NON-BANK FINANCIAL INSTITUTIONS REGULATORY AUTHORITY

(NBFIRA)

INSURANCE PRUDENTIAL RULES

In terms of Section 50 of the NBFIRA Act

IPR1G

Prescribed Valuation Method General Insurance Liabilities

Effective March 1, 2012

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6. Contents

7. Introduction

1.1. Insurance Prudential Rules

1. The NBFIRA's Insurance Prudential Rules (IPRs) set out the prudential requirements for regulated insurers operating in Botswana.

2. This note sets out material that may form the basis of IPR1G.

1.2. Valuation of General Insurance Liabilities

3. A general insurer's insurance liabilities are made up of claims liabilities and premium liabilities. The claim liability reserve is a reserve in respect of claims that have occurred in the past. The unearned premium liabilities reserve is a reserve with respect to future claims on business already written. Both these liabilities should be valued in accordance with the requirements set out in IPR1G.

1.3. Valuation of Assets

4. Valuation of assets is set out in detail in IPR2G. In principle, assets must be valued at fair value, except where IPR2G indicates otherwise. The main exception to the use of fair value is in respect of the valuation of group undertakings.

8. Definitions

5. For these purposes, unless the context indicates otherwise:

6. "Act" means the Insurance Industry Act, Cap 46:01 and a word or expression to which a meaning has been given in the Act, has that meaning;

7. "annual return" means the regulatory return an insurer must submit to the Regulatory Authority annually;

8. "PCT" means the prescribed capital target as set out in Insurance Prudential Rules IPR3G;

9. "best-estimate assumption" means an assumption that:

   a. Is realistic;
   b. Depends on the nature of the business concerned; and
   c. Is guided by immediate past experience, as modified by any knowledge or expectation of the future.

10. "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;

11. "claims handling cost" means the staff and other related operational cost that will be incurred by the general insurer in settling a claim;

12. "fair value" means the fair value of an asset determined by reference to the Botswana Framework of Generally Accepted Accounting Practice;

13. "gross basis" means before any allowance for any approved reinsurance as per section iv.5;

14. "IPR" means a Insurance Prudential Rule issued by the Regulatory Authority; and

15. "net basis" means net of any approved reinsurance as per section iv.5;

16. "Outstanding Case Estimates" means an estimate in respect of claims that have been reported before year end but that have not been finalised by that time;

17. "policy" means a general insurance policy;

18. "Unexpired Risk Reserve" means a reserve to cover the claims and expenses relating to unexpired periods of risk for which the insurer or reinsurer has already received or expects to receive premiums;

3. Claims liabilities

4. The claims liabilities consist of the:

   a. Outstanding Claims Reserve ("OCR")

   b. Incurred But Not Reported Reserve ("IBNR")

5. These claims liabilities need to be calculated on a gross and net basis.

6. Both these reserves need to be calculated at a best-estimate level and should include an allowance for the insurer's claims handling cost.

3.1 OCR

7. As soon as a potential claim has been reported to the insurer, they are required to raise an estimate of the expected cost of this claim, on their claims administration system. These estimates must be updated as new information is gathered and claim payments are made.

8. The best estimate of the OCR will then be calculated as the sum of all outstanding case estimates on the insurer's claims administration system at the end of the financial period in question.

3.2 IBNR

9. The level of IBNR reserve to be held by a specific insurer or reinsurer can be determined using a:

   a. Prescribed Valuation Method ("PVM")

   b. Detailed calculations performed by an Approved Person

3.2.1 PVM

10. If the PVM methodology is chosen by the insurer, they will be required to hold an IBNR reserve of:

    a. 10% of gross written premiums for the gross reserve calculation

    b. 10% of gross written premiums net of any approved reinsurances (as per section iv.5) for the net reserve calculation

3.2.2 Detailed calculations

11. A general insurer can apply to the Regulatory Authority for permission to deviate from the PVM. The application would take the form of a valuator's report, prepared by an Approved Person, where the report will need to be prepared in accordance with BGR3. The purpose of BGR3 is to provide the Approved Person with guidance when preparing a valuation report on the liabilities of a general insurer. This is required when the insurer applies to the Regulatory Authority for permission to hold insurance liabilities on a basis other that the PVM basis above.

12. The initial application will have to be submitted at least 6 months before the financial year-end for which the insurer intends to use detailed calculations. Once initial approval has been granted, the Approved Person's report will need to accompany the annual returns submitted to the Regulatory Authority.

13. When performing the calculation the Approved Person will be required to:

    a. Calculate the reserve at a best-estimate level

    b. Use generally accepted actuarial techniques such as the Chain Ladder or Bornheutter Ferguson methods to perform the calculations

    c. Calculate the reserve such that it will be sufficient to:

        ii. Cover the cost of claims that have occurred before the end of the financial year but have not been reported to the company

        iii. Cover the cost of claims that have been reported by financial year-end but for which the raised outstanding claims reserves are too low to cover future claim costs (The latter is normally referred to as an incurred but not enough reported reserve (IBNER)). Thus the IBNR reserve calculation will also need to incorporate any potential deficiencies in OCR.

        iv. The claims handling cost associated with each of these claims

    d. Calculate the reserve on a line of business level as defined by the Regulatory Authority. (However, this requirement will not prevent the Approved Person from undertaking the necessary analysis to determine the most suitable basis, taking into account the nature of the data and the particular circumstances of the insurer).

4. Unearned Premium Liabilities

14. The unearned premium liabilities should be sufficient to cover the claims and expenses relating to unexpired periods of risk for which the insurer has already received premiums by the end of the financial period.

15. The unearned premium liabilities will consist of the sum of:

    a. Unearned Premium Provision ("UPP")

    b. Unexpired Risk Provision ("URP")

4.1 UPP

16. The level of UPP to be held by a specific insurer can be determined using a:

    a. Prescribed Valuation Method ("PVM")

    b. Detailed calculations performed by an Approved Person

4.1.1 PVM

17. The Unearned Premium Provision (UPP) must be calculated using the 365ths method thus assuming that the premium is earned evenly over the duration of the policy. The PVM will need to be calculated:

    a. On a gross and net basis

    b. On the written premium net of any commissions and other initial expenses paid to agents

    c. On a line of business level as specified by the Regulatory Authority

4.1.2 Detailed calculations

18. A general insurer could apply to the Regulatory Authority for permission to deviate from the PVM. As with the IBNR reserves, the application would take the form of a valuator's report, prepared by an Approved Person. This report needs to be prepared in accordance with BGR3.

19. The initial application will have to be submitted at least 6 months before the financial year-end for which the company intends to use the calculations. Once initial approval has been granted, the valuator's report will need to accompany the annual returns submitted to the Regulatory Authority every year.

20. The calculation needs to:

    a. Be done on a gross and net basis using a best estimate calculation basis

    b. Take into account the actual spread of the risk over the period of the contract

4.2 URP

21. Where an insurer has specific knowledge that its premiums are inadequate to meet claims and the associated cost, an URP will need to be raised in addition to the UPP. Appropriate prudence would need to be borne in mind when setting the URP.

22. Since the calculation of the URP would depend on the context and the specific circumstances of the insurer, a formula is not prescribed for it. However, the calculations will need to be performed by an Approved Person.

23. Details of any calculations will then have to be provided to the NBFIRA as part of the Approved Person's valuation report.

5. Reinsurance

24. For the calculation of the general insurer's net liabilities the insurer should take into account the impact of any allowable reinsurance contract entered into by the insurer.

25. Allowable reinsurance is defined as reinsurance placed with a reinsurer with a credit rating of BBB or better. Credit ratings may be obtained from any acceptable credit rating agency, but the same credit rating agency must be used to provide ratings for all reinsurers. Where applicable the credit rating must be that applicable to the local office of the reinsurer.

26. In financial or other reinsurance arrangements, where some or all of the risk is transferred back to the insurer, the insurer must hold whatever is the appropriate amount of liabilities in the light of the risk that is effectively retained.