Prudential Standard FSM 1

Framework for Financial Soundness of Microinsurers

Objectives and Key Requirements of this Prudential Standard

This Standard sets out the framework for assessing the financial soundness of South African microinsurers from a regulatory perspective. The principles set out in this Standard are supported by a specialised Standard and Attachment that address particular aspects of the framework (collectively the Financial Soundness Standards for Microinsurers). The specialised Standard contains the technical details of the valuation of assets and liabilities, and determination of eligible own funds, of microinsurers.

It is the responsibility of the board of directors of a microinsurer to ensure that the microinsurer meets the financial soundness requirements on a continuous basis.

Capital (referred to in the Financial Soundness Standards for Microinsurers as eligible own funds) is the cornerstone of a microinsurer's financial soundness and the primary means of ensuring the security of policyholder obligations. The Financial Soundness Standards for Microinsurers are designed to ensure that microinsurers can meet policyholder obligations by holding eligible own funds of sufficient quality and quantity to absorb significant unforeseen losses arising from the typical risks associated with a microinsurer's activities.

The Financial Soundness Standards for Microinsurers address the two related matters of assessing how much eligible own funds a microinsurer actually holds and how much it is required to hold for regulatory purposes.

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1. Application

1.1. This Standard applies to all microinsurers licensed under the Insurance Act, 2017 (the Act).

1.2. Unless otherwise indicated, all references to “microinsurer” in this Standard can also be read as a reference to microinsurance reinsurers. Similarly, a reference to “microinsurance” obligations/policies in this Standard can be read as a reference to “microinsurance reinsurance” obligations/policies, unless otherwise specified.

2. Roles and Responsibilities

2.1. The regulatory minimum financial soundness requirement must be met at all times. Ultimate responsibility for the prudent management of the financial soundness of a microinsurer, however, rests not with the Prudential Authority but with the microinsurer’s board of directors. This responsibility goes beyond meeting the regulatory minimum.

2.2. The board of directors must ensure a microinsurer maintains an appropriate level of eligible own funds commensurate with the amount of capital which the microinsurer is expected to hold. If, through the supervisory review process, the Prudential Authority is not satisfied that a microinsurer is holding sufficient eligible own funds to cover its risks, the Prudential Authority may increase the capital requirement.[1]

2.3. The board of directors must have in place procedures to monitor the financial soundness of a microinsurer 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 of the financial soundness requirements within the following three months.[2]

2.4. The board of directors must also seek and receive the Prudential Authority’s approval before effecting any capital reduction (other than through normal dividend payments).[3]

2.5. A microinsurer’s head of 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 underlying the valuation of the microinsurer’s technical provisions and calculation of the microinsurer’s capital requirements.[4]

2.6. A microinsurer’s auditor appointed under section 32 of the Act must audit the financial soundness of a microinsurer in accordance with its legal and

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[1] The terms under which the Prudential Authority may increase the financial soundness minimum are set out in section 37 of the Act.

[2] The obligations of the board of directors in this regard are set out in section 39 of the Act.

[3] The obligations of the board of directors in this regard are set out in section 38 of the Act.

[4] A microinsurer’s head of actuarial function may be subject to different requirements as those that apply to the head of actuarial function of an insurer, depending on the nature, scale and complexity of the microinsurance business and the functions performed.

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 microinsurer to be not financially sound.

2.7. 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 Microinsurers (GOM 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 Microinsurers

4.1. The framework for financial soundness of microinsurers is built on the following principles:

a) Microinsurers must hold eligible own funds of sufficient quantity to absorb significant unforeseen losses arising from the risks associated with a microinsurer's activities, as may be approximated by the prescribed minimum capital requirement (see section 6 below).
b) The regulatory approach to determining eligible own funds held and setting the required level of capital for financial soundness is largely formula-based, as an approximation of a risk-based approach.
c) In determining eligible own funds, both assets and liabilities must be valued on a basis consistent with market-based methodologies, unless otherwise specified. For technical provisions, a formula-based approach is largely used as an approximation of a market consistent approach.
d) The financial soundness framework includes a trigger level of eligible own funds relative to required capital, below which regulatory intervention will occur.

5. Determining Eligible Own Funds – Key Elements

5.1. For the purposes of meeting financial soundness requirements for microinsurers, eligible own funds are equal to basic own funds.

5.2. Basic own funds consist of the excess of assets over liabilities valued in accordance with the methodology set out in FSM 2 (Valuation of Assets, Liabilities and Eligible Own Funds), less any adjustments for disallowed assets as set out in section 10 of FSM 2.

5.3. Disallowed assets are those assets of the microinsurer that are in excess of the maximum permissible amount as prescribed in the microinsurance asset spreading requirements.

6. Financial Soundness Requirements – Key Elements and Methodology

6.1. The concept of capital required by a microinsurer for financial soundness purposes is applied as the prescribed Minimum Capital Requirement (MCR), which is the absolute minimum level of eligible own funds that the Prudential Authority considers necessary to protect policyholders.

6.2. The MCR, which is designed to be a relatively simple measure, has two elements:

a) 15% of the greater of the amount of net written premium[5] in respect of policies entered into:
   - 12 months preceding the current reporting date; or
   - 12 months preceding the previous reporting date.

b) An absolute floor, the Absolute Minimum Capital Requirement (AMCR), which is R4 million.

6.3. Additional capital requirements may be applied to a microinsurer to capture market risk. This will only be applicable to microinsurers who choose to apply to the Prudential Authority to invest their excess assets in other asset classes besides cash, cash equivalents or investment funds restricted to money market funds.[6] The capital add-on calculation will be at the discretion of the Prudential Authority and on a case-by-case basis.

6.4. The financial soundness of cell captive microinsurers will be assessed differently as outlined in Attachment 3 of this Standard.

7. Assessing Financial Soundness of Microinsurers – Key Elements

7.1. Financial soundness of microinsurers is measured by the extent of the excess of the eligible own funds over the MCR. For comparative purposes, the Prudential Authority measures a microinsurer's financial soundness by means of the ratio of eligible own funds to MCR, which is termed the MCR cover ratio.

7.2. Microinsurers are required to monitor and assess their financial soundness on an ongoing basis. Microinsurers are required to calculate the MCR on at least a quarterly basis. The results of this calculation must be reported to the Prudential Authority in line with timeframes required for financial reporting purposes.

7.3. Microinsurers must also calculate and report their MCR when:

a) Their risk profile changes materially since the time of the last MCR calculation; or

b) Otherwise requested to do so by the Prudential Authority.

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[5] Net written premium refers to the total amount of all the premiums payable for the whole policy contract term to the microinsurer under policies entered into by it in the respective 12 month period net of eligible reinsurance premiums. Premium includes all costs of providing benefits, including commission.

[6] Cash and cash equivalents are defined as per the CIC table.

8. Regulatory Intervention

8.1. The financial soundness framework establishes a trigger point for regulatory intervention.[7] The MCR is a solvency control level which, if breached, is likely to result in the strongest regulatory intervention. If the Prudential Authority is satisfied that a microinsurer has failed or may, in the following three months, fail to meet the prescribed MCR it may, in addition to directing the microinsurer to rectify the breach, suspend or withdraw the microinsurer's licence, or exercise the resolution powers set out in Chapter 9 of the Act.

8.2. In practice, while financial soundness levels signal the need for regulatory intervention, regulatory monitoring and intervention is typically more nuanced and graduated than is implied by the discrete point involved. Any microinsurer whose level of eligible own funds approaches the MCR should expect heightened supervisory oversight, with the potential for regulatory intervention.

9. Structure of the Financial Soundness Standards for Microinsurers

9.1. The Financial Soundness Standards for Microinsurers are organised as follows:

FSM 1	Framework for Financial Soundness of Microinsurers
FSM 2	Valuation of Assets, Liabilities and Eligible Own Funds

9.2. The Financial Soundness Standards for Microinsurers may be supported by Guidance Notes that aim to assist microinsurers in complying with the requirements outlined in the Standards. While the Standards have the force of law and are used to establish minimum requirements with which microinsurers must comply, the Guidance Notes provide guidance only and do not have the same level of enforceability as the Standards. Microinsurers are not obliged to adopt the guidance, and are free to demonstrate that the requirements of the Standards are otherwise met.

[7] The Prudential Authority's powers to intervene in this respect are set out in section 39 of the Act.

Attachment 1: Definitions used in the Financial Soundness Standards for Microinsurers

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

- auditor;
- basic own funds;
- board of directors;
- captive insurer;
- cell captive insurer;
- cell structure;
- commercial lines;
- eligible own funds;
- insurance obligations;
- life insurance business;
- life insurance policy;
- life insured;
- microinsurance business;
- microinsurer;
- non-life insurance business;
- non-life insurance policy;
- personal lines;
- policyholder;
- premium;
- prescribed;
- prudential authority;
- prudential standard;
- reinsurer; and
- reinsurance business.

The following terms are as defined in accordance with Schedule 2 of the Act:

- beneficiary; and
- group policy.

Where a term in the Financial Soundness Standards for Microinsurers is defined in accordance with the definition used for International Financial Reporting Standards (IFRS), microinsurers must apply the definition that applies under IFRS at the relevant point in time.

The terms used in Attachment 1 of FSI 1 (Framework for Financial Soundness of Insurers) apply to the Financial Soundness Standards for Microinsurers. The following table sets out definitions of additional terms used throughout the Financial Soundness Standards for Microinsurers:

Term	Definition
financial soundness standards for microinsurers	Collective term for the suite of Prudential Standards for the financial soundness of South African microinsurers as set out in section 9.1 of this Standard.
promoter	A "cell captive microinsurer" as defined under section 1 of the Act.
technical provisions	The amount that a microinsurer 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 FSM 2 (Valuation of Assets, Liabilities and Eligible Own Funds).

Attachment 2: Abbreviations

Abbreviation	Definition
AMCR	absolute minimum capital requirement
BOF	basic own funds
FSM	Financial Soundness Standard For Microinsurers
IBNR	incurred but not reported
IFRS	international financial reporting standards
MCR	minimum capital requirement
OCR	outstanding claims reserve
UPR	unearned premium reserve
URP	unexpired risk provision

Attachment 3: Cell Captive Microinsurers

The following steps will be required for calculating the eligible own funds at promoter level for cell captive microinsurers.

1. The eligible own funds of the microinsurance licence will be decreased to the extent that surplus eligible own funds in a ring-fenced fund are not available to meet losses outside that ring-fenced fund.

2. In determining eligible own funds for ring-fenced funds and the microinsurer as a whole, a microinsurer should:

   a) Determine the amount of eligible own funds that reside outside of the ring-fenced funds in accordance with the requirements set out in the prudential standards for microinsurers;
   b) Determine the amount of eligible own funds that reside within each of the ring-fenced funds in accordance with the requirements set out in the prudential standards for microinsurers;
   c) Exclude amounts representing future shareholder transfers from eligible own funds where the transfer (via a distribution of dividends to shareholders or otherwise) has been declared or approved by the board of directors;[8]
   d) For the microinsurer as a whole, recognise as eligible own funds the amount up to the minimum of the notional MCR and eligible own funds (with a floor of zero) of each ring-fenced fund, plus the eligible own funds of the microinsurer outside of the ring-fenced funds; and
   e) The notional MCR for a cell is subject to a minimum of R250 000.

3. The total MCR for the microinsurance licence as a whole where a cell structure is involved (MCR_{Total}) must be calculated as:

   $$MCR_{Total} = MCR_{cells} + MCR_{diversified\_shortfall}$$

   Where:

MCR_{cells}	=	Adjusted MCR across cells as calculated under section 4 of this Standard
$MCR_{diversified\_shortfall}$	=	Diversified MCR shortfall across cells as calculated under sections 5 to 8 of this Standard

4. To calculate the MCR across cells, the MCR and eligible own funds for each cell must be calculated as if the cell were a stand-alone entity. The adjusted MCR across cells(MCR_{cells}) represents the amount of capital that can be covered by all cells, and must be calculated as:

[8] For clarity, amounts representing the value of future shareholder transfers may be assumed to be unrestricted and included as part of the eligible own funds available to meet the required capital for the insurer as a whole.

$$MCR_{cells} = \sum_i MCR_{cell\_i}$$

Where:

MCR_{cell_i}	=	The MCR covered by cell *i*, representing the amount of capital that can be covered by cell *i*. The amount that can be covered is the lesser of the MCR or the eligible own funds of the cell, with a floor of zero. That is, MCR_{cell_i} must be calculated as: $MCR_{cell\_i} = max[min(MCR_i, EOF_i), 0]$
MCR_i	=	MCR for cell *i*
EOF_i	=	Eligible own funds for cell *i*

5. The calculation of the diversified MCR shortfall across cells ($MCR_{diversified\_shortfall}$) involves two steps:

   a) Determining the shortfall per cell ($MCR_{shortfall,i}$); and
   b) Calculating the diversified MCR covered by the promoter ($MCR_{diversified\_shortfall}$).

6. The diversified MCR covered by the promoter represents a diversified MCR calculated from the shortfalls within the cells. The shortfall for each cell ($MCR_{shortfall,i}$) is calculated as the difference between the cell's MCR and eligible own funds, in those cases where eligible own funds are not sufficient to cover the MCR in a particular cell. Negative eligible own funds should not be included in this calculation (i.e. where the cell's eligible own funds are negative, the shortfall will be equal to the MCR for that cell).

7. The diversified shortfall is then calculated by applying a correlation matrix to the various shortfalls of the cells. It is assumed that the correlation factors between cells are the same. The correlation factor β is determined by the Prudential Authority and is currently set to 50%. The Prudential Authority may prescribe a different percentage for a particular cell captive microinsurer and a microinsurer may also apply to the Prudential Authority to use a different percentage.

8. The diversified MCR covered by the promoter is calculated by applying the correlation factor β to the MCR covered by the promoter on behalf of the cells. That is, the diversified MCR shortfall across cells ($MCR_{diversified\_shortfall}$) which is covered by the promoter should be calculated as:

$$MCR_{diversified\_shortfall} = \sqrt{(1-\beta) \cdot \sum_i \left(MCR_{shortfall,i}\right)^2 + \beta \cdot \left(\sum_i MCR_{shortfall,i}\right)^2}$$

Where:

β	=	Correlation factor as determined under section 7 of this Standard
$MCR_{shortfall,i}$	=	Shortfall in cell *i* covered by the promoter as calculated under section 6 of this Standard