South African Reserve Bank
Prudential Authority

Prudential Standard FSI 4.4

Operational Risk Capital Requirement

Objectives and Key Requirements of this Prudential Standard

This Standard sets out the details for calculating the capital requirement for operational risk for insurers using the Standardised Formula to calculate the Solvency Capital Requirement (SCR).

The ultimate responsibility for the prudent management of the financial soundness of an insurer rests with its board of directors. The board of directors must ensure that the insurer has systems and controls in place to adequately calculate its operational risk capital requirement according to the Financial Soundness Standards for Insurers.

The calculation of the operational risk capital requirement under the standardised formula is based on a simple linear measure applied to an insurer's earned premiums and technical provisions and, for linked insurance obligations, to assets under management.

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1. Application

1.1. This Standard applies to all insurers licensed under the Insurance Act, 2017 (the Act), other than microinsurers, Lloyd's and branches of foreign reinsurers.

1.2. Unless otherwise indicated, all references to "insurer" in this Standard can be read as a reference to life insurers, non-life insurers and reinsurers. Similarly, a reference to "insurance" obligations/policies in this Standard can be read as a reference to "reinsurance" obligations/policies, unless otherwise specified.

2. Roles and Responsibilities

2.1. Ultimate responsibility for the prudent management of the financial soundness of an insurer rests with the insurer's board of directors. The board of directors must ensure the insurer meets the Solvency Capital Requirement (SCR) on a continuous basis, regardless of the approach taken to its computation. The board of directors must also ensure that the insurer has in place appropriate systems, procedures and controls to meet the principles and requirements of this Standard on an ongoing basis.

2.2. An insurer's head of actuarial function must be appointed under section 32 of the Act and is responsible for expressing an opinion to the board of directors regarding the accuracy of the calculation of the capital requirement for operational risk.

2.3. An insurer's auditor must audit the financial soundness of an insurer 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 insurer to be not financially sound.

2.4. The roles and responsibilities of the board of directors and the head of actuarial function are described in more detail in the Governance and Operational Standards for Insurers (GOI 3).

3. Commencement and Transition Provisions

3.1. This Standard commences on 1 July 2018.

Version Number	Release Date
1	1 July 2018

4. Scope and Key Elements of Operational Risk

4.1. Operational risk is the risk of loss arising from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal risk, but excludes risks arising from strategic decisions and reputational risk.

4.2. The calculation of the operational risk capital requirement under the standardised formula uses a simple linear measure of operational risk based on the scale of an insurer's operations. The measures used to calculate the operational risk capital requirement for investment insurance obligations differ to those that apply to other (non-investment) insurance obligations.

4.3. Investment insurance obligations in this Standard means insurance obligations for the following lines of business as set out in Part A of Attachment 1 of FSI 2.2 (Valuation of Technical Provisions):

a) Line of business 3; and
b) Lines of business 4 and 5 only if the insurance obligations can be allocated to investment insurance obligations using the principle of proportionality.

4.4. For investment insurance obligations, the operational risk capital requirement is calculated by the maximum of a proportion of expenses and applying step-wise, decreasing linear risk factors to the volume of assets under management (AUM) in respect of those insurance obligations,. For all other insurance obligations, the operational risk capital requirement is calculated by reference to two main measures of an insurer's scale – earned premiums and technical provisions. The operational risk capital requirement for non-investment insurance obligations is subject to a cap of 30% of the Basic Solvency Capital Requirement (BSCR).

4.5. The operational risk capital requirements for investment and non-investment insurance obligations must be aggregated to calculate the insurer's overall capital requirement for operational risk (SCR_{Op}), using the following formula:

$$SCR_{Op} = min(30\% \cdot BSCR, Op) + Op_{Investment}$$

Where:

$BSCR$	=	The Basic SCR covering capital requirements for market and underwriting risks, as calculated in section 6.3 of FSI 4 (Calculation of the SCR Using the Standardised Formula)
Op	=	Operational risk capital requirement for all insurance obligations other than investment insurance obligations, calculated in accordance with section 5 below
$Op_{Investment}$	=	Operational risk capital requirement for investment insurance obligations, calculated in accordance with section 6 below

5. Non-Investment Insurance Obligations

5.1. The operational risk capital requirement for all insurance obligations other than investment insurance obligations (Op) must be calculated as:

$$Op = max(Op_{premiums}, Op_{provisions})$$

Where:

$Op_{premiums}$	=	Operational risk capital requirement determined using earned premiums as the measure of scale, as calculated under section 5.2 below
$Op_{provisions}$	=	Operational risk capital requirement determined using technical provisions (excluding the risk margin) as the measure of scale, as calculated under section 5.5 below

5.2. The measure $Op_{premiums}$ must be calculated as:

$$Op_{premiums} = 4\% \cdot Earn_{Life} + 3\% \cdot Earn_{NL} + max\left[4\% \cdot \left(Earn_{Life} - 1.2 \cdot pEarn_{Life}\right), 0\right] + max\left[3\% \cdot \left(Earn_{NL} - 1.2 \cdot pEarn_{NL}\right), 0\right]$$

Where:

$Earn_{Life}$	=	Earned premiums during the past 12 months for all non-investment life insurance obligations
$Earn_{NL}$	=	Earned premiums during the past 12 months for all non-life insurance obligations
$pEarn_{Life}$	=	Earned premium during the 12 months prior to the past 12 months for all non-investment life insurance obligations
$pEarn_{NL}$	=	Earned premium during the 12 months prior to the past 12 months for all non-life insurance obligations

5.3. For the purpose of calculating $Op_{premiums}$, all earned premium measures must be calculated without deducting premiums ceded to reinsurance.

5.4. For single premium business the insurer must determine what an appropriate earned premium is using its internal data and history.

5.5. The measure $Op_{provisions}$ must be calculated as:

$$Op_{provisions} = 0.45\% \cdot max\left(TP_{Life}, 0\right) + 3\% \cdot max\ (TP_{NL}, 0)$$

Where:

TP_{Life}	=	Technical provisions for all non-investment life insurance obligations, excluding the risk margin
TP_{NL}	=	Technical provisions for all non-life insurance obligations, excluding the risk margin

5.6. For the purpose of calculating $Op_{provisions}$, the technical provisions measures must be calculated without deducting amounts recoverable from reinsurance contracts and other risk mitigation instruments.

6. Investment Insurance Obligations

6.1. The operational risk capital requirement for investment insurance obligations ($Op_{Investment}$) must be calculated by reference to both the expenses and AUM associated with such obligations and must be calculated as:

$$Op_{Investment} = \sum_{i} max\left(25\% \cdot Exp_i\ , Op_{AUM(i)}\right)$$

Where:

i	=	The groupings of investment insurance obligations for calculation of the operational risk capital requirement according to level 3 of the lines of business as set out in Part A of Attachment 1 of FSI 2.2 (Valuation of Technical Provisions) as follows: 1 – Linked insurance obligations, i.e. lines of business 3a(iii), 3b(iii), 3c(iii), 3d(iii), 4a(iv), 4b(iv), 5a(x), 5b(x) and 5c(x); 2 – Market related insurance obligations, i.e. lines of business 3a(ii), 3b(ii), 3c(ii), 3d(ii), 4a(iii), 4b(iii), 5a(ix), 5b(ix) and 5c(ix); and 3 – Other investment insurance obligations, i.e. lines of business 3a(i), 3a(iv), 3b(i), 3b(iv), 3c(i), 3c(iv), 3d(i), 3d(iv), 4a(ii), 4a(v), 4b(ii), 4b(v), 5a(viii), 5a(xi), 5b(viii), 5b(xi), 5c(viii) and 5c(xi).
Exp_i	=	Amount of annual expenses incurred during the previous 12 months in respect of investment insurance obligations. Annual expenses for the purpose of this calculation shall include all direct and indirect expenses excluding commission only.
$Op_{AUM(i)}$	=	The value calculated using the formulas set out in sections 6.2 to 6.4 below where AUM is the Rand value of assets under management related to investment

insurance obligations

6.2. Formulas used for calculating $Op_{AUM(1)}$ are set out in the table below:

Assets Under Management (AUM)	$\boldsymbol{Op_{AUM(1)}}$
From R0 to R25 billion	0.25% · AUM
From R25 billion to R50 billion	R62.5 million + 0.15% · (AUM – R25 billion)
From R50 billion to R100 billion	R100 million + 0.075% · (AUM – R50 billion)
Greater than R100 billion	R137.5 million + 0.025% · (AUM – R100 billion)

6.3. Formulas used for calculating $Op_{AUM(2)}$ are set out in the table below:

Assets Under Management (AUM)	$\boldsymbol{Op_{AUM(2)}}$
From R0 to R25 billion	0.35% · AUM
From R25 billion to R50 billion	R87.5 million + 0.25% · (AUM – R25 billion)
From R50 billion to R100 billion	R150 million + 0.175% · (AUM – R50 billion)
Greater than R100 billion	R237.5 million + 0.125% · (AUM – R100 billion)

6.4. Formulas used for calculating $Op_{AUM(3)}$ are set out in the table below:

Assets Under Management (AUM)	$\boldsymbol{Op_{AUM(3)}}$
From R0 to R25 billion	0.45% · AUM
From R25 billion to R50 billion	R112.5 million + 0.35% · (AUM – R25 billion)
From R50 billion to R100 billion	R200 million + 0.275% · (AUM – R50 billion)
Greater than R100 billion	R337.5 million + 0.225% · (AUM – R100 billion)