

# Prudential Standard FSG 1

## Framework for Financial Soundness of Insurance Groups

### ***Objectives and Key Requirements of this Prudential Standard***

*This Standard sets out the high-level framework for assessing the financial soundness of insurance groups operating in South Africa from a regulatory perspective. The principles set out in this Standard are supported by two further Standards that detail the methodology and technical computations required to assess the financial soundness of an insurance group.*

*It is the responsibility of the board of directors of the controlling company of an insurance group to ensure that the insurance group meets the financial soundness requirements on a continuous basis.*

*The key principles and requirements underpinning the financial soundness framework for insurance groups include:*

- The Prudential Authority will designate insurance groups, including the scope of entities that will be subject to group-wide capital adequacy assessment under the Financial Soundness Standards for Insurance Groups;*
- Insurance groups must calculate their group-wide capital adequacy using either the Deduction and Aggregation (D&A) method or, subject to the approval of the Prudential Authority, the Accounting Consolidation (AC) method;*
- In assessing the eligible own funds and Solvency Capital Requirement (SCR) of the insurance group as a whole, intra-group transactions and potential restrictions on the availability of certain own funds must be assessed and appropriately accounted for in group capital adequacy calculations; and*

*Insurance groups may apply to the Prudential Authority to use an Internal Model for the purpose of calculating all or part of the group SCR.*

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## 1. Application

- 1.1. This Standard applies to all insurance groups that have been designated under section 10 of the Insurance Act, 2017 (the Act) by the Prudential Authority.
- 1.2. An insurer must notify the Prudential Authority if it is part of a group of companies as per section 9 of the Act. The Prudential Authority will then determine:
  - a) Whether the insurer is to be supervised on a group-wide basis as part of a designated insurance group;
  - b) If an insurance group is designated, the scope of entities that will form part of that insurance group; and
  - c) The entity that will be designated as the head of the insurance group (i.e. the controlling company).
- 1.3. In making a determination as to the scope of entities that will form part of an insurance group, the Prudential Authority will have regard to:
  - a) The scope of all legal entities included in the consolidated accounts of the group of companies;
  - b) All insurers within the overall group structure, including entities which have control over insurers;
  - c) Any entity that is significant to the insurance group's capital position or its financial standing;
  - d) All parts of the group that may present potential sources of risk to the licensed insurers, including entities that may not be part of the consolidated accounts of the group but nevertheless present potential sources of operational or financial risk to the insurance group and the licensed insurers (e.g. outsource partners);
  - e) The level of control or influence the controlling company has over other entities within the group; and
  - f) Any entity that has the potential to create risks that, if realised, could produce significant losses for the group.
- 1.4. The controlling company of an insurance group will either be:
  - a) An insurer that is licensed by the Prudential Authority; or
  - b) A holding company that is licensed by the Prudential Authority.
- 1.5. In general, subject to the materiality considerations discussed in section 1.6 below, all participations of the controlling company (including subsidiaries and associates<sup>1</sup>) will be regarded to be within the scope of the insurance group. This includes the following types of entities:
  - a) Operating and non-operating holding companies;
  - b) Insurers;
  - c) Other regulated financial and credit institutions;
  - d) Non-regulated entities; and
  - e) Special Purpose Vehicles (SPVs).

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<sup>1</sup> The terms "subsidiaries" and "associates" in the Financial Soundness Standards for Insurance Groups are defined in accordance with definitions used for International Financial Reporting Standards (IFRS).

- 1.6. The Prudential Authority may elect to exclude certain entities from its determination of an insurance group for the purposes of group capital adequacy calculations, where such entities do not pose material risks to the financial soundness of the insurance group that may impact the objective of policyholder protection.<sup>2</sup> While the Prudential Authority will consider each entity on a case-by-case basis, the following entities will normally be considered material and not eligible for exclusion:
- a) Any entity subject to regulation or supervision by a financial regulatory body and which is subject to prudential requirements (referred to as “regulated financial or credit institutions” in the Financial Soundness Standards for Insurance Groups);
  - b) Any entity with assets in excess of 1% of the consolidated assets of the group;
  - c) Any entity with net income after tax in excess of 5% of the consolidated net income after tax of the group; or
  - d) Any entity with intra-group exposures with other entities in the group in excess of 2% of the consolidated amount of intra-group exposures.
- 1.7. The consideration of materiality, to be performed on a case-by-case basis as referred to in section 1.6 above, will specifically consider the following elements related to the entity’s activities:
- a) Participation, influence and other contractual obligations that the entity might impose on the insurance group or that the insurance group might impose on the entity;
  - b) Interconnectedness between different entities, whether within the scope of the insurance group or not;
  - c) Any risk to which the entity might expose the insurance group;
  - d) The concentration of risks for the insurance group;
  - e) Potential risk transfer to any entity in the insurance group; and
  - f) Intra-group transactions and exposures between different entities whether within the scope of the insurance group or not.
- 1.8. If the Prudential Authority excludes entities from group capital adequacy calculations as per section 1.6 above, on the basis of immateriality, the insurance group must not recognise any own funds of the excluded entity in its group capital adequacy assessment.<sup>3</sup> Any solvency capital requirements associated with the excluded entity must also be excluded from the group capital adequacy assessment. However, if the excluded entity has a deficit in own funds before or after the elimination of intra-group transactions, the full deficit after the elimination of intra-group transactions must be added to the insurance group’s own funds.<sup>4</sup>
- 1.9. The insurance group must regularly monitor the materiality of entities excluded and notify the Prudential Authority if its assessment of materiality changes. The insurance group must also notify the Prudential Authority if:

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<sup>2</sup> For clarity, entities that are excluded for the purposes of group capital adequacy calculations may still be included as part of the insurance group for the application of other Standards (such as those relating to governance).

<sup>3</sup> In the context of the Financial Soundness Standards for Insurance Groups, the term “own funds” for non-insurance entities in the insurance group refers to capital resources.

<sup>4</sup> In the context of non-regulated entities that are excluded on the basis of immateriality, deficits would arise in the event that the net asset value of the entity is less than zero.

- a) The aggregate amount of assets for those entities excluded due to immateriality exceeds 10% of the consolidated assets of the insurance group;
  - b) The aggregate amount of net income after tax for those entities excluded due to immateriality exceeds 20% of the consolidated net income after tax of the insurance group; or
  - c) In the case of entities that have a deficit in own funds relative to capital requirements, the aggregate amount of the deficits exceeds 10% of the insurance group's eligible own funds.
- 1.10. Insurers that are part of a wider international group (i.e. where the ultimate parent is located outside South Africa) may be subject to group supervision by the Prudential Authority. The scope of these insurance groups will be determined by the Prudential Authority, and the Prudential Authority will designate the controlling company of the insurance group to be a company in South Africa.
- 1.11. The Prudential Authority may choose to identify insurance sub-groups within the insurance group. In such circumstances, the insurance sub-groups (as defined by the Prudential Authority) will also be required to comply with the Financial Soundness Standards for Insurance Groups at the sub-group level.

## 2. Roles and Responsibilities

- 2.1. The regulatory minimum financial soundness requirements must be met at all times. Ultimate responsibility for the prudent management of the financial soundness of an insurance group rests not with the Prudential Authority, but with the board of directors of the controlling company of the insurance group.<sup>5</sup> This responsibility goes beyond meeting the regulatory minimum.
- 2.2. The board of directors must ensure that the insurance group maintains an appropriate level and quality of own funds commensurate with the type, amount and concentration of risks to which the group is exposed. The board of directors must also consider the fungibility and transferability of own funds across the insurance group, including potential restrictions on the availability of certain own funds to absorb group losses. If, through the supervisory review process, the Prudential Authority is not satisfied that an insurance group is holding sufficient own funds to cover its risks, the Prudential Authority may increase the minimum.<sup>6</sup>
- 2.3. The board of directors must have in place procedures to monitor financial soundness at the insurance group level, and to identify any deterioration in its actual or expected capital resources or business conditions. The board of directors must without delay notify the Prudential Authority of any such deteriorating circumstances that could lead to a breach, within the following three months, of the financial soundness requirements.<sup>7</sup>

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<sup>5</sup> All references to the board of directors in this Standard refer to that of the controlling company of the insurance group.

<sup>6</sup> The terms under which the Prudential Authority may increase the financial soundness minimum are set out in section 37 of the Act.

<sup>7</sup> The obligations of the board of directors in this regard are set out in section 39 of the Act.

- 2.4. The board of directors and senior management of the controlling company must ensure that, where approvals are required from the Prudential Authority pertaining to the insurance group or controlling company, those approvals have been obtained.
- 2.5. The board of directors must also seek and receive the Prudential Authority's approval before effecting any capital reduction at the controlling company level (other than through normal dividend payments).<sup>8</sup>
- 2.6. The controlling company's head of the actuarial function is responsible for expressing an opinion to the board of directors regarding the accuracy of the calculations and the appropriateness of the assumptions used to determine eligible own funds<sup>9</sup> and SCR at the insurance group level (referred to as group eligible own funds and group SCR respectively).
- 2.7. The controlling company's auditor appointed under section 32 of the Act must audit the financial soundness of the insurance group in accordance with its legal and regulatory obligations. The auditor must report to the board of directors and Prudential Authority any matters identified during the performance of its responsibilities that may cause the insurance group to be not financially sound.
- 2.8. The roles and responsibilities of the board of directors and the head of the actuarial function are described in more detail in the Governance and Operational Standards for Insurance Groups (GOG 1).

### 3. Commencement and Transition Provisions

- 3.1. This Standard commences on 1 July 2018.

Version Number	Commencement Date
1	1 July 2018

### 4. Principles underlying the Framework for Financial Soundness of Insurance Groups

- 4.1. The assessment of capital adequacy on a group-wide basis should enable the Prudential Authority to form a sound judgment of the insurance group's financial soundness. The assessment should appropriately account for forms of intra-group transactions, including internal participation structures and intra-group transfers of capital and risks.
- 4.2. The purpose of the financial soundness framework for insurance groups is not to replace the assessment of capital adequacy of solo insurers within the group. Rather, the framework aims to ensure that:

<sup>8</sup> The obligations of the board of directors in this regard are set out in section 38 of the Act.

<sup>9</sup> The head of actuarial function may rely on the controlling company's auditors for the valuation of assets and liabilities other than technical provisions.

- a) Risks emanating from the wider insurance group are appropriately accounted for in the assessment of group financial soundness;
  - b) The capital adequacy of solo insurers is not overstated (e.g. there is no double use of own funds eligible for the group SCR, and there is no multiple gearing or leveraging of the quality of capital); and
  - c) The overall impact of intra-group transactions is appropriately assessed.
- 4.3. For the purposes of assessing the financial soundness of an insurance group, the valuation of balance sheet items at the group level must apply the same valuation principles that apply at the solo insurer level. That is, the valuation principles set out in FSI 2 (Measurement of Assets, Liabilities and Eligible Own Funds) and associated Standards, must be applied to the valuation of the insurance group's assets, liabilities and own funds, unless otherwise specified by the Prudential Authority or in the Financial Soundness Standards for Insurance Groups.
- 4.4. Insurance groups are required to monitor and assess their financial soundness on an ongoing basis. Insurance groups are required to calculate their group eligible own funds and group SCR on at least an annual basis, and report the results of this calculation to the Prudential Authority in line with timeframes required for financial reporting purposes. The Prudential Authority may also require the insurance group to calculate group eligible own funds and group SCR at other intervals.

## 5. Methods for Assessing Insurance Group Financial Soundness

- 5.1. There are two methods available for assessing group-wide capital adequacy under the financial soundness framework for insurance groups:
- a) The Deduction and Aggregation (D&A) method; and
  - b) The Accounting Consolidation (AC) method.
- 5.2. The default method that insurance groups must use to calculate both group eligible own funds and group SCR is the D&A method.
- 5.3. The D&A method calculates group eligible own funds and group SCR by aggregating the adjusted solo own funds and solo SCRs of the controlling company and its participations.<sup>10</sup> Intra-group transactions between entities within the insurance group, and potential restrictions on certain own funds at the group level, must be appropriately accounted for prior to aggregation of solo own funds and solo SCRs. Further details of the computations required to calculate group eligible own funds and group SCR under the D&A method are set out in FSG 2 (Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method).
- 5.4. Insurance groups that wish to use the alternative AC method to calculate group-wide capital adequacy must apply to the Prudential Authority to do so. An insurance group's application to use the AC method should include *inter alia* details of its reasons for applying to use the AC method, and the group's capabilities to ensure accurate calculation of group SCR and group eligible own funds under this method.

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<sup>10</sup> The aggregation of adjusted solo own funds and solo SCRs for participations of the controlling company must be based on the proportional share of the controlling company's economic interest in the participation.

- 5.5. Application of the AC method is only permitted for:
- a) Insurance subsidiaries licensed by the Prudential Authority that are part of the insurance group;<sup>11</sup> and
  - b) The controlling company of the insurance group, if the controlling company is an insurer licensed by the Prudential Authority.

All other entities within the insurance group must be assessed using the D&A method.

- 5.6. The AC method calculates eligible own funds and SCR using a consolidated balance sheet approach for those entities in the scope of the AC method. The consolidated balance sheet approach involves treating those entities in the scope of the AC method as if it were a single entity, then applying the solo-insurer requirements (i.e. requirements prescribed under the Financial Soundness Standards for Insurers) to that single entity. The eligible own funds and SCR for the remainder of the insurance group (i.e. entities not within the scope of AC method) must be assessed using the D&A method. To calculate the overall eligible own funds and SCR of the insurance group, the respective measures of eligible own funds and SCR for all entities in the group (i.e. entities within the scope of the AC method, and those outside the scope of the AC method) must be aggregated using the D&A method. Further details of the computations required under the AC method are set out in FSG 3 (Assessing the Financial Soundness of Insurance Groups Using the Accounting Consolidation Method).
- 5.7. Regardless of which method is applied, the Prudential Authority may direct an insurance group to apply a capital requirement higher than that prescribed in the Standards (referred to as a “capital add-on”).<sup>12</sup> If an insurance group uses the D&A method, any solo level capital add-ons required by the Prudential Authority must be included in the calculation of the group SCR, and the Prudential Authority may require an additional capital add-on for the insurance group based on the risk profile of the group as a whole. If an insurance group uses the AC method, the Prudential Authority will assess whether any solo-level capital add-ons should flow through to the calculation of the group SCR, and whether a capital add-on at the group level should be applied.

## 6. Use of Internal Models

- 6.1. Insurance groups may apply to the Prudential Authority for approval to use an internal model to calculate all or part of their group SCR. Approval to use an internal model to calculate group SCR will be based on the insurance group demonstrating that it satisfies the criteria and requirements for use of an internal model in FSI 5 (Calculation of the SCR Using a Full or Partial Internal Model).

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<sup>11</sup> For clarity, insurance associates that are part of the insurance group are not permitted to be included under the AC method.

<sup>12</sup> The terms under which the Prudential Authority may direct a capital add-on are set out in section 39 of the Act. Capital add-ons may be applied at the level of solo insurers licensed by the Prudential Authority or at the level of the controlling company.

- 6.2. An insurance group applying to use an internal model to calculate all or part of the group SCR must also demonstrate that the internal model produces outcomes that accurately reflect the risks arising at the level of the insurance group, and that are specific to the insurance group.
- 6.3. The scope of entities and risks that are to be included in a group internal model is also subject to Prudential Authority approval.



## Attachment 1: Definitions used in the Financial Soundness Standards for Insurance Groups

The following terms used in the Financial Soundness Standards for Insurance Groups are defined in accordance with section 1 of the Act:

- ancillary own funds;
- auditor;
- basic own funds;
- board of directors;
- control;
- control function;
- controlling company;
- director;
- eligible own funds;
- group of companies;
- head of a control function;
- insurer;
- intra-group transaction;
- policyholder;
- prescribed;
- prudential authority;
- prudential standard;
- reinsurance business; and
- reinsurer.

Where a term in the Financial Soundness Standards for Insurance Groups is defined in accordance with the definition used for IFRS, insurers must apply the definition that applies under IFRS at the relevant point in time.

The following table sets out definitions of additional terms used throughout the Financial Soundness Standards for Insurance Groups:

Term	Definition
actuarial function	The control function within an insurer responsible for attesting to the accuracy of the calculations and the appropriateness of the assumptions with regards to the technical provisions and the SCR.
adjusted net equity method	As defined in section 5.4 of FSI 2.1 (Valuation of Assets and Liabilities Other than Technical Provisions).
bank	An entity as defined in section 1 of The Banks Act, 1990 or an entity which would have been a bank in terms of the Banks Act, 1990 if it were incorporated in South Africa, regulated by a designated authority as defined in section 250 of the Financial Sector Regulation Act, 2017.

Term	Definition
best estimate (liability)	Probability-weighted average (mean) of future cash-flows stemming from insurance business, taking into account the time value of money and all possible scenarios of future potential outcomes, calculated in accordance with the requirements in FSI 2.2 (Valuation of Technical Provisions).
credit institution	A “credit provider” as defined in section 1 of the National Credit Act, 2005, or an entity which would have been a credit provider in terms of the National Credit Act if it were incorporated in South Africa, regulated by a designated authority as defined in section 250 of the Financial Sector Regulation Act, 2017.
equivalent jurisdiction	Jurisdictions that have been designated as having an equivalent regulatory regime to South Africa, as prescribed by the Prudential Authority.
financial institution	As defined in section 1 of the Financial Sector Regulation Act, 2017, or an entity which would have been a financial institution in terms of the Financial Sector Regulation Act if it were incorporated in South Africa, regulated by a designated authority as defined in section 250 of the Financial Sector Regulation Act.
financial soundness standards for insurance groups	Collective term for the suite of Prudential Standards for the financial soundness of insurance groups regulated by the Prudential Authority.
group eligible own funds	Eligible own funds of the insurance group.
group SCR	Solvency Capital Requirement of the insurance group.
internal model	The model approved by the Prudential Authority for an insurance group to calculate its SCR, subject to meeting the requirements set out in FSI 5 (Calculation of the SCR Using a Full or Partial Internal Model).
look-through approach	The assessment of risks at the level of the underlying assets for a collective investment fund (or similar type of investment vehicle), as set out in Attachment 1 of FSI 4.1 (Market Risk Capital Requirement).
loss-absorbing capacity of deferred taxes	The capacity for changes in the value of an insurance group’s deferred tax assets and liabilities to absorb losses under the stresses assumed in the calculation of the SCR.

Term	Definition
loss-absorbing capacity of technical provisions	The extent to which an insurer is able to pass on risks to policyholders by way of changes to policyholder benefits.
management action	A mechanism or action approved by a governance structure within the insurance group that will be implemented in response to the occurrence of a specified adverse event, whereby the action aims to reduce the impact of the specified adverse event on the insurer's basic own funds.
non-equivalent jurisdiction	Jurisdictions that have not been designated by the Prudential Authority as having an equivalent regulatory regime to South Africa.
own funds	Sum of basic own funds and ancillary own funds. In the context of the Financial Soundness Standards for Insurance Groups, this includes capital resources in non-insurance entities within the insurance group.
participations	Investments in companies in which the insurance group owns a significant proportion of the issued share capital or over which it exerts significant influence/control (e.g. where the insurance group maintains more than 20% of the voting rights of the company).
principle of proportionality	The principle of adopting calculation methodologies that are proportionate to the nature, scale and complexity of the risks being measured.
risk margin	The part of technical provisions, in addition to the best estimate liability, to ensure that the value of technical provisions is equivalent to the amount that insurers would be expected to take over the insurance obligations, calculated in accordance with the requirements in FSI 2.2 (Valuation of Technical Provisions).
standard	Prudential Standard.
subordinated liabilities	Liabilities that rank after the claims of all other creditors and which are to be paid, in the event of liquidation or bankruptcy, only after all other debts have been met.
standardised formula	The default method for calculating the SCR based on the prescribed requirements of FSI 4 (Calculation of the SCR Using the Standardised Formula) and related Standards.

Term	Definition
technical provisions	The amount that an insurer sets aside to fulfil its insurance obligations and settle all commitments to policyholders and other beneficiaries over the lifetime of the obligations, calculated in accordance with the requirements of FSI 2.2 (Valuation of Technical Provisions).

## Attachment 2: Abbreviations

Abbreviation	Definition
AC	accounting consolidation
BSCR	basic solvency capital requirement
D&A	deduction and aggregation
FSG	financial soundness standard for insurance groups
FSI	financial soundness standard for insurers
IFRS	international financial reporting standards
SCR	solvency capital requirement
SPV	special purpose vehicle