating solvency of an insurer, 100% of the fair value of these assets shall be considered.

b) **Government Securities/Prescribed Assets**: 100% of the fair value of the securities shall be considered.

c) **Term Deposits**: 100% of the fair value shall be considered. However, insurance companies are free to come up with their own discounts for term deposits in line with the credit rating of their banks and any other factors. If the deposits are held with banks under curatorship or liquidation, such deposits shall not be considered for the purposes of calculating solvency.

d) **Quoted Equities**: Given the volatile nature of equities a discount of 30%, as may be amended from time to time, shall be applied on all quoted equities for insurers. The discount is based on the volatilities of the Zimbabwe Stock Exchange which were measured in terms of the standard deviations of monthly prices of the industrial index and mining index for the period since the inception of the multicurrency regime in February 2009 to March 2014.

e) **Unquoted/Private Equities**: All private equities shall be valued by an independent and qualified professional, subject to the provisions of paragraph 5.4 below annually. Such valuations shall form input into the audited financial statements of the insurance/reinsurance company. Non-marketability and illiquidity discounts of 20% and 30%, as may be amended from time to time, respectively shall be applied on the fair value of all investments in unquoted/private equity. The discounts indicated above are based on international best practice. For example if the fair value of unquoted equities is $100,000, the value of the unquoted equities considered for the calculation of solvency shall be calculated as follows: $100,000 x (1- 0.2)(1-0.3) = $56,000.

f) **Properties**: The insurance companies shall be required to hire independent and qualified valuators to value their properties annually prior to publication of audited financial statements. At a minimum the valuation reports should indicate the market value, replacement cost and the forced sale value, cost per square meter, availability of encumbrances and name of owners as shown on the title deeds.

The value of properties that shall be considered for solvency calculation is the forced sale value. This helps to cater for possible overvaluations of the properties (see also 5.4 below). However, the value consistent with International Financial Reporting Standards as amended from time to time shall be disclosed in the statement of financial position.

g) Receivables other than premium debtors shall only be considered for the purposes of calculating solvency if they are aged less than **sixty (60) days** from the due date. The Commission reserves the right to request schedules of the outstanding payments and details of the debtors, nature of transactions, trading history with each debtor e.t.c.

h) For the other assets whose treatment may have not been detailed in this section, their treatment shall generally be guided by factors highlighted in paragraph 3 and 4 above.

5.4 Where the Commission has reason to believe that the assets are overvalued, it reserves the right to appoint an independent, qualified and accredited valuator to conduct another valuation of the assets of an insurer. Expenses for such a valuation exercise shall be borne by the insurer in question. Valuations conducted by loss assessors and management, related parties or other parties not independent shall not be acceptable for the purposes of assessing the solvency of an insurance company.

6 Liabilities

6.1 The liabilities of an insurance entity for each line of business shall, to the extent possible, and at a minimum, include liabilities determined to allow for:

a) All current claims reported but not yet fully paid (known outstanding claims), including legal and assessment fees associated with the said claims. This shall include full value of all claims that are under litigation as well as legal and other costs associated with the same claims;

b) All claims that have occurred even though they have not been reported (incurred but not reported, or IBNR provision). The IBNR provision shall be calculated as an average of actual IBNR claims as a percentage of Net Written Premiums for at least **five (5) preceding** years, or a minimum of 5% and 10%, as may be amended from time to time, of Net Premium Written for direct insurers and reinsurers respectively, whichever is greater. Other actuarial methods for determining IBNR provisions such as Chain Ladder Method, BornHuetter Ferguson Method etc. shall also be acceptable where they are appropriate given the size, nature, complexity and risk profile of the insurer. However, where the other methods have been used, they should be certified by an independent and qualified actuary. Determination of IBNR Reserve through applying a minimum of 5% or 10% of Net Premium Written, whichever is applicable shall only be used as a last option where there is no scope for use of other methods as explained above e.g. where there is inadequate data;

c) All Incurred But Not Enough Reported (IBNER) claims, for example, in catastrophe insurance, where the claims as initially reported may not adequately reflect the ultimate liabilities, the procedures for estimation of IBNER shall be as follows:

   i. Establish the **estimated cost** of all reported outstanding claims in the preceding reporting periods which should, at a minimum, be **three (3)** years;
   ii. Compare the result in (i) above with the **actual cost** of settling the said claims over the same period and for each period calculate the **excess of the actual cost over the estimated cost** of the claims. Where this value is negative, we take zero;
   iii. On the other hand, establish the actual cost of all settled claims in the preceding reporting periods which should, at a minimum, be **three (3)** years;
   iv. Out of the claims highlighted in (iii) above, identify all reopened claims and their actual subsequent cost. Compute the **incremental value** of the claims after the reopening for each reporting period. Again, where the value is negative, we take zero;
   v. For each reporting period add the result in (ii) to the result in (iv) to establish the IBNER for each reporting period;
   vi. Express the result for each reporting period in (v) above as a fraction of total incurred and reported claims i.e. settled claims and known outstanding claims incurred in the said reporting period. **NB:** The outstanding claims in this case refer to those with loss dates in the current reporting period;

vii. Calculate the average for the reporting periods and multiply the average with the total reported claims for the period under review.

viii. In addition, all insurers should provide for IBNER reserves for catastrophes.

d) Liabilities in respect of future risk periods arising from contractual commitments which exist at the reporting date (for example, in non-life by setting up a provision for unearned premiums (UPR) and, if necessary, for unexpired risk).

UPR shall be determined by consistently applying the normal industry acceptable practices like the 1/365th ,1/24th ,1/12th ,1/8th or any other method acceptable to the Commission. The insurer shall be required to disclose the method it uses to determine its UPR and all changes in the method shall have to be justified and be approved by the Commission.

In addition, every registered insurer conducting insurance business other than life and funeral insurance business shall provide in its financial statements, a provision for Additional Unearned Premium Reserves (AUPR) for each class of business. This reserve shall be provided for where it is likely that the UPR will not be enough to the unexpired risks. For example in the following circumstances:

i. Where the result shows that an underwriting loss or deficit has been made. Such underwriting loss or deficit shall be determined by deducting from net earned premium of that class of business, the claims incurred inclusive of movements in incurred but not reported (IBNR) and IBNER, net incurred commission, a proportion of administrative/underwriting expenses and any other relevant expenses incurred under that class of business;

ii. A major shift in the policy terms and conditions that is likely to result in premiums charged not being enough;

iii. After legislative changes which will result in more claims;

iv. After the occurrence of a risk event affecting a particular line of business;

v. After a change in the social behavior of policyholders, e.g. when policyholders become more litigious.

The Additional Unearned Premium Reserve shall be calculated on the basis of:

i. The weighted average ratio of underwriting deficit as a fraction of Net Earned Premium for that class of business for preceding corresponding reporting periods covering at least three (3) years. The weighting shall be stipulated by the Commission from time to time.

ii. Applying the percentage as determined in (i) above to the closing balance of Unearned Premium Reserve net of reinsurance for that particular class of business to estimate Unexpired Risk Reserve (URR). URR estimates the expected claims from unexpired risks at a given date.

iii. Deduct Unearned Premium Reserves net of reinsurance from the result in (ii) above;

iv. Establish the weighted average ratio of actual underwriting result as a fraction of actual net earned premium in respect of historical periods beyond the end of corresponding reporting dates for at least three preceding years. For example, if the reporting period under consideration is the first quarter of the year ending 31 March, the actual data should be used in respect of historical periods from 1 April to 31 December for at least **three (3)** preceding years. This adjustment helps to account for seasonality of claims;

v. Where the result in (iv) is greater than that in (i) apply it to the Unearned Premium Reserves net of reinsurance for that class of business to determine URR and deduct Unearned Premium Reserves net of reinsurance; AUPR shall thus be the excess of URR over UPR or zero, whichever is greater as shown by the equation AUPR = Max (URR – UPR,0)

vi. The result of (iii) or (v) whichever is greater shall be the AUPR and shall be used to reduce the Net Earned Premium and Increase the Unearned Premium Reserve. However, for regulatory purposes UPR and AUPR shall be reported separately.

e) Any additional shortfall that may be expected because future premiums for future risk periods are known, or expected to be inadequate, even after providing for AUPR;

f) Future maintenance and claim settlement expenses, including the effects of inflation;

g) Where applicable, inflation with respect to the cost of claims. Please not that this refers to inflation within the class of business in question which may not necessarily be the same as the one applicable to the whole economy;

h) Premiums payable to reinsurers. Reversals/write offs for any liabilities in respect of premiums ceded to reinsurers and retrocessionaires, can only be carried out within **sixty (60) days** from the date of inception of the insurance policy in question. Thereafter the reversals shall be subject to the insurer or reinsurer being liable to pay the reinsurer or retrocessionaire, as the case maybe, the premium for the period the said reinsurer or retrocessionaire was on risk. Such premium shall be calculated on a *pro-rata* basis; and

i) Any other factors as may be necessary.

6.2 All the reserves for short term insurance companies that will feed into its annual audited financial statements shall be certified by an independent and qualified actuary. It is imperative that henceforth, all insurers keep data in a format that will allow the determination of the reserves by their actuaries.

7 Enforcement Measures

7.1 After taking cognizance of all the issues raised above, all short term insurers and reinsurers are required to comply with minimum capital requirements stipulated in Statutory Instrument 21 of 2013 and minimum margin of solvency in terms of *section 24* of the *Insurance Act [Chapter 24:07]*, as may be amended from time to time.

7.2 In the event of non-compliance with the above mentioned requirements the insurer in question should immediately:

a) Advise the Commission in writing within **thirty (30) days** from the date when the insurer became aware of the non-compliance; and

b) Submit a concrete recapitalization plan to the Commission for approval within **thirty (30) days**, indicating timeframes within which certain milestones of the plan will have been achieved.

7.3 If the recapitalization plan is not submitted, or the recapitalization plan submitted to the Commission is not approved, or the insurer/reinsurer fails to implement the plan within the specified period, the Commission will take any or all of the following actions:

a) Stop the insurer/reinsurer from writing new business including renewal of existing policies;

b) Publish a notice to stakeholders to the effect that the insurer/reinsurer has been stopped from writing new business;

c) Prohibit the declaration or payment of dividends or any other payments as the Commission may deem necessary;

d) Prohibit disposal of any assets of an insurer/reinsurer;

e) Take custody of any documents from the insurer/reinsurer such as title deeds and share certificates;

f) Disqualify, remove or suspend any person, including a director or senior manager from management of or participation in the affairs of the insurer;

g) Cancel the registration of the insurer/reinsurer in terms of *section 22* of the *Insurance Act [Chapter 24:07]*; and

h) Transfer insurance business to another sound insurance company.

8 Conclusion

8.1 All insurers are required to take note of the guidance in this circular and take necessary action to ensure that they are compliant with the same.

8.2 All financial statements shall continue to be prepared in terms of International Financial Reporting Standards. However, separate adjustments to the same financial statements shall be made in line with the issues highlighted in this circular, mainly for the purpose of determining the solvency of an insurance company.

8.3 In a bid to standardize reporting and assist the market especially in the calculation of reserves, the Commission shall revise the quarterly report template to account for all the issues highlighted in this circular.

8.4 For any clarification on the issues raised in this circular, do not hesitate to contact the Commission.

8.5 Please be guided accordingly.

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