GUIDELINES ON CAPITAL ADEQUACY

IRA/PG/XX

To: All Insurance Companies

GUIDELINES ON CAPITAL ADEQUACY

These guidelines on capital adequacy is issued pursuant to section 3A of the Insurance Act for observance by Insurance and Reinsurance Companies transacting insurance business.

These guidelinesprovides a framework for determining the adequacy of capital of an insurer.

It is worth noting that financial soundness of the insurer and ultimate protection of policyholders is dependent on maintaining a strong capital adequacy position.

To this end, the Insurance Regulatory Authority issues this guideline on determination of capital adequacy to be effective from dd/mm/yyyy.

SAMMY M. MAKOVE
COMMISSIONER OF INSURANCE & CHIEF EXECUTIVE OFFICER

THE INSURANCE ACT (CAP 487)

IRA/PG/XX

GUIDELINE TO THE INSURANCE INDUSTRY

ON CAPITAL ADEQUACY

AUTHORIZATION

INEXERCISE of the powers conferred by sections 3A (a), (b) and (g) of the Insurance Act, the Insurance Regulatory Authority (herein referred to as the Authority) issues the guideline set out here below, for observance by all insurers registered under the Insurance Act Cap 487, in respect of determination of capital adequacy.

1.0 INTRODUCTION

1.1 These guidelines aim to ensure that insurers maintain a capital adequacy level that is commensurate to their risk profile at all times.

1.2 These guidelines have been developed based on the following principles:

a) Allowance of greater flexibility for an insurer to operate at different risk levels in line with its business strategies;

b) Explicit quantification of the prudential buffer level with the aim of improving transparency;

c) Provide incentives for insurers to put in place appropriate risk management infrastructure and adopt prudent practices;

d) Promote convergence with international practices so as to enhance comparability across jurisdictions and reduce opportunities for regulatory arbitrage within the financial sector; and

e) Provide an early warning signal on the deterioration in capital adequacy level, hence allowing prompt and pre-emptive supervisory actions to be taken.

1.3 The Authority requires all insurers to be maintain adequate capital at all times.

1.4 The insurer shall keep at all times assets whose value is not less than the value of its liabilities.

1.5 The insurer's Board and Senior Management shall ensure that the insurer maintains adequate capital at all times.

2.0 CAPITAL ADEQUACY

2.1 The Capital Adequacy level is assessed using the Capital required[1]and the Capital available[2].

2.2 The required Capital Adequacy Ratio[3]must be met at all times. If an insurance company falls below required capital adequacy level at any time, it must inform the Authority of this fact immediately.

2.3 The Capital Adequacy Ratio shall at all times be at least 100% of the Capital Required.

2.4 These Guidelines set two capital requirements providing the upper and lower levels of supervisory intervention.

2.5 The Prescribed Capital Requirement (PCR) is the level above which there is no supervisory intervention on capital adequacy grounds.

2.6 The Minimum Capital Requirement (MCR) is the level below which the supervisor's strongest actions are taken.

2.7 The MCR shall be determinedas provided for by the Insurance Act.

2.8 The PCR shall be calculated as 200% of the MCR.

[1]Capital required is the amount of capital that an insurer is required to have and is determined by the Authority.
[2] Capital Available represents the actual capital available and it consists of paid up shares, share premium, retained earnings and reserves subject to the admissibility by the Authority from time to time.
[3]The Capital Adequacy Ratio (CAR) is a measure of the Capital Available as a percentage of the Capital required

Capital Required

2.9 The Capital Requiredshall be equivalent to the MCR as determined by the Authority.

2.10 For the purposes of determining the MCR, the Risk Based Capital shall be determined as per these Guidelines.

Capital Available

2.11 The Capital Available shall be divided into tiers based on the following criteria:

i. Whether it is paid up or not;
ii. Whether it is available immediately to absorb losses;
iii. Its ranking in a wind-up (i.e. subordination of the capital);
iv. The extent of any obligation to pay dividends/interest;
v. Term to maturity/redemption; and
vi. The existence of any incentives for the company to redeem the capital.

2.12 Tier 1 Capitalshall be the highest quality, most loss absorbent and permanent form of capital. MCR shall be covered by Tier 1 Capital.

2.13 Tier 1 Capital of an insurer is the aggregate of the following:

i. Issued and fully paid-up ordinary shares;
ii. Share premiums;
iii. Statutory reserves; and
iv. Retained profits.

2.14 Tier 1 Capital shall consist of Government bonds, Treasury Bills, deposits, cash and cash equivalents as provided for in the Insurance Act.

2.15 Tier 2 Capital shall consist of:

i. Cumulative irredeemable preference shares;
ii. Capital loan stocks and other similar capital instruments;
iii. Irredeemable subordinated debts;
iv. Available-for-sale reserves;

v. Revaluation reserves for self-occupied properties and other assets;and
vi. General reserves

2.16 The following assets are not included in the capital available computation and are therefore inadmissible for the purposes of calculating the insurance company's capital adequacy:

i. Goodwill and other intangible assets (e.g. capitalised expenditure);
ii. Deferred tax income/(expenses) and deferred tax assets;
iii. Assets pledged to support credit facilities obtained by an insurer or other specific purposes;
iv. Assets over their concentration limits;
v. All credit facilities granted by an insurer and secured by its own shares;
vi. Prepayments
vii. Computer Equipment in use for more than two years
viii. Office equipment
ix. Furniture and fittings
x. Loans to directors and agents
xi. Unsecured Loans
xii. Loans to related companies
xiii. Premiums receivables
xiv. Receivables from reinsurers outstanding over six months
xv. Receivables from related parties
xvi. Receivables from insurers
xvii. Inwards reinsurance due
xviii. Merchandise inventory
xix. Prepaid expenses
xx. Other assets as determined by the Authority from time to time.

2.17 An insurer shall, for the purposes of calculating the capital adequacy apply the following concentration limit factors:

i. Deposits in any one financial institution -10% of Total assets
ii. Shares of any one institution - 10% of Total assets
iii. Property - 30% of Total assets
iv. Investment in related parties- 10% of Total assets

2.18 Assets shall be valued using a fair value approach.

2.19 For the purposes of determining the Capital Adequacy, the "Fair Value" of assets shall be:

i. In the case of an asset which is listed on a licensed stock exchange andfor which a price was quoted on that stock exchange on the date as at which the value is calculated, the price last so quoted; and
ii. In any other case, the price which could have been obtained upon a sale of the asset between a willing buyer and a willing seller dealing at arms-length, as estimated by the insurer.

2.20 The Authority's estimate of the assets shall be used where the Authority is of the opinion that there aremarket abuses under 2.19(i) or is not satisfied with the estimate under 2.19(ii).

2.21 A life insurer shall for the purpose of determining the value of liabilities, adopt a statutory valuation basis as outlined IRA/PG/.....

2.22 A non-life insurer shall for the purpose of determining the value of liabilities, adopt a statutory valuation basis as outlined IRA/PG/.....

3.0 DETERMINATION OF RISK BASED CAPITAL

3.1 Risk Based Capital (RBC) shall be the square root of the sum of squares of Capital required for:

i. Insurance Risk;
ii. Market Risk; and
iii. Credit Risk;

plus the Capital Required for Operational Risk i.e.

$$\text{RBC} = \sqrt{\begin{array}{c}\text{Insurance Risk Capital}^2 + \text{Market Risk Capital}^2 \\ + \text{Credit Risk Capital}^2\end{array}} + \text{Operational Risk Capital}$$

Capital Required for Insurance Risk

3.2 Capital required for insurance risk aims to cushion the insurer against adverse experience relative to the amount of technical provisions.

Capital Requiredfor Insurance Risk – General Business

3.3 Insurers writing general insurance business shall hold capital against fluctuations in the premium reserves and claim reserves.

3.4 An insurer shall, for the purposes of calculating the capital required for insurance risk use the risk factors provided in Appendix 2.

3.5 The capital required for insurance risk shall be computed as the sum of the product ofrisk factorsand the respective reserves for each class of business.

Capital Required for Insurance Risk – Life Business

3.6 Insurers writing life business shall,where applicable, hold capital against adverse experience resulting from the following risks:

i. Mortality;
ii. Longevity;
iii. Morbidity;
iv. Disability;
v. Expenses;
vi. Lapses; and
vii. Catastrophes

3.7 The capital required for life insurance risk shall be the difference between policyholders liability computed using stressed risk factors less policyholders' liabilityusing best estimate assumptions.

3.8 The stress riskfactors are outlined in Appendix 1.

Capital Required for Catastrophe Risk

3.9 Ageneral insurer shall, for the purposes of calculating the capital required for catastrophes, apply a charge of 5% of the previous year's Net earned premiums.

3.10 This capital charge of5% shall be added to the insurance risk capital.

Capital Requiredfor Market Risk

3.11 Capital required for market risk aims to cushion against the volatility in the market prices of assets used to back policyholder liabilities.

3.12 The insurer shall be required to determine capital for Equity Risk, Property Risk and Currency Risk.

3.13 An insurer shall, for the purposes of calculating the capital required for market risk apply a capital charge to balance sheet asset value.

3.14 The capital charges for market risk to be applied are as defined in Appendix 3

Capital Required for Currency Risk

3.15 This capital charge captures volatility in the foreign currency exchange rates.

3.16 The capital charge for the currency risk to be applied to the value of foreign currency reservesconverted toUSD shall be 1%

3.17 The capital shall be computed as:

Value of reservesin USD* Capital Charge

3.18 This capital charge of 1% shall be added to the market risk capital

Capital Required for Credit Risk

3.19 The credit risk capital charge aims to cushion against risk of losses resulting from counterparty default.

3.20 An insurer shall, for the purposes of calculating the capital required for reinsurance ceded, apply such factors as provided in Appendix 4 to reinsurance share of technical liabilities.

Capital Required for Operational Risk

3.21 The operational risk capital acts as a cushion against losses that may arise from failed process, systems and people.

3.22 The Operational Risk Capital shall be computed as the higher of
   i. 30% of the square root of sum of squares of the capital required for insurance risk, market risk and credit risk; and
   ii. 3% of the gross earned premium over the last 12months.

4.0 ENFORCEMENT

Supervisory Strategies

4.1 Where the Authority determines that an insurer has not met the requirements of this guideline, the Authority may impose any or all of the remedial measures to correct the situation in accordance with the provisions of the Insurance Act.

Breaching the Capital Requirements

4.2 TheBoard and Senior Managementshall, within 30 days, inform the Authority if the capital requirementshave been breached orare likely to be breached within the next three months.

4.3 The level of supervisory intervention will be determined by the extent of the breach as indicated by the Capital Adequacy Ratio.

Capital adequacy Ratio between 150% and 200%

4.4 The insurer shall be required, but not limited to:
   i. Inform the Authority of any concerns;
   ii. Submit statutory returns, applications and any other additional information that may be required; and
   iii. Address concerns raised by the Authority.

Capital adequacy Ratio between 110% and 150%

4.5 In addition to the requirements under 4.4 above, the insurer shall submit acceptable remedial plans to the Authority.

Capital adequacy Ratio between 110% and MCR

4.6 In addition to the requirements under 4.5 above, the Authority may impose sanctions as it deems fit.

Breaching the MCR

4.7 The Board and Senior Managementshall, immediately,inform the Authority immediately if the MCR has been breached oris likely to be breached within the next three months.

4.8 Within 30 days of any breach, the insurance company shall submit a recovery planto the Authority for approval.

4.9 The company shall rectify the breach as per the approved action plan.

4.10 If the short-term finance scheme does not work, the regulator will withdraw the company's authorisation to sell any more business.

4.11 The Authority shall impose severesanctions.

5.0 EFFECTIVE DATE

5.1 The effective date of this guideline is dd/mm/yyyy.

6.0 ENQUIRY

Enquiries on any aspect of this guideline shall be referred to;

Address: The Chief Executive Officer

Insurance Regulatory Authority,

P.O. Box 43505-00100,

Nairobi

Telephone: +254 20 4996000

Facsimile: +254 20 2710126

E-mail: commins@ira.go.ke

7.0 APPENDIX 1: Insurance Risk Factors – Life Business

Parameter	Stress Risk Factor
Mortality	6% increase of base mortality rates
Longevity	7% decrease of base mortality rates
Morbidity/Disability	40% increase in morbidity/disability inception rates in the first year followed by 15% increase in morbidity/disability rates in subsequent years 10% decrease in morbidity/disability recovery rates
Expenses	5% increase in best estimate assumption for expenses 1% increase in best estimate assumption for inflation
Lapses	15% increase in lapse rates for new business and a 5% increase in lapse rates for in force business
Catastrophe	An absolute increase in the rate of policyholders dying over the following year of 1.5 per mille.

8.0 APPENDIX 2: Insurance Risk Factors – General Business

Premium Reserve - Risk Factor		Claim Reserve - Risk Factor	
Class of Business	**Risk Factor**	**Class of Business**	**Risk Factor**
Aviation	39%	Aviation	29%
Engineering	8%	Engineering	4%
Fire Domestic	3%	Fire Domestic	2%
Fire Industrial	9%	Fire Industrial	6%
Liability	9%	Liability	9%
Marine	7%	Marine	8%
Motor Private		Motor Private	
Property damage	5%	Property damage	5%
Liability	12%	Liability	12%
Motor Commercial		Motor Commercial	
Property damage	3%	Property damage	3%
Liability	13%	Liability	13%
Motor Commercial-PSV		Motor Commercial-PSV	
Property damage	3%	Property damage	3%
Liability	14%	Liability	14%
Personal Accident	6%	Personal Accident	9%
Theft	4%	Theft	4%
Workmen's Compensation	18%	Workmen's Compensation	19%
Miscellaneous	8%	Miscellaneous	6%

9.0 APPENDIX 3: Market Risk Capital Charges

Asset	Capital Charge (%)
Property	
Land and Buildings	*40*
Investment Property	*40*
Fixed Assets	
Computer equipment	
Current year	*25*
One year preceding the Current Year	*50*
Two Years preceding the Current Year	*75*
Motor vehicles	*75*
Investment in related companies	*50*
Government Securities	*0*
Other Securities	*20*
Equity Securities	
Ordinary Shares Quoted	*30*
Ordinary Shares Unquoted	*40*
Preference Shares Quoted	*30*
Preference Shares Unquoted	*40*
Debt Securities	
Corporate Bonds	*30*
Commercial Paper	*30*
Debentures (Quoted)	*30*
Debentures (Unquoted)	*40*
Loans	
Secured Loans	*30*
Unsecured Loans	*100*
Loans to Related Parties	
Secured Loans	*30*
Unsecured Loans	*100*
Loans to Unrelated Parties	
Secured Loans	*10*
Unsecured Loans	*100*
Mortgages	*30*
Term Deposits	*0*
Cash and Cash Balances	*0*
Reinsurer Share of Technical Reserves	*as per schedule*
Other Assets	*50*

10.0 APPENDIX 4: Credit Risk - Capital Charges

S&P, Fitch, GCR	Moody's	AM Best	Capital Charge
AAA to AA-	Aaa to Aa3	A++ to A-	1%
A+ to A-	A1 to A3	B++ to B+	4%
BBB+ to BBB-	Baa1 to Baa3	B to B-	5%
BB+ to BB-	Ba1 to Ba3	C++ to C+	14%
B+ to B-	B1 to B3	C to D	22%
CCC+ or below	Caa1 or below	E or below	45%
Unrated	Unrated	Unrated	100%
Locally Regulated Reinsurers			1%