BOARD NOTICE 38 OF 2004

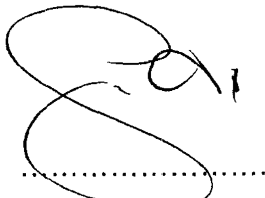
FINANCIAL SERVICES BOARD
REGISTRAR OF LONG-TERM INSURANCE

LONG-TERM INSURANCE ACT, 1998
(ACT NO. 52 OF 1998)

Prescribed requirements for the calculation of the value of the assets, liabilities and capital adequacy requirement of long-term insurers

1. I, Jeffrey van Rooyen, Registrar of Long-term Insurance, after consulting the Actuarial Society of South Africa, hereby prescribe, under paragraph 2 of Schedule 3 of the Long-term Insurance Act, 1998 (Act No. 52 of 1998), the requirements for the calculation of the value of the assets, liabilities and capital adequacy requirement of long-term insurers, as set out in the Schedule hereto.

2. Notice 1877 of 2003, published in *Government Gazette* number 25189 of 18 July 2003 is hereby repealed.



J VAN ROOYEN

Registrar of Long-Term Insurance

SCHEDULE

Prescribed requirements for the calculation of the value of the assets, liabilities and capital adequacy requirement of long-term insurers
(Paragraph 2 of Schedule 3 of the Long-term Insurance Act, 1998)

1. Definitions

In these Requirements, unless the context indicates otherwise:

"**Act**" means the Long-term Insurance Act, 1998 (Act No. 52 of 1998), and a word or expression to which a meaning has been given in the Act, has that meaning;

"**annual return**" means the statutory return an insurer must submit to the Registrar annually;

"**ASSA**" means the Actuarial Society of South Africa;

"**ASSA guideline**" means any guideline issued from time to time by ASSA, in consultation with the Registrar, which supplements these Requirements;

"**best-estimate assumption**" means an assumption that:

(a) is realistic;
(b) depends on the nature of the business concerned;
(c) is guided by immediate past experience, as modified by any knowledge or expectation of the future;

"**bonus stabilisation reserve**", in relation to a category of participating policies, means the aggregate of the fair value of the underlying assets relating to that category of policies, less the aggregate of the policy accumulation funds within that category of policies;

"**capital requirement**", in relation to a regulated financial institution, means the capital or solvency margin, as the case may be, required for that institution by the regulatory authority concerned;

"**compulsory margins**" mean the margins that must be added, in terms of paragraph 4.5;

"**discretionary margins**" mean the margins that may be added, in terms of paragraph 4.7;

"**GAAP**" means South African Statements of Generally Accepted Accounting Practice;

"**group undertaking**", in relation to an insurer, means a juristic person in which the insurer alone, or with its subsidiaries or holding company, directly holds 20% or more of the shares, if the juristic person is a company, or 20% or more of any other ownership interest, if the juristic person is not a company;

"**insurer**" means a long-term insurer;

"**listed**" means listed on a stock exchange or similar trading facility, which is recognised generally by the international community of institutional investors;

"**materiality guidelines**" refer to acceptable margins of error and approximate valuation methods, and not to the effect of different valuation assumptions;

"**net asset value**", in relation to a group undertaking, means its net asset value calculated in accordance with paragraph 8;

"**policy**" means a long-term policy;

"**policy accumulation fund**", in relation to a policy, means the accumulated sum of:

(a) the premiums, net of risk and other charges, invested under the policy; and either
(b) the bonuses, including non-vesting bonuses, net of fund and other charges, declared under the policy; or
(c) the investment returns, net of fund and other charges, earned on the underlying assets relating to the policy;

"**policyholder fund**" means a policyholder fund as defined in section 29A of the Income Tax Act, 1962 (Act No. 58 of 1962);

"**regulated financial institution**" means:

(a) a financial institution as defined in paragraph (a) of the definition of 'financial institution' in section 1 of the Financial Services Board Act, 1990 (Act No. 97 of 1990);
(b) a bank as defined in section 1(1) of the Banks Act, 1990 (Act No. 94 of 1990), or a mutual bank as defined in section 1(1) of the Mutual Banks Act, 1993 (Act No. 124 of 1993);
(c) an entity that carries on business similar to the business of an entity referred to in paragraph (a) or (b), which is not regulated by a law that regulates an entity referred to in paragraph (a) or (b), but which is subject to substantially similar regulation outside South Africa;

"**Schedule 3**" means Schedule 3 of the Act;

"**unbundled policy**" means a policy designed with separate risk and investment components.

2. Statutory valuation method

2.1 The value of the assets, liabilities and capital adequacy requirement of insurers must be calculated according to the method set out in:

2.1.1 Schedule 3;

2.1.2 these Requirements, supplemented by one or more ASSA guidelines.

2.2 This method is referred to as the statutory valuation method.

2.3 It requires, among other things, that the insurer brings into account:

2.3.1 premiums to be received in the future;

2.3.2 assumptions regarding future investment returns, bonus declarations, expenses, mortality experience, morbidity experience, lapses, surrenders, and other relevant factors, which assumptions:

(a) must be best-estimate assumptions;

(b) must take into account the reasonable expectations of policyholders;

(c) must be modified by compulsory margins;

(d) may be modified further by discretionary margins to ensure the prudent release of profit;

2.3.3 a minimum level of financial resilience through the determination of a capital adequacy requirement.

2.4 Schedule 3, these Requirements, and the ASSA guidelines apply in conjunction, but in the following order of priority: firstly Schedule 3, secondly these Requirements, and thirdly the ASSA guidelines. Therefore, if there is an overlap or conflict, Schedule 3 prevails over these Requirements and the ASSA guidelines, and these Requirements prevail over the ASSA guidelines.

3. General requirements

3.1 Except if these Requirements specifically direct otherwise:

3.1.1 profit must be recognised over the lifetime of policies, to avoid losses in the future as a result of the premature recognition of profit;

3.1.2 assets and liabilities must be valued on bases that are mutually consistent;

3.1.3 assets and liabilities must be valued on the same basis as for the annual financial statements of the insurer.

3.2 Where the insurer applies materiality guidelines in the valuation of its assets or liabilities, they may not be less conservative than the materiality guidelines applied by its external auditors.

4. Valuation of contingent liabilities for policy benefits that have not become claimable

4.1 The premiums that must be valued, are those still to be paid under the policy, which the insurer has not yet recognised for accounting purposes, subject to paragraph 4.2.

4.2 Profit may not be recognised in respect of policy options that may be exercised by policyholders. However, losses that are expected in respect of such options must be recognised. The insurer may group its business into broad categories with expected similar option exercise patterns. Only the net loss in a category, if any, has to be recognised.

4.3 Where shareholders may participate in the net investment returns earned on the underlying policy assets the insurer must include in its liabilities a provision for the portion it expects to allocate to shareholders. Where the allocated portion will be

available as a buffer in adverse situations, the provision must be the higher of:

4.3.1 the expected allocation to shareholders;

4.3.2 the increase, in the value of the policy liability concerned, arising from the application of the compulsory margins.

The basis of calculation of the provision must be disclosed in the annual return.

4.4 The value of the liabilities must be increased by any positive bonus stabilisation reserve. If there is a negative bonus stabilisation reserve, the value of the liabilities may be reduced by, at most, the amount that can reasonably be expected to be recovered by a distribution of lower bonuses during the ensuing three years. This may be done only if the statutory actuary is satisfied, as far as is reasonably possible in the circumstances, that the bonuses will be reduced to the extent necessary during the ensuing three years, if the fair value of the corresponding assets does not recover more than would be produced by normally assumed future investment returns.

4.5 The following compulsory margins must be added to the best-estimate assumptions, provided that an assumption must be increased, or decreased, depending on which alternative gives rise to an increase in the liability of the category of policies concerned:

Item	**Compulsory margin as a percentage of the best-estimate assumption**
Mortality claims	7,5%
Morbidity claims	10%
Health claims	15%
Lapses	25%
Termination of disability income benefits being paid	10% - of reserves for claims
Surrenders	10%
Expenses	10%
Expense inflation	10% - of the estimated escalation rate
Charge against investment return	A reduction of 0,25 percentage points per year in the management fee, or in an equivalent asset-based or investment performance-based margin.
Note	If the best-estimate assumption is, say, 5%, and the compulsory margin is, for example, 10%, then the assumption including the margin would be 5,5% or 4,5%, as the case may be.

4.6 The compulsory margins must be added throughout the lifetime of policies. Future management actions may not be assumed to reduce the compulsory margins.

4.7 Discretionary margins may be added to the best-estimate assumptions where, in the opinion of the statutory actuary:

4.7.1 the compulsory margins, in a particular case, are not sufficient for the prudent release of profit;

4.7.2 it is necessary in order to defer the release of profit consistent with the policy design or company practice of the insurer.

4.8 The insurer must, in its annual return:

4.8.1 define the discretionary margins;

4.8.2 quantify them where they are explicit;

4.8.3 give the reason why they have been added;

4.8.4 explain the broad effect they are expected to have on earnings.

4.9 The deferred tax asset or liability, determined according to GAAP, relating to assets of a policyholder fund and which is recognised in the annual financial statements, must be taken into account in determining the value of the liabilities of the fund.

5. Reasonable expectations of policyholders

5.1 The reasonable expectations of policyholders will depend on the type of policy, the practice of the insurer, the manner in which benefits are quoted and presented to policyholders, and the expectations created by marketing material.

5.2 The reasonable expectations of policyholders must be taken into account to the extent that, in the opinion of the statutory actuary, they are likely to influence the decisions of the insurer on bonus declarations.

5.3 Except in the case of market-related and linked policies:

5.3.1 the future bonus rates assumed for policies must be consistent with the discount rate used in the valuation of the corresponding liabilities, taking into account the reasonable expectations of the policyholders as determined by the statutory actuary after having considered the issues set out in this paragraph 5;

5.3.2 where the maintaining of the bonus rates last declared is not assumed for all future years, this must be disclosed in the annual return, with details of the reductions or increases in assumed bonus rates;

5.3.3 where applicable, the value of non-vesting bonuses that have accumulated must be included in the valuation – and in addition, depending on the circumstances, future additions to such bonuses may have to be assumed, for example, where the amount of a bonus depends on a scale that is related to the duration the policy has been in force.

6. Valuation of unbundled policies

6.1 The liabilities in respect of unbundled policies may not be less than the sum of:

6.1.1 their underwriting liabilities;

6.1.2 their policy accumulation funds, including any bonus stabilisation reserve in

respect of those policies.

6.2 The value of the underwriting liabilities must be determined according to the following formula, and by discounting the experience expected in the future in respect of the items in the formula:

A plus B plus C minus D

where:

A represents mortality and morbidity claims, including compulsory margins and, if any, discretionary margins;

B represents commissions, expenses, and expense inflation, including compulsory margins and, if any, discretionary margins;

C represents the cost of guarantees that have been given under the policy;

D represents the provision in the premium for expenses, guarantees, risk cover and profit, and the fees that may be deducted from future investment returns in terms of the policy.

7. Valuation of assets

7.1 Except if these Requirements specifically direct otherwise, assets must be valued at fair value.

7.2 The value of a group undertaking must be limited to the percentage of the shareholding or other ownership interest of the insurer in the group undertaking, multiplied by the lower of the fair value or net asset value of the group undertaking.

7.3 If the group undertaking is listed, the value in paragraph 7.2 may be increased by:

A multiplied by B

where:

A equals the difference between the fair value and the net asset value of the group undertaking, provided that **A** must be taken as nil if the net asset value is more than the fair value;

B is:

(a) until 31 December 2003: the lower of 60% and the percentage of the holding by the insurer in the group undertaking;

(b) from 1 January 2004 until 31 December 2004: the lower of 40% and the percentage of the holding by the insurer in the group undertaking;

(c) from 1 January 2005: the lower of 20% and the percentage of the holding by the insurer in the group undertaking.

7.4 If a group undertaking is not a regulated financial institution, and its fair value is less than 0,25% of the value of the liabilities of the insurer, it may be valued at fair value, notwithstanding paragraph 7.2.

7.5 If there is more than one group undertaking as contemplated in paragraph 7.4, each may be valued at fair value, provided that their combined fair value is not more than 2,5% of the value of the liabilities of the insurer. If their combined fair value is more than 2,5% of the value of the liabilities of the insurer, only so many of them, selected by the insurer, as will have a combined fair value of not more than 2,5% of the value of the liabilities of the insurer, may be valued at fair value. The others must then be valued as required by paragraph 7.2.

7.6 If an insurer holds shares, directly or indirectly through a subsidiary or a trust, in its holding company, the value of those shares must for purposes of valuation be limited to the following:

7.6.1 if the holding company is listed - 5% of the value of the liabilities of the insurer. ";"

7.6.2 if the holding company is not listed - nil.

7.7 Paragraph 7.6 applies also where the insurer, directly, or indirectly through a subsidiary or trust, holds shares in its holding company under a share incentive scheme linked to shares in its holding company.

7.8 Paragraph 7.6 does not apply where the insurer holds shares in its holding company under a collective investment scheme, an index-based investment scheme or any similar investment scheme that is recognised generally by the international community of institutional investors.

8. Net asset value of a group undertaking

8.1 If the group undertaking is a regulated financial institution

8.1.1 The net asset value of the group undertaking is the fair value of its assets, less the sum of the value of its liabilities and its capital requirement.

8.1.2 These values must be calculated as required by the regulatory authority concerned.

8.1.3 If the group undertaking is a company, and its main business is insurance business, the insurer must, in calculating these values, exclude so much of its capital and reserves as shareholders, other than the insurer, may withdraw in cash when they cease to be shareholders, in terms of the articles of association of, or a contract with, the group undertaking.

8.2 In other cases

8.2.1 The net asset value of the group undertaking is the value of its assets, less the value of its liabilities.

8.2.2 If the group undertaking carries on most of its business in South Africa,

these values must be calculated in accordance with GAAP.

8.2.3 If the group undertaking carries on most of its business in another country, these values must be calculated in accordance with accounting standards generally accepted in that country.

8.2.4 In calculating these values, the following items must be excluded, to the extent that, according to the insurer, they can be ascertained with reasonable effort and are material:

(a) an amount that remains unpaid after the expiry of a period of 12 months from the date on which they became due and payable;
(b) an amount representing administrative, organisation or business extension expenses incurred directly or indirectly;
(c) an amount representing goodwill or an item of a similar nature;
(d) an amount representing a prepaid expense or a deferred expense;
(e) an amount representing a holding in a subsidiary of the group undertaking in excess of the net asset value, calculated on the same basis as contemplated in this paragraph 8, of the subsidiary.

9. Capital adequacy requirement

9.1 The capital adequacy requirement for an insurer must be determined by its statutory actuary, when reporting in terms of the Act, as the highest stated in paragraphs 9.1.1, 9.1.2 and 9.1.3 below.

9.1.1 An amount that will ensure that the liability of the insurer under each policy is not less than the amount that will become available to the policyholder on the surrender or lapse of that policy, making due allowance for the reasonable expectations of the policyholder.

9.1.2 The higher of:

(a) the amount determined in accordance with ASSA guidelines for calculating the capital adequacy requirement, which must take into account prevailing investment and inflation conditions;
(b) the highest amount determined on such scenarios as may have been prescribed by the Registrar:

Provided that both the ASSA guidelines and the scenarios, if any, prescribed by the Registrar may, in the case of a particular insurer, permit values to be adjusted by the use of one or more stochastic models as agreed between the insurer and the Registrar: Provided further that the risks to be considered must include adverse trends or fluctuations that are expected in the future in respect of:

(i) lapses;
(ii) surrenders;
(iii) mortality, morbidity or other claims, including the impact of HIV/AIDS;
(iv) expenses;

(v) decreases in the fair value of investments, caused by market or currency changes;

(vi) mismatching between assets and liabilities in respect of all, or particular, categories of policies, including the failure to reflect timeously or correctly investment portfolio changes requested by the policyholder, where the policyholder has such investment choice.

9.1.3 The minimum capital adequacy requirement, which is to be the higher of:

(a) R10 million;

(b) an amount representing operating expenses, as defined and reported in the annual return last submitted to the Registrar, multiplied by 13 and divided by 52 or, if different, the number of weeks included in the reporting period.

9.2 In determining the capital adequacy requirement in accordance with paragraphs 9.1.1 and 9.1.2, credit for offsetting factors may be taken into account only where:

9.2.1 the board of directors of the insurer has approved the relevant management action;

9.2.2 the statutory actuary is satisfied, as far as is reasonably possible in the circumstances, that the management action will be taken.

9.3 In determining the capital adequacy requirement in accordance with paragraphs 9.1.1 and 9.1.2, the capital adequacy requirement of a branch of the insurer must be added to the capital adequacy requirement of the insurer. The capital adequacy of the branch must be the higher of:

9.3.1 the capital adequacy requirement of the branch, calculated in accordance with these Requirements;

9.3.2 such capital requirement as may be prescribed by the regulatory authority in the country in which the branch carries on most of its insurance business.

9.4 The capital adequacy requirement determined in accordance with these Requirements caters for the more general contingencies. If the statutory actuary considers this capital adequacy requirement to be inadequate for any reason, such higher capital adequacy requirement as the statutory actuary considers is prudent must be created for the insurer.

10. The Registrar may relax provisions

10.1 The Registrar may relax a provision in these Requirements, for such duration and on such conditions as the Registrar may determine.

10.2 An insurer must apply for such relaxation in writing, in the form and with the supporting information, documents and explanation the Registrar may require.

11. Short title

This Notice is called the Notice on the Prescribed Requirements for the Calculation of the Value of Assets, Liabilities and Capital Adequacy Requirement of Long-term Insurers, 2004.