LEGAL NOTICE NO. 39

THE INSURANCE ACT

(*Cap.* 487)

IN EXERCISE of the powers conferred by section 3A (1) (a), (b) and (g) of the Insurance Act, the Insurance Regulatory Authority issues the following guidelines—

THE INSURANCE (CAPITAL ADEQUACY) GUIDELINES, 2017

Citation.

1. These guidelines may be cited as the Insurance (Capital Adequacy) Guidelines, 2017.

Interpretation.

2. In these guidelines unless the context otherwise requires—

"minimum capital requirements" means the level of capital below which an insurer is regarded not viable to operate effectively;

"prescribed capital requirement" means the level of capital above which the Authority shall not intervene on capital adequacy grounds; and

"stress factors" means the assumptions that shall be applied by an insurer for the determination of capital that shall take into consideration the current and prospective impacts of an adverse outcome.

Objective and principles of the guidelines.

3. (1) The objective of these guidelines is to ensure that insurers maintain a capital adequacy level that is commensurate to their risk profile.

(2) The principles of these guidelines are the—

(a) allowance of greater flexibility for an insurer to operate at different risk levels in line with the insurer's business strategies;

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

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

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

(e) provision of an early warning signal on the deterioration in capital adequacy level, hence allowing prompt and pre-emptive supervisory actions.

Responsibility.

4. (1) An insurer shall maintain adequate capital at all times.

(2) An insurer shall develop and implement an internal capital management policy.

Capital adequacy.

5. (1) An insurer shall assess capital adequacy level using the capital required and the capital available.

(2) An insurer shall meet the capital adequacy ratio at all times as required under the Act.

(3) An insurer shall promptly notify the Authority if the insurer falls below the required capital adequacy level.

(4) An insurer shall maintain a capital adequacy ratio of at least one hundred percent of the minimum capital prescribed under the Act.

(5) The prescribed capital for an insurer shall be two hundred percent of the minimum capital as required under the Act.

Capital required.

6. (1) The capital required for an insurer shall be equivalent to the minimum capital required under the Act.

(2) For the purpose of determining the minimum capital requirement, the risk-based capital shall be determined in accordance with paragraph 12 of these guidelines.

Capital available.

7. The capital available to an insurer shall be divided into two tiers based on the following criteria—

(a) whether it is paid up or not;

(b) whether it is available immediately to absorb losses or not;

(c) its ranking in liquidation of the insurer;

(d) the extent of any obligation by the insurer to pay dividend or interest;

(e) the period to the maturity or redemption of the capital of the insurer; and

(f) the existence of any incentives for the insurer to redeem capital.

Tiers of capital.

8. (1) The tier 1 capital of an insurer shall be the highest quality, most loss absorbent and permanent form of capital.

(2) The minimum capital required of an insurer shall be tier 1 capital.

(3) The tier 1 capital of an insurer is the aggregate of—

(a) the issued and fully paid up ordinary shares of the insurer;

(b) share premium;

(c) statutory reserves maintained by the insurer; and

(d) profits retained by the insurer.

(4) The tier 1 capital of an insurer shall be in the form of government bonds, treasury bills, deposits, cash and cash equivalents.

(5) The tier 2 capital shall consist of—

(a) irredeemable preference shares issued by the insurer;

(b) capital loan stocks and other similar capital instruments held by the insurer;

(c) subordinated loans subject to approval by the Authority;

(d) convertible preference shares issued by the insurer;

(e) revaluation reserves for self-occupied properties and other assets owned by the insurer; and

(f) general reserves held by the insurer.

Inadmissible assets.

9. The capital available to an insurer that is not admissible for the determination of the insurer's capital adequacy shall be—

(a) goodwill and other intangible assets in the name of or held by the insurer;

(b) deferred tax assets of the insurer;

(c) assets pledged to support the credit activities obtained by an insurer or for other purposes;

(d) assets over their concentration limits;

(e) all credit facilities granted by an insurer and secured by the insurer's own shares;

(f) prepayments made by the insurer;

(g) the fixed assets of the insurer;

(h) the unsecured loans advanced by the insurer;

(i) receivables from other insurers;

(j) inventory; and

(k) other assets held or owned by the insurer as may be determined by the Authority.

Investment concentration limits.

10. (1) For the purpose of calculating a general insurer's capital adequacy, the general insurer shall apply the following concentration limit factors—

(a) for deposits in any one financial institution or group of related companies, ten percent of total assets;

(b) for shares of any one institution or group of related companies, ten percent of total assets;

(c) for property, thirty percent of the total assets; and

(d) for investment in related parties, ten percent of total assets.

(2) For the purpose of calculating a life insurer's capital adequacy, the life insurer shall apply the following concentration limit factors—

(a) for deposits in any one financial institution or group of related companies, ten percent of total assets;

(b) for shares of any one institution or group of related companies, ten percent of total assets;

(c) for property, fifty percent of total assets; and

(d) for investment in related parties , ten percent of total assets.

Valuation.

11. (1) An insurer shall value assets using a market-consistent basis.

(2) For the purpose of determining the capital adequacy of an insurer, the market value of assets shall be—

(a) in the case of an asset which is listed on a licensed securities exchange and for which a price was quoted on that securities exchange on the date as at which the value is calculated, the price last quoted for the asset; and

(b) in any other case, the price which could have been obtained by the insurer upon a sale of the asset between a willing buyer and a willing seller dealing in an arms-length transaction, as estimated by the insurer.

(3) Where the Authority determines that there is over-estimation or under-estimation in the valuation of assets held by an insurer, the Authority may require an independent revaluation of the asset and the expense of the revaluation shall be met by the insurer.

(4) The Authority shall prescribe a valuation basis that an insurer shall apply when determining the liabilities of the insurer.

Determination of risk-based capital.

12. The risk-based capital of an insurer shall be the square root of the sum of the squares of capital required for—

(a) insurance risk;

(b) market risk;

(c) credit risk; and

(d) capital required for operational risk,

as provided in the following formula—

$$\sqrt{\text{insurance risk}^2 + \text{market risk}^2 + \text{credit risk}^2}$$

+ Capital required for operational risk

Capital required for insurance risk.

13. (1) The capital required by an insurer to provide for insurance risk shall be for the purpose of cushioning the insurer against adverse experiences relative to the amount of technical provisions.

(2) An insurer writing general insurance business shall hold capital against fluctuations in the insurer's premium reserves and claim reserves.

(3) An insurer shall, for the purpose of calculating the capital required for insurance risk, use the risk factors set out in Appendix 2.

(4) The capital required by an insurer for insurance risk shall be computed as the value of the insurer's claim reserves multiplied by the risk factor plus the value of the insurer's premium reserves multiplied by the risk factors for each class of business.

(5) An insurer shall compute the claims reserves as a sum of the best estimate liability and the risk margin.

(6) An insurer shall compute the premium reserves as a sum of the best estimate liability and the risk margin.

(7) A general insurer shall, for the purpose of calculating the capital required for catastrophes, apply a charge of two percent of the previous year's net earned premiums.

(8) An insurer writing life business shall, where applicable, hold capital against adverse experiences resulting from the following risks—

(a) mortality;

(b) longevity;

(c) morbidity;

(d) disability;

(e) expenses;

(f) lapses; and

(g) catastrophes.

(9) The life insurance liabilities risk factors shall be for the purpose of addressing the risk of under-estimation of the insurer's liabilities and adverse claims experience.

(10) The life insurance capital charge shall be equal to the adjusted value of life insurance liabilities computed using the parameters stipulated in Appendix 1 less the sum of the best estimate value of the life insurance liabilities and provision of risk margin for adverse deviation as shall be prescribed by the Authority. Capital required for insurance risk for life insurer shall be the square root of the sum of the squares of capital required for parameters stipulated in appendix 1 as provided in the following formula —

$$\sqrt{Mortality^2 + Longevity^2 - Morbidity\ and\ Disability^2 + Expenses^2 - Lapses^2 - Catastrophe^2}$$

(11) When an insurer computes its life insurance risk capital charges, the appointed actuary shall be required to determine and declare for each insurance product separately and to decrease or increase life stress factors according to the nature of the insurance product.

(12) The stress factors for major risks inherent in life insurance liabilities are set out in Appendix 1.

(13) For group life and group credit policies for which premium and claims liabilities have been reserved by an insurer, the applicable risk charges shall correspond to that as required for general insurance liabilities.

(14) For deposit administration and group pension savings plan offered by the insurer, a one percent risk charge shall be applicable to the fund amount.

Capital required for market risk.

14. (1) The capital required by an insurer for market risk shall be for the purpose of cushioning against volatility in the market prices of assets held by the insurer used to back policyholder liabilities.

(2) The market risk capital charges shall be for the mitigation of the risk of financial losses arising from—

(a) the reduction in the market value of assets held by an insurer due to exposures to equity, interest rate, property, currency risks;

(b) non-parallel movements between the value of liabilities faced by the insurer and the value of assets held by the insurer backing the liabilities due to the fluctuation in interest rates in the market; and

(c) concentration of exposures to particular counterparties or asset classes.

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

(4) The capital required for market risk shall be square root of the sum of the squares of capital required for equity, property, interest rate and currency risks as provided in the following formula—.

$$\sqrt{equity\ risk^2 + property\ risk^2 - interest\ rate\ risk^2 + currency\ risk^2}$$

(5) An insurer shall apply the factors set out in Appendix 4 for the purpose of calculating the capital required for market risk.

(6) Equity risks are exposures to equity instruments including ordinary shares or similar instruments that exhibit market behaviour similar to equities.

(7) Property risks are exposures to immovable properties both for investment and for self-occupied purposes.

(8) Interest rate risks are exposures to interest rate related assets and liabilities including debt securities, commercial papers and debentures.

(9) The interest rate risk shall be computed for life insurance funds and general insurance funds with discounting factors.

(10) An insurer shall reduce the capital charge to address interest rate risks to the extent that the weighted average duration of the exposures in interest rate related assets match the weighted average duration of the insurance liabilities.

(11) The amount of capital charges required by an insurer shall be the higher of the reduction in surplus under the increasing and decreasing rate scenario:

Provided that if the reduction in surplus is higher under the increasing scenario in one fund but higher under the decreasing scenario in another fund, then the dominant scenario at the company level should be selected and applied consistently to all funds:

Provided further that any resulting negative capital charges for each individual fund should be taken as zero.

(12) The yield to value of the securities under the base scenario should be the risk-free yield in the case of Government securities or the implied market yield for quoted securities or securities with similar characteristics.

(13) For the purposes of determining the interest rate risk charge, the base yield curve should be multiplied by (1 + stress-up), and (1 – stress-down) for the increasing and decreasing scenarios respectively.

(14) The stress up and stress down to be applied in determining the interest rate risk charge shall be twenty five percent.

(15) An insurance fund which has exposures in currencies which are different from that of the liabilities will be subjected to a currency risk charge of eight percent on the net open position.

(16) For the purposes of calculating the capital charge for currency risks, the net balance sheet positions for exposures to each of the different currencies are converted into Kenya shillings at the spot exchange rates at the valuation date.

(17) The sum of the net short positions or the sum of the net long positions, whichever is higher, is then multiplied by the eight percent risk charge to arrive at the currency capital charge.

(18) The insurer's net position in each currency should be calculated by aggregating the following positions—

(a) all asset items less liabilities; and

(b) the value of all amounts to be received less the value of all amounts to be paid under unsettled spot transactions and forward foreign exchange transactions.

(19) For the purposes of these guidelines—

(a) "increasing or decreasing rate scenario" means the increasing interest or decreasing interest rate on both the assets and liabilities to test the effect of surplus;

(b) "yield to value" means the determination of the value of securities using the yield curve;

(c) "base scenario" means the set of assumptions used to calculate the best estimates;

(d) "base yield curve" means the yield curve for the Government bonds and treasury bills; and

(e) "spot exchange rate" means the prevailing exchange rate at a particular time.

Capital required for credit risk.

15. (1) The credit risk capital charge shall be for the purpose of cushioning an insurer against risk of losses resulting from counterparty default.

(2) An insurer shall, for the purpose of calculating the capital required for credit risk, apply the factors provided in Appendix 3.

Capital required for operational risk.

16. (1) The operational risk capital shall be used by an insurer as the cushion against losses that may arise from failed processes, systems and people.

(2) The operational risk capital shall be computed as the higher of—

(a) thirty percent of the square root of the sum of the squares of the capital required for insurance risk, market risk and credit risk; and

(b) three percent of the previous year's gross earned premium.

Remedial measures.

17. (1) Where the Authority determines that an insurer has not met the requirements of these guidelines, the Authority may impose any or all the remedial measures to correct the situation in accordance with the provisions of the Act.

(2) An insurer shall, within thirty days, inform the Authority if the insurer has breached or is likely to breach the prescribed capital requirements.

(3) A notice by an insurer of the breach or potential breach of these guidelines shall state the remedial action taken or planned to be taken and the period when action shall be taken.

(4) The Authority may enter into an agreement with the board of directors of an insurer requiring the insurer to rectify its deficiencies within a period directed by the Authority.

(5) The level of supervisory intervention by the Authority to address a breach or potential breach of these guidelines shall be determined by the extent of the breach or potential breach as indicated by the capital adequacy ratio.

Sanctions.

18. (1) Where the Authority determines that an insurer has not met the provisions of these guidelines, the Authority may impose any or all of the following administrative sanctions to correct the situation in accordance with the Act, including—

(a) require the insurer to invest in a specified manner;

(b) restrict or prohibit the insurer from investing in certain asset classes or individual assets to safeguard insurance funds;

(c) suspend, dismiss, disqualify or revoke the appointment of an officer of the insurer in a position as a board member, member of the senior management or key person in control function;

(d) impose additional reporting requirements on the insurer;

(e) restrict declaration and payment of dividends by the insurer;

(f) withdraw or impose conditions on the business license of the insurer; and

(g) take any other action as may be deemed necessary.

APPENDICES

APPENDIX 1

(a) Insurance Risk Factor—Life insurance companies

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
	5% increase in lapse rates for in force business
Interest rate	10% decrease
Catastrophe	An absolute increase in the rate of policyholders dying over the following year of 1.5 per mille.
Retirement savings business	
Parameter	Risk factor
Pension plans	1.0%
Deposit Administration	1.0%

(b) Insurance risk factors—Life Reinsurance Companies

Class of business	*Life reserve risk—risk charge*
Ordinary life	3.5
Annuities	1.5%
Investment linked	1.5%

APPENDIX 2

(a) Insurance risk factors—General Insurance Companies and Life Insurance Companies transacting group life and group credit business

Class of Business	*Premium Reserve—Risk Charge*	*Claims Reserve—Risk Charge*
Aviation	39%	29%
Engineering	8%	4%
Fire domestic	3%	2%
Liability	9%	9%
Marine	7%	8%
Motor vehicle private—Property damage	5%	5%
Motor vehicle private—Liability	12%	12%

Class of Business	*Premium Reserve—Risk Charge*	*Claims Reserve—Risk Charge*
Motor vehicle commercial		
Motor vehicle commercial—Property damage	3%	3%
Motor vehicle commercial—Liability	13%	13%
Motor vehicle commercial PSV-Property damage	3%	3%
Motor vehicle commercial PSV—Liability	14%	14%
Personal accident	6%	9%
Theft	4%	4%
Workmen's compensation	18%	19%
Miscellaneous	8%	6%
Medical	15%	13%
Group life	10%	8%
Group credit	12%	10%

(b) Insurance risk factors—Reinsurance Companies

Class of Business	*Premium Reserve—Risk Charge*	*Claims Reserve—Risk Charge*
Aviation	42%	26%
Engineering	9%	6%
Fire domestic	5%	3%
Liability	13%	12%
Marine	12%	10%
Motor vehicle private—Property damage	8%	7%
Motor vehicle private—Liability	16%	15%
Motor vehicle commercial—Property damage	6%	5%
Motor vehicle commercial-Liability	17%	16%
Motor vehicle commercial PSV—Property damage	5%	5%
Motor vehicle commercial PSV — Liability	17%	16%
Personal accident	10%	12%
Theft	7%	6%
Workmen's compensation	20%	22%
Miscellaneous	8%	8%
Medical	15%	13%
Group life	10%	8%
Group credit	12%	10%

APPENDIX 3

(a) Credit risk—Insurance and Reinsurance Companies capital charges

Asset	*Risk charge*
Government securities—National and County	0%
Foreign government bonds	5%
Corporations' and other organisations' bonds	12%
Term deposits	0%
Cash and cash balances	0%
Policy loans	0%
Secured loans—corporations and other organisations	10%
Secured loans—staff and individuals	30%
Investment in subsidiaries, associates and joint ventures	40%
Mortgages	30%
Secured loans to related parties	100%
Category 1—Reinsurers rated above A-	1.5%
Category 2— Reinsurers rated above BBB	10%
Category 3— Reinsurers rated below BBB	35%
Category 4— Reinsurers unrated	100%
Category 5 – Reinsurers licenced under the Insurance Act	2.5%
Insurance receivables—amount outstanding for less than 30 days	30%
Insurance receivables—amount outstanding for over 30 days	100%
Reinsurance receivables—amount outstanding for less than 60 days	20%
Reinsurance receivables—amount outstanding for over 60 days	100%
Assets under Deposit Administration and Pension Plans	1.5%
Assets under Unit Linked	2.0%

APPENDIX 4

Market Risk—Insurance and Reinsurance Companies capital charges

Equity risk	*Risk charge*
Listed ordinary shares on the Nairobi Securities Exchange	30%
Listed ordinary shares on other regional securities exchanges	30%
Listed preference shares on the Nairobi Securities Exchange	35%
Listed preference shares on other regional securities exchanges	40%
Unlisted shares or private equity	40%

Interest rate risk

Scenario	*Asset value*	*Liability value*	*Surplus*
Base interest rate			
Increasing interest rate			

Scenario	*Asset value*	*Liability value*	*Surplus*
Decreasing interest rate			
Interest rate risk capital			

Currency risk				
Type of currency	*Net on balance sheet position*	*Net forward position*	*Net long position*	*Net short position*
Total position				
Exposure				
Currency risk charge				8%
Currency risk capital charge				

Dated the 9th February, 2017.

GODFREY K. KIPTUM,
Acting Commissioner of Insurance and Chief Executive Officer.
Insurance Regulatory Authority.

ABDIRAHIN H. ABDI,
Chairman,
Insurance Regulatory Authority.

PRINTED AND PUBLISHED BY THE GOVERNMENT PRINTER, NAIROBI