THE INSURANCE COMMISSION
OF THE BAHAMAS

Long-term Insurance Capital Adequacy

Draft Guidelines

3/2/2018

This Guideline outlines the capital adequacy requirements for long-term insurance companies. It details the approach to determining the required risk based capital and the available capital taking into consideration the quality of available capital.

Table of Contents

Long-term Insurance Capital Adequacy Guideline 3

1. Citation...3
2. Definitions...3
3. Application...3
4. Regulatory Capital Available...3
   - A. Tier 1 Capital...4
   - B. Tier 2 Capital...4
   - C. Deductions...5
5. Regulatory Capital Requirement...5
   - A. Asset Default Risk Charge...6
   - B. Off Balance Sheet Risk Charge...7
   - C. Foreign Currency Mismatch Risk Charge...7
   - D. Asset Liability Mismatch Risk Charge...7
   - E. Mortality Risk Charge...8
   - F. Morbidity Risk Charge...9
   - G. Lapse Risk Charge...9
   - H. Interest Margin Pricing Risk Charge...9
6. Regulatory Capital Ratio and Capital Management...10
7. Returns, Audit and Declarations...10
8. Grandfathering Provision...11
9. Transitional Provisions...11

Schedule 1- Declarations...12

- Declaration by the Chief Financial Officer...12
- Declaration by the Actuary...12
- Declaration by a Director of the Company...12

Long-term Insurance Capital Adequacy Guideline

Pursuant to s. 78, Insurance Act, 2005 and reg. 90, Insurance (General) Regulations, 2010

1. Citation

This Guideline may be cited as the Long-term Insurance Capital Adequacy Guideline.

2. Definitions

In this Guideline:

i. "foreign insurer" means a branch of a foreign insurance company, which is registered to carry on insurance business in The Bahamas;

ii. "policy liabilities" mean the policy benefit liabilities as determined under section 62 of the Insurance Act (2005) for long term insurance business;

iii. "Regulatory Capital Ratio" means the Regulatory Capital Available divided by Regulatory Capital Requirement; and

iv. "Net amount at risk" is the net sum assured minus the net reserve, where the sum assured and the reserve are net of reinsurance;

v. "Adjustable Life" is a type of permanent individual life insurance policy where the premium, sum assured and period of protection can be changed throughout the life of the policy. The policy combines traditional coverage with a savings component; and

vi. "Adjustable premium policies" are permanent individual life policies where premiums may be adjusted by the insurer due to changes in the underlying experience of the policies.

3. Application

These Guidelines apply to both domestic and foreign insurers in respect of insurance business both in and outside of The Bahamas. The term "policy liabilities" defined above apply equally to the policy liabilities both inside and outside of The Bahamas. The Regulatory Capital Available and Requirement are to be determined using the unconsolidated financial statements of the insurer.

4. Regulatory Capital Available

Financial instruments will only be considered for regulatory capital where these instruments:

- are permanent;
- are free of mandatory fixed charges against earnings; and
- have a subordinated legal position to the rights of policyholders and other creditors

Total Available Capital consists of Tier 1 (core capital) and Tier 2 (supplemental capital). Tier 1 capital comprises the highest quality elements. Tier 2 elements fall short of either of the first two capital qualities but contribute to the overall strength of the company as a going concern.

All capital instruments must be issued and fully paid for in cash or, with the approval of the Insurance Commission of The Bahamas ("the Commission"), in property.

Regulatory Capital Available for a domestic insurer is the sum of Tier 1 and Tier 2 Capital, less the deductions from capital as summarized in this section. For a foreign insurer the Regulatory Capital Available is the sum of the total amount of initial deposit in accordance with s. 43, Insurance Act, 2005 ("the Act"), and the statutory funds held in trust in accordance with s. 45(4) of the Act, plus any excess assets in The Bahamas less the total liabilities and reserves required in The Bahamas.

A. Tier 1 Capital

Net Tier 1 (or core) Capital shall be the amount by which the value of Gross Tier 1 Capital (see "a" below) exceeds the total of the deductions (noted in "b" below).

a. Gross Tier 1 Capital shall be the accumulation of:
   1. ordinary share capital (issued and fully paid);
   2. contributed surplus;
   3. retained earnings (or deficit);
   4. preference shares or other financial instruments that meet the requirements of Tier 1 Capital as outlined in this section;
   5. the life surplus reserves on participating and non-participating business; and
   6. revaluation reserves approved by the Commission.
   7. Non-controlling interest

b. The amount to be deducted from Gross Tier 1 Capital shall be the accumulation of:
   1. the cash surrender value deficiencies, calculated on an aggregate basis for each line of business separately multiplied by 0% in the first year of implementation; 33% in the second year; 67% in the third year and 100% thereafter;
   2. negative policy liabilities, calculated on a policy by policy basis by line of business, multiplied by 0% in the first year of implementation; 33% in second year; 67% in third year and 100% thereafter; and
   3. unrealized gains on assets included in retained earnings, revaluation reserves or life surplus reserves.

   For the calculation of the cash surrender value deficiencies and negative reserves mentioned above, line of business shall refer to "class of business" as defined in s. 3, Insurance (General) Regulations, 2010 ("the Regulations").

c. Financial instruments, unless specifically approved as core capital by the Commission prior to December 31, 2014, may only be included in Tier 1 Capital if they meet the following conditions:
   a. they are of perpetual duration and fully paid;
   b. there is no option for redemption at the request of the holder;
   c. they are fully subordinated to the interests of policyholders and other creditors;
   d. dividends are not cumulative in the event of non-payment; and
   e. the amount does not exceed 33% of Tier 1 Capital excluding preference shares.

   Net Tier 1 Capital must exceed the minimum stated capital prescribed in regulation 60 of the Regulations.

B. Tier 2 Capital

Tier 2 Capital is divided into Tiers 2A, 2B and 2C and shall not exceed 100% of Net Tier 1 Capital.

Tier 2A Capital comprises the following:

a. preference shares or other financial instruments that would have been included in Tier 1 Capital but for the limit in Tier 1 Capital;
b. hybrid capital instruments that do not meet the definition of Tier 1 Capital but meet the requirements for Tier 2A outlined below;
c. unrealized gains excluded from Tier 1 Capital with unrealized gains on real estate limited to 20% of Net Tier 1 Capital.

Hybrid capital instruments may only be included in Tier 2A Capital if they meet the following conditions:

a. they are of perpetual duration and fully paid up;
b. there is no option for redemption at the request of the holder;
c. they are fully subordinated to the interests of policyholders and other creditors;
d. dividends or interest are able to be deferred (as for example with cumulative preference shares) where the profitability of the company would not support payment; and
e. must not contain restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than the insolvency, bankruptcy or winding-up of the insurer.

Tier 2B Capital includes limited-life instruments that meet the following criteria:

a. the initial minimum term is greater than five years;
b. they are fully paid up in cash or, with the approval of the Commission, in property;
c. they are fully subordinated to the interests of policyholders and other creditors; and
d. if the remaining term of the instrument is less than five years, the amount of the instrument included in Tier 2B Capital is amortized according to the following schedule:
    i. remaining term 4 years but less than 5 years 80%
    ii. remaining term 3 years but less than 4 years 60%
    iii. remaining term 2 years but less than 3 years 40%
    iv. remaining term 1 year but less than 2 years 20%
    v. remaining term less than 1 year nil

Limit: Tier 2B Capital shall not exceed 50% of Net Tier 1 Capital.

Tier 2C Capital instruments include:

a. 75% of the amount deducted from Tier 1 Capital for cash surrender value deficiencies and
b. the amount deducted from Tier 1 Capital for negative policy liabilities.

C. Deductions

The sum of Tier 1 and Tier 2 Capital shall be reduced by the following:

a. Goodwill and other intangible assets;
b. new capital issues between two or more companies that represent either directly or indirectly, back-to-back placements;
c. pension plan assets; and
d. investment in financial subsidiaries.

5. Regulatory Capital Requirement

The Regulatory Capital Requirement is sum of the following:

A. Asset Default Risk Charge
B. Off Balance Sheet Risk Charge;
C. Foreign Currency Mismatch Risk Charge;
D. Asset Liability Mismatch Risk Charge
E. Mortality Risk Charge;
F. Morbidity Risk Charge;
G. Lapse Risk Charge; and
H. Interest Margin Pricing Risk Charge.

A. **Asset Default Risk Charge**

Asset Default Risk Charge is the sum of the various asset class amounts comprising total assets multiplied by an appropriate risk factor for each asset class as shown in Table 1.

Table 1

Asset Class	**Factor**
-	
Cash, bank balances and bank deposits	0.00
Bank certificates of deposit	0.00
Treasury bills	0.00
Treasury notes/bonds	0.00
Government and government guaranteed securities	0.00
Government corporation/agency bonds (not guaranteed)	0.10
Corporate bonds - listed	0.20
Corporate bonds - not-listed	0.20
Real estate / Investment Property	0.15
Equity securities - listed	0.20
Equity securities - not-listed	0.20
Preferred shares - listed	0.15
Preferred shares - not-listed	0.15
Other debt instruments - listed	0.20
Other debt instruments - not-listed	0.20
Mortgage loans – performing	0.00
Mortgage loans - non-performing (overdue 90 days or more)	0.20
Mutual funds	0.20[1]
Investment in financial subsidiaries	0.00
Investment in related parties if not financial subsidiary	1.00
Other investments	0.25
Policy loans	0.00
Due from reinsurers	0.00
Deferred acquisition costs	1.00
Receivables from agents:	
0 - 30 days outstanding	0.10
31 - 60 days outstanding	0.15
Over 60 days outstanding	0.25

[1] Alternatively, the "look through" approach may be used for the underlying assets of the fund; using the corresponding factors on a pro rata basis.

Asset Class	**Factor**
Premium receivables:	
0 - 30 days outstanding	0.00
31 - 60 days outstanding	0.15
Over 60 days outstanding	0.15
Interest receivable on investments	0.00
Goodwill and other intangible assets	0.00
Land and building (used in operations)	0.15
Accounts receivable	0.15
Prepayments	0.15
Equipment and machinery	0.15
Office, furniture and fixtures	0.15
Computer software	0.15
Leasehold improvements	0.15
Motor vehicles	0.15
Other assets	0.25

Where Policy Loan value is greater than the underlying policy cash value the policy loan asset value should not be greater than the cash value.

B. Off Balance Sheet Risk Charge

Off Balance Sheet Asset Risk Charge is the sum of the amount of the transaction undertaken through synthetic assets and derivatives multiplied by a risk factor based on the type of contract and its term to maturity as stated in reg. 72 of the Regulations or Table 2, as appropriate.

The Off Balance Sheet Liability Risk Charge shall be based on the risk factor for the counterparty.

C. Foreign Currency Mismatch Risk Charge

The Foreign Currency Mismatch Risk Charge shall be

a. 2% of the total of the net open positions in any other currency issued by countries rated BBB and above, expressed in Bahamas dollars; and
b. 8% of the total of the net open positions in any currency issued by countries rated BBB- and below, expressed in Bahamas dollars.

The net open position shall be the absolute value of the assets denominated in a currency less the liabilities denominated in that currency. The value shall be converted to Bahamian dollars using the prevailing selling rate at the valuation date as determined by the Central Bank of The Bahamas.

Where the actuary can demonstrate that provisions for foreign currency mismatch have been established within the policy liabilities, then such provisions can be offset against this capital requirement.

D. Asset Liability Mismatch Risk Charge

The Asset Liability Mismatch Risk Charge shall be 10% of the absolute change in performing a 1% parallel shift in the valuation interest rate of the liabilities.

Where the insurer has an asset liability management approach in place and has the ability to stress test the assets supporting the liability segment, a similar 1% parallel shift in the assets should be determined. The Asset Liability Mismatch Risk Charge is the minimum of:

i) the absolute change in the liabilities minus the absolute change in the assets, when a 1% parallel shift is applied; and
ii) the charge calculated as above.

E. Mortality Risk Charge

The Mortality Risk Charge for long term insurance business is the sum of the exposure for each type of policy multiplied by the appropriate risk factor as shown in Table 2.

Table 2

Type of policy	Measure of exposure	Factors
Individual Life	Net amount at risk	0.0005 (Less than 1 year guaranteed term remaining) 0.0010 (1-5 years guaranteed term remaining) 0.0020 (Over 5 years guaranteed term remaining)
Group Life	Net amount at risk	0.0005 (Less than 1year guaranteed term remaining) 0.0010 (1-5 years guaranteed term remaining) 0.0020 (Over 5 years guaranteed term remaining)
Participating Adjustable Life & Universal Life, where mortality costs are reasonably flexible.	Net amount at risk	0.0010 Where this is not the case, use the factors for “All other policies”
Accidental Death and Dismemberment: Participating, Adjustable Life & Universal Life	Net amount at risk	0.0003
Accidental Death and Dismemberment: Individual and Group Life	Net amount at risk	0.00015 (Less than 1year guaranteed term remaining) 0.0003 (1-5 years guaranteed term remaining) 0.0006 (Over 5 years guaranteed term remaining)
All annuities involving life contingencies	Total policy liabilities	0.01
All other policies	Net amount at risk	0.0005 (Less than 1year guaranteed term remaining) 0.0010 (1-5 years guaranteed term remaining) 0.0020 (Over 5 years guaranteed term remaining)

F. Morbidity Risk Charge

Personal Accident Disability Waiver and Health Insurance

The new claims risk component relates to claims arising from the current year's coverage, and includes the risks of incidence and claims continuance. The factors shown in Table 3 shall be applied to the Annual Earned Premiums.

Table 3

Percentage of Annual Earned Premiums	
Individual	**Group**
20%	15%

The continuing claims component covers risk of claims continuance arising from coverage provided in prior years. The factors shown in Table 4 below shall apply to disabled life reserves related to claims incurred in prior years, including the portion of the provision for incurred but unreported claims.

Table 4

Risk	Factor
Disabled Life Reserve	0.06
Incurred but not reported claims	0.10

G. Lapse Risk Charge

The Lapse Risk Charge shall be calculated for all individual life business and includes participating and adjustable premium policies and all other policy series.

Determination of the Lapse Risk Charge shall be as follows:

a. the total net policy benefit liabilities are to be determined in accordance with section 62 of the Insurance Act, 2005;
b. the total net policy benefit liabilities are then recalculated using increased lapse margins for adverse deviation. For participating and adjustable premium policies, the lapse rate margin assumption is adjusted by 7.5% of the underlying lapse rate assumption. For other policies the lapse rate margin assumption is adjusted by 15% of the underlying lapse rate assumption. Where at a particular duration a lower lapse rate assumption results in a higher reserve, the lapse rate assumption is adjusted by reducing the rate. Where at a particular duration the lapse rate assumption results in a higher reserve, the lapse rate assumption is adjusted by increasing the rate.
c. The reserve calculated in step (a) is to be subtracted from the reserve calculated in step (b).

H. Interest Margin Pricing Risk Charge

The Interest Margin Pricing Risk Charge is the sum of the policy liabilities net of reinsurance multiplied by the appropriate risk factor for the type of policy as shown in Table 5.

Table 5

Type of Policy	Factor
Guaranteed Investment Contract (GIC) type deferred annuities that are renewable at new business rates; policies with no re-pricing risk; policy liabilities that are not discounted for interest.	0
Adjustable premiums/adjustable interest credits, Universal life where the crediting rates are reasonably flexible[2], Other types of GIC policies.	0.005
All other policies	0.010

No factor should be applied where the contract offers renewal only at the rate for new business or for which no renewal option is offered.

6. Regulatory Capital Ratio and Capital Management

Regulatory Capital Ratio (RCR) means the Regulatory Capital Available divided by Regulatory Capital Requirement expressed as a percentage. Companies are required to establish a Target Capital Ratio (TCR) in excess of a Regulatory Capital Ratio of 150% and manage their capital levels such that the regulatory capital ratio is always in excess of its TCR.

The TCR should be determined based on the company's Own Risk and Solvency Assessment, necessary to cover the risks specified in the capital tests as well as all other risks of the insurer. The TCR should be based on stress testing and scenario testing to establish a capital buffer commensurate with the variability and risks in the business. A RCR below 150% will attract regulatory attention and require insurance companies to present a capital plan outlining how the company will return to a capital ratio in excess of the TCR. A drop in the capital ratio to a level below the Minimum Capital Ratio (MCR) of 120% will attract the most severe regulatory intervention including suspension of registration under the Insurance Act. The MCR is set at 120% rather than 100% to cover operational risks that are not explicitly measured, but form part of the minimum requirement under the RCR.

All insurers are required to assess the quality and adequacy of capital resources to meet regulatory requirements and other capital needs. This must be reported in the insurer's annual capital management plan.

7. Returns, Audit and Declarations

a. An insurer is required to submit to the Commission, Capital Adequacy Returns in such form as the Superintendent of Insurance may from time to time specify in accordance with the requirements of s. 58 of the Act;
b. In addition to the Capital Adequacy Returns required to be submitted under this Guideline and the Act, an insurer shall provide a declaration by the Chief Financial Officer, the Actuary, and a Director of the insurer in the format as set out in Schedule 1 of this Guideline.

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[2] The reasonable flexibility of the crediting features should have been tested in pricing the policy or elsewhere, and should demonstrate that the company may recuperate at least half of any unexpected losses due to disintermediation risk. This would be done by comparing the price with and without future adjustments, using the regular or reduced component as appropriate. The tests performed should be available upon request.

8. Grandfathering Provision

Unrealized gains on real estate prior to the commencement of this Guideline that have not subsequently been realized, will be treated as though they were realized and shall not be subject to restrictions on regulatory capital in this Guideline.

9. Transitional Provisions

Reg. 73 of the Regulations states that "after relevant consultations, the Commission may, upon giving at least six months notice … change the nature and manner of determining the solvency margins…". The solvency margin requirement of long-term insurance business (Life & Health) is included in reg. 90. This will require an amendment to allow for this Guideline to be implemented.

Schedule 1- Declarations

Declaration by the Chief Financial Officer

I, …………………….., Chief Financial Officer of Company Name, Address of Company have reviewed the calculation of the Regulatory Capital Ratio of **Company Name,** as at **(Date).** In my opinion, the calculation has been determined in accordance with the Long-term Insurance Capital Adequacy Guideline and any applicable instructions of the Insurance Commission of The Bahamas.

Signature of the Chief Financial Officer Date

Declaration by the Actuary

I, …………………………, Actuary of Company Name, Address of Company have reviewed the calculation of the Regulatory Capital Ratio of **Company Name,** as at **(Date).** In my opinion, the calculation has been determined in accordance with the Long-term Insurance Capital Adequacy Guideline and any applicable instructions of the Insurance Commission of The Bahamas.

Signature of the Actuary Date

Declaration by a Director of the Company

I, …………………………, Officer of Company Name, Address of Company have reviewed the calculation of the Regulatory Capital Ratio of **Company Name,** as at **(Date).** In my opinion, the calculation has been determined in accordance with the Long-term Insurance Capital Adequacy Guideline and any applicable instructions of the Insurance Commission of The Bahamas.

Signature of a Director Date