Attachment I

Terms of Reference

(A) Background

The Insurance Regulatory Commission of Sri Lanka (IRCSL) was established with the purpose of developing, supervising and regulating the insurance industry in Sri Lanka.

(B) RBC & One-off Surplus

The IRCSL has implemented the Risk Based Capital (RBC) regime for Insurers in Sri Lanka with effect from 01.01.2016. Accordingly, the policy liability valuation methodology of 'Net Premium Valuation" (NPV), which was previously adopted, has been changed to "Gross Premium Valuation" (GPV) when migrating to the RBC regime. As a result, most insurance companies have identified additional surplus in the accounts due to lower liabilities under GPV basis. **This additional surplus is referred to as the "One-off Surplus".**

This additional surplus was broadly described as "Surplus created due to change in Valuation Method of Policy Liabilities from Net Premium Valuation (NPV) to Gross Premium Valuation (GPV)".

It is observed that companies have used different methods to compute the one off surplus. Companies have generally used either the distribution basis or solvency basis to compute the above surplus. However, more differences were noted in computation of the NPV and GPV liabilities under above two scenarios such as use of accounting basis, internal basis, method similar to liability adequacy testing, policy reserves floored at surrender value etc., which figures can vary accordingly.

Variations were also observed when considering universal life products for One-off Surplus. The method of valuation of universal life products has not been defined separately in the present RBC Rule.

With regard to the treatment for negative liabilities under GPV, some companies have zeroed negative liabilities as best practice where some have not. Further, different bases were adopted when zeroing the negative liabilities such as zeroing at fund level, product level and policy level.

As per the available information, total One-off Surplus reported by insurance companies (15 insurers) amounted to Rs. 35 billion (approx) for Participating business and Rs. 24 billion (approx) for non-participating business. This is accounted for 45% of the total policy liabilities valued at GPV basis on 01.01.2016.

The IRCSL intends carrying out revisions/ amendments to RBC Rules in year 2018 having obtained Technical Assistance from a donor agency, based on issues identified after implementation, such as recognition of negative liabilities for long term policy liability valuation, non-availability of a policy liability valuation method for Universal Life Products, issues relating to risk free rate and surrender value capital charge etc. Therefore, there could be effects to the one off surplus as well.

(C) Tax Effects -

It is understood that the transfer of surpluses from long term funds to shareholders' funds will be taxed at 28% (participating fund will be charged concessionary rate of 14% for three years) with effect from the financial year commencing 2018/2019.

(D) Objective –

The objective of the assignment is to obtain advice to provide procedures/ common standards for the identification, maintenance, transferring and distribution of the surpluses created due to change in valuation methodology of policy liabilities from NPV to GPV, commonly known as the one off surplus and any disclosures required.

(E) Scope –

a) Identification

1. To provide recommendations on computation of One-off Surplus including computation of the policy liabilities in terms of the GPV & NPV methodology as best practice (notwithstanding the Solvency Margin Rules) to apply to all Insurance Companies.
2. To provide justifications for best practices recommended in item 1 above (for any deviations on rules and assumptions based therein). To review the one-off surplus computation of each individual insurers reported currently based on the above and to provide recommendations.
3. To review the individual insurance company's reporting's such as SLFRS reporting, regulatory reporting (Balance Sheet and Market Consistent Balance Sheet's) and provide recommendations to adopt a uniform method across the industry.

Source of information

i) Reviews on Solvency Margin Rules, Returns and Audited Financial Statements submitted by Insurance Companies, available working papers and comments received from the Insurance Association of Sri Lanka, insurance companies etc.
ii) To conduct discussions with the IRCSL, Individual Insurance Companies, Actuarial Association of Sri Lanka etc. in order to obtain further information if necessary.
iii) To request any other information where necessary.

b) Maintenance of One-off Surplus & Disclosures

1. To provide recommendations on maintenance of One-off-Surplus in the Financial Statements/ Regulatory Returns.
2. To provide recommendations on maintenance of assets for One-off Surplus.
3. To provide recommendations on charging other related costs and income etc (if necessary).
4. To provide recommendations on disclosure requirements

c) Transfers/ Distribution of One-off Surpluses

1. To recommend a procedure and requirements to be considered when allowing transfers/ distribution of One-off surplus including period of maintenance, any yearly distribution caps, impact of possible RBC Rule changes for identified implementation issues.

The above to be recommended having evaluated the possible impact to financial status of insurers due to distribution of surplus under different scenarios etc.

d) Training

To provide training programs to the staff of the IRCSL on recommendations made this assignment and to conduct workshops / dialogues with the insurers to accomplish the above activities.

e) Post Review

To provide verification of subsequent information/ responses/ returns submitted by insurers on the One-off Surplus based on (a) (c) and to provide recommendations on same.

(F) Expected Deliverables -

1. To provide a draft report outlining the observations and recommendations covering the scope of the assignment.
2. To conduct meetings / training with staff of the IRCSL and with industry participants / IASL.
3. To provide the final report.
4. To provide comments / recommendations on post verification of correspondence / returns from insurers.

The Adviser is required to submit a statement to the Director General of the IRCSL at the end of each three working days from the commencement of the agreement detailing the work done during the relevant period performing the Services.