Insurance & Pensions
Commission

Circular No. 4 of 2014

10 September 2014

Life Offices Association (LOA)

Zimbabwe Association of Funeral Assurers (ZAFA)

Life Assurance Companies that are not LOA members,

Funeral Assurance Companies which are not members of ZAFA

Reassurance Companies

Fund Administrators

Guidance on Calculation of Capital and other Related Issues

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 and Statutory Instrument 20 of 2013* relating to fund administrators.

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 life offices, life reassurers, funeral assurers and fund administrators **with immediate effect** pending the development of a more robust risk based capital framework. This circular applies to both policyholder and shareholder funds on a total balance sheet basis.

2 Definition of Terms

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

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

2.3 Commission: Means the Insurance and Pension Commission established in terms

of the *Insurance and Pensions Commission Act [Chapter 24:21]*.

2.4 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 security for a loan, assets that are held in an entity under curatorship or under liquidation and an asset whose realization/recoverability is subject to a legal dispute.

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

2.6 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 assurer or fund administrator;

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

c) is an entity in which a close relative of a person described in (b) has a significant investment in the assurer/ fund administrator;

d) is an employee of the assurance company in question; and

e) has any other conflict of interest as may be determined by the Commission.

3 Roles of Capital

The roles of capital are as detailed hereunder:

a) **Loss-absorbing Function**-An assurer/ fund administrator must have adequate unencumbered and admissible capital reserves to cushion 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 assurer/ fund administrator is exposed such as underwriting, credit, market and liquidity risks.

c) **Confidence Function** – The higher the capital base the higher the confidence in the assurer/fund administrator by stakeholders including facultative reassurers and the public.

d) **Capital as a Regulatory Tool**- One of the key mandates of regulators is to ensure financial stability. Capital allows an assurance company to absorb losses, and in a worst case, allows it to wind down its business without loss to policyholders or disruption of the orderly functioning of the financial system, thus ensuring financial stability. Solvency ratios have long been regarded as valuable tools for assessing the "stretching" of the business, safety and soundness of assurers 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 assurers with financial flexibility. Assurers that are strongly capitalized can take advantage of growth opportunities. Strongly capitalized assurers are better placed in terms of promoting innovation, providing new products, offering new services or new distribution channels.

f) **Scope for Higher Retention and Profitability** - A large capital base enables an assurer 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

For the capital of an assurance company to be effectively used to play the above

mentioned roles and thus being considered as of high quality, it should have the

following characteristics:

c) it should not be in the form of borrowed funds;

d) it must be unencumbered. For the avoidance of doubt, this does not imply that the assurer cannot obtain loans using its assets. Assurers may access loans using their assets as collateral. However, this may make it difficult for the pledged assets to be readily available for use in backing liabilities, hence the exclusion of encumbered assets;

e) it must allow for legal subordination to the rights of policyholders;

f) The investment of that capital must predominantly be in assets whose profile matches that of the assurer's liabilities; and

g) The capital of an assurer must not be concentrated in one asset class or issuer. All assurance companies should work towards complying with the investment guidelines stipulated in Circular No. 1 of 2013 which is effective on 1 April 2016.

5 Admissible Assets

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

a) Operating assets such as motor vehicles, furniture and fittings, and Information Technology (IT) hardware. However, in the event where the assurer is winding up, operating assets that can realize a value after disposal shall be considered in meeting the assurers' liabilities. In the case of funeral assurers, assets which are used in providing the promised funeral services such as stocks of coffins, funeral hearses and motor vehicles used for providing funeral services shall be considered. However, the capital of the same funeral assurers should enable the assurer to pay cash in lieu of services should policyholders opt for it.

b) Intangible assets such as goodwill and software;

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

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

f) Premium debtors aged more than **ninety (90)** and **one hundred and twenty (120)days,** in the case of life assurers and reassurers respectively, from the date when they were due shall not be considered, except in so far as the premiums are secured under automatic non-forfeiture conditions against the surrender value of the policies concerned;

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

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

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

j) any admissible assets which shall form an excess over the threshold for a given asset class, as stipulated in Circular No. 1 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 may not be easily and readily available to be used to back insurance liabilities for an assurer on a going concern basis.

5.3 Treatment of all admissible assets shall be as detailed hereunder subject to the underwriters always ensuring that their assets and liabilities are matched:

a) **Cash and Money Market Instruments**: For the purposes of calculating solvency of an assurer, 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, assurers 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

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 assurers. 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 annually by an independent and qualified professional, subject to the provisions of paragraph 5.4 below. Such valuations shall form an input into the audited financial statements of the assurer/reassurer. Non-marketability and illiquidity discounts of 20% and 30%, respectively shall be applied on the fair value of all investments in unquoted/private equity. These discounts may be amended from time to time and 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**: Assurance 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, forced sale value, cost per square meter, availability of encumbrances and names 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).

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 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) **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 assurer/fund administrator. Expenses for such a valuation exercise shall be borne by the entity in question. Valuations conducted by loss assessors, management, related parties or other parties not independent from the entity concerned shall not be acceptable for purposes of assessing the solvency of an assurer/fund administrator.

6 Liabilities

6.1 The liabilities of an assurance 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 reserves/assurance contract liabilities which should be actuarially determined; and

c) Any other factors as may be necessary.

6.2 All the reserves for life offices that will feed into their annual audited financial statements shall be certified by an independent and qualified actuary.

7 Enforcement Measures

7.1 After taking cognizance of all the issues raised above, all assurers and reassurers/fund administrators are required to comply with minimum capital requirements stipulated in Statutory Instrument 21 of 2013 and Statutory Instrument 20 of 2013 for fund administrators other than life assurers. These same entities must also comply with minimum margins of solvency in terms

a) Advise the Commission in writing within **thirty (30) days** from the date when the entity 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 affected entity fails to implement the plan within the specified period, the Commission will take any or all of the following actions:

a) Stop the entity from writing new business including renewal of existing policies;

b) Publish a notice to stakeholders of the action taken in 7.3 (a) above;

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 the entity concerned;

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

f) Disqualify, remove or suspend any person, including a director or senior manager participating in the affairs of the concerned entity;

g) Cancel the registration of the affected entity in terms of the relevant provisions of the *Insurance Act* and the *Pension and Provident Funds Act*;

h) Transfer business of the affected entity to another sound entity in the same class of business.

8 Conclusion

8.1 All assurers/fund administrators 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, for the purpose of determining the solvency of an assurance company, separate adjustments to the same statements shall be made to certain values in the financial statements in line with the issues highlighted in this Circular.

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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M. S. Mpofu (Mrs.)
Commissioner of Insurance, Pension and Provident Funds