PGN101(1998): LIFE OFFICES - MAXIMUM DIVIDEND THAT MAY BE DECLARED

First Issued: Jan 1994
Last Revised: May 1997

1. INTRODUCTION

1. Compliance with this amended professional guidance note as set out in section 4 is **mandatory** for valuators of South African life offices with immediate effect. Sections 2 and 3 below comment on fundamental issues of principle which were taken into account in formulating this professional guidance note.

2. The purpose of this professional guidance note, which was developed by a committee consisting of members of the Actuarial Society of South Africa (ASSA), the South African Institute of Chartered Accountants (SAICA), and the Chief Actuary of the Financial Services Board, is to assist both the valuator and the external auditor in fulfilling their statutory duties.

3. In terms of Circular RV116 issued by the Financial Services Board, the valuator is required to satisfy himself with regard to dividends payable to and profits reserved for shareholders, bearing in mind the financial soundness of the insurer.

4. To facilitate the sound financial management of life offices, it was considered necessary to develop this professional guidance note to assist the valuator in determining the maximum amount that may be declared by a life office, in terms of both dividends and distributable earnings .

5. In an audit guide to be issued by SAICA entitled "Auditors Relationship with Actuaries in the Long Term Insurance Industry", the external auditor is required to discuss various aspects with the valuator, including the distribution of surplus.

2. SOLVENCY

1. **Legal position**
   The new draft Long Term Insurance Bill contains the limitation that unless a company complies with the solvency requirements (total assets exceed total liabilities on both the prescribed and financial soundness bases), no dividend may be declared.

2. **Actuarial position - solvency**
   Total assets must exceed total liabilities on both valuation bases, after providing for the dividend.

Total liabilities would include liabilities for unmatured policies, contingency reserves, current liabilities and provisions for taxation and dividends declared.

3. COMMON LAW RULES

1. **Unrealised Capital Appreciation**
The Companies Act, 1973 is silent on the issue of declaring dividends out of unrealised capital appreciation. Common law rules do not clarify whether or not unrealised capital appreciation may be taken into account for the purposes of determining earnings/dividends as there is no South African case law in this regard and legal opinion on the matter differs. From the point of view of generally accepted accounting practice, there are differing views held and a more conservative approach is usually taken.

The maximum amount from which a dividend can be declared, as calculated by the valuator, will, through the allowance made in the valuation, provide to some extent for a future fall in the market value of the underlying investments. The declaration of dividends is the responsibility of the board of directors, who may deem it prudent to make further provision for unrealised capital appreciation (refer to paragraph 4.8).

2. **Share Capital**
Both the Companies Act and common law rules prohibit the payment of dividends out of share capital. In the case of a life insurance company, assessing whether a dividend is being paid out of share capital is extremely difficult, hence the necessity to devise an appropriate test to assist in this regard.

4. PROFESSIONAL GUIDANCE NOTE

1. Both the prescribed and financial soundness valuations should be completed in order to determine the maximum amount from which a dividend can be declared (A).

2. The results on both the prescribed and financial soundness valuation bases should be analysed as follows:

Actuarial Valuation of assets			xxxx
Less:	Current liabilities		xxxx
	Actuarial valuation of policy liabilities		xxxx
Free Reserves			xxxx(B)
Less: Max{a,b}, where			
a = issued share capital plus non-distributable reserves		xxxx	
b = capital adequacy requirement		xxxx	
Adjusted free reserves			xxxx(C)

Note:

The current liabilities reflected above do not include the current dividend.

3. The maximum amount, including any liability for Secondary Tax on Companies (STC), from which a dividend can be declared (A) is equal to the lower of:

- free reserves (B) on the prescribed valuation basis; and

- adjusted free reserves (C) on the financial soundness valuation basis

4. The maximum amount which may be disclosed as distributable earnings for the year is equal to the maximum amount from which a dividend can be declared (A), as calculated per paragraph 4.4, less distributable reserves as disclosed in the financial statements of the previous year.

5. The abovementioned basis is applicable whether the dividend is payable in cash or specie, or in the form of a capitalisation issue.

6. In the case of a dividend declared prior to the completion of the valuation, or where no valuation is to be undertaken, such as in the case of an interim dividend declaration, the directors must receive an assurance from the valuator, before the dividend is declared, that based upon the studies he has undertaken, the company would have been able to satisfy the conditions indicated above, if the required valuation had been completed. If a dividend is declared without such assurance having been given, and the valuator has reservations regarding the company's ability to satisfy the conditions indicated above, he should regard this as a material matter in terms of sub-section (5) of section 10 of the Insurance Act, and report accordingly to the Registrar.

7. It would not necessarily be prudent or possible to distribute as a dividend, the maximum amount (A) from which a dividend can be declared, as calculated per paragraph 4.4, particularly bearing in mind the relative volatility of the surplus earned from year to year. Prudence will be a matter for the board of directors to decide on, based on advice from, inter alia, the valuator. In addition, the Articles of Association may contain constraints regarding the payment of dividends.

DIVIDEND TEST EXAMPLE

ANALYSIS OF VALUATION RESULTS

	PRESCRIBED VALUATION (before dividend)		
	Assets	=	1150
	Liabilities	=	950
(B)	Free reserves	=	200
	FINANCIAL SOUNDNESS VALUATION (before dividend)		
	Assets	=	1100
	Liabilities	=	740
(B)	Free reserves	=	360
	less: Max of (a,b)		200
	where:		
	(a) shareholders' capital plus non-distributable reserves	= 200	
	(b) capital adequacy requirements	= 150	
(C)	Adjusted free reserves	=	160 (including distributable reserves of 120)

MAXIMUM DIVIDEND

(A)	Maximum amount from which a	= minimum of 200 and 160
	dividend can be declared	= 160

MAXIMUM DISCLOSED DISTRIBUTABLE EARNNINGS FOR THE YEAR

Maximum distributable earnings which	= maximum dividend (A) less
can be disclosed for the year	existing distributable reserves
	= 160-120
	= 40

Scenario A - Dividend declaration of 30
If a dividend of 30 were declared, it can be financed from the maximum distributable earnings of 40.

Scenario B - Dividend declaration of 100
If a dividend of 100 were declared, only 40 of the dividend can be financed from the maximum distributable year's earnings. The balance of 60 would have to be funded from distributable reserves.