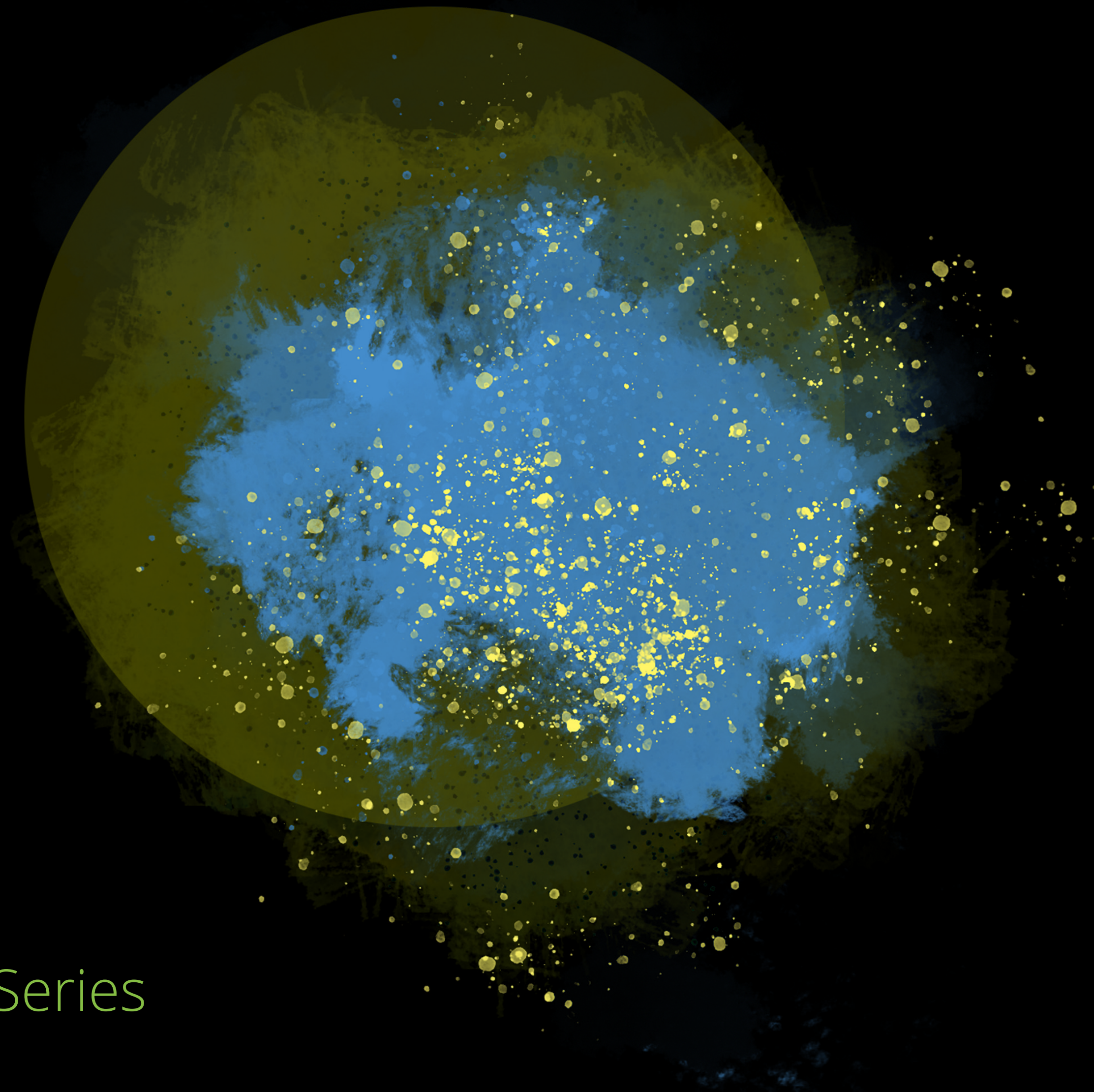
Deloitte.



SAM Interpretation Series

Group Returns

SAM Interpretation Series
Group Returns

Introduction
With over 5 years into insurers reporting under the Solvency Assessment and Management (SAM) framework, many insurance groups have changed gear from implementation to capital optimisation. This naturally results in different interpretations of the Financial Soundness Standards for Insurance Groups (FSGs) emerging. With the recent requirement for insurance group returns to be audited, it becomes necessary to delve a bit deeper into the different interpretations relating to the FSGs.

The Basics
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.

The default method that insurance groups must use to calculate both group eligible own funds and group SCR is the D&A method. Insurance groups that wish to use the alternative AC method to calculate group-wide capital adequacy must apply to the Prudential Authority (PA) to do so.[1]

As a consequence, the D&A method is the most prevalent method adopted by insurance groups and we have therefore focused on the interpretations observed under this method.

The eligible own funds of the insurance group as calculated under the D&A method must be calculated according to the following steps [2]:

1. Eliminate intra-group transactions
2. Assess the transferability and fungibility restrictions on the group own funds;
3. Aggregate the adjusted solo own funds of the controlling company and that of the participation in the insurance group after allowing for the pro-rated economic interest of the group in the relevant participation; and
4. Apply eligibility limits related to tiering.

The Solvency Capital Requirement (SCR) of the insurance group as calculated under the D&A method must be calculated as the sum of [3]:
1. The SCR of the controlling company, after adjusting for intra-group transactions; and
2. The solo SCRs of each participation in the insurance group, after adjusting for intra-group transactions, pro-rated by the insurance group's economic interest in the relevant participation.

The FSGs further go on to outline specific requirements for the measurements of the solo own funds and SCR that are dependent on the entity type. The following entity types are specified:

- South African insurer licensed by the Prudential Authority;
- Non-South African insurer regulated in an equivalent jurisdiction;
- Non-South African insurer regulated in a non-equivalent jurisdiction;
- Controlling company which is not an insurer licensed by the Prudential Authority;
- Regulated financial institution – banks and credit institutions;
- Regulated financial institution – institutions other than banks, credit institutions or insurers; and
- Non-regulated entity.

References
1. Paragraph 5.1, 5.2 and 5.4 of FSG 1
2. Paragraph 5 of FSG 2
3. Paragraph 6.1 of FSG 2

Interpretations

We have seen three specific areas of interpretation emerge as insurance groups have applied the D&A method:

1. Designation of the controlling company;
2. Financial Advisory and Intermediary Services (FAIS) Act application; and
3. Treatment of insurers regulated in a non-equivalent jurisdiction.

Designation of the controlling company

Two interpretations have been observed.

Designation interpretation 1

The table contained in paragraph 4.3 of FSG 2 explicitly includes a row for a controlling company which is not an insurer licensed by the PA. The footnote further goes on to state that if the controlling company is an insurer licensed by the PA, its solo own funds and solo SCR are determined by the requirements applicable to insurers in the Financial Soundness Standards for Insurers (FSIs). This could imply that unless the controlling company is an insurer licensed by the PA, all controlling companies, regardless of entity type have to measure their solo own funds and solo SCR in line with the requirements pertaining to controlling companies which is not an insurer licensed by the PA.

Under this approach, the solo own funds would have to be measured as the adjusted Net Asset Value (NAV) as calculated on the basis of valuation requirements for participations in paragraphs 5.4 and 5.5 of FSI 2.1. Furthermore the solo SCR would have to be derived by applying the stress prescribed in paragraph 6.11 of FSI 4.1 or by applying a look-through approach in line with FSI 4.1.

Designation interpretation 2

Under this interpretation, insurance groups might argue that the designation of an entity as a controlling company should not affect the overall solvency position of the group. For example, the solo own funds and solo SCR for a bank or credit institution in the group that is not a controlling company would be measured in line with the Basel framework.

However if this bank or credit institution was designated as the controlling company, the solo own funds and solo SCR would need to be measured as detailed under the first interpretation. This may fundamentally affect the solvency position of the group as the solo own funds and solo SCR is dependent on whether this particular entity is the controlling company or not.

Insurance groups may therefore argue that a more appropriate application of paragraph 4.3 of FSG 2 which allows for consistency in treatment irrespective of designation would be as follows:

- If the controlling company is a non-regulated entity, estimate the solo own funds and solo SCR in line with the first interpretation.
- If the controlling company is a regulated entity, then apply the requirements applicable to that regulated entity.

The above approach recognises that the only difference between the requirements applicable to non-regulated entities and the controlling company is the ability to use a look-through approach in estimating the solo SCR which is an option afforded to controlling companies as information may be more readily available to performing the look-through approach at the controlling company level.

FAIS Act application

Two interpretations have been observed.

FAIS Act interpretation 1

For the regulated financial institution – institutions other than banks, credit institutions or insurers entity type, paragraph 4.3 of FSG 2 requires that the solo own funds and solo SCR is estimated as per the relevant sectoral rules. To the extent that there are no specific capital resources or capital requirements under the sectoral rules, entities need to be treated as a non-regulated entity. Insurance groups vary in their application of the FAIS Act where it is considered as the "relevant sectoral rules".

As the FAIS Act does not detail specific capital resources requirements, insurance groups are aligned that the solo own funds are therefore estimated in line with the requirements of a non-regulated entity.

However when estimating the solo SCR, some insurers interpret the FAIS Act capital requirement which is specified as assets being greater than liabilities to be a "specific capital requirement" under the relevant sectoral rules and hence hold an SCR of zero. The supporting argument for this interpretation is that a specific capital requirement (even if this just stated as assets being greater than liabilities) is mentioned under the FAIS Act and while the capital requirements for insurers are calibrated to a 1-in-200 year event, the FSGs make no mention that the same return period applies to the insurance group as a whole.

FAIS Act interpretation 2

Under this interpretation, insurance groups may argue that the zero capital requirement is not aligned to the spirit of the standard and hence either the liquidity risk requirement from the FAIS Act is held as a proxy for the capital requirement or the capital requirements are estimated in line with the non-regulated entity classification.

Treatment of insurers regulated in a non-equivalent jurisdiction

Non-equivalent insurer interpretation 1

Paragraph 4.3 of FSG 2 requires that the solo own funds and solo SCRs of all insurance participations in non-equivalent jurisdictions must be assessed using the FSIs in South Africa.

However the FSIs often make specific reference to South African exposures and hence some judgement exists in applying the FSIs to an insurer domiciled in a non-equivalent jurisdiction. Some areas where specific reference is made to South African exposures is as follows:

1. Treatment of South African government bonds within spread and concentration risk
2. Treatment of South African equities within equity risk
3. Treatment of foreign exposures within currency risk
4. Treatment of non-life insurance catastrophe risk.

One interpretation of the above is that the references to South Africa remain and consequently exposures domiciled in the non-equivalent jurisdiction are treated as foreign exposures.

Non-equivalent insurer interpretation 2

An alternative interpretation is that all references to South Africa should be replaced with the country in which the non-equivalent jurisdiction is domiciled in. This will consequently have the impact of treating South African exposures as foreign exposures.

Consequently certain sub-modules that have been calibrated to the South African environment such as natural catastrophe risk which is based on South African cresta zones may need special consideration.

For example, non-equivalent insurers that write business within South Africa may need to then attract a factor based catastrophe charge for these exposures. However these non-equivalent insurers that write business in the non-equivalent jurisdiction may apply the natural catastrophe risk charge but allocate exposures to the zone attracting the highest capital charge in line with FSI 4.3.

Illustrative Example

To illustrate the impacts of the different interpretations on the treatment of insurers regulated in non-equivalent jurisdictions, we present the market risk and non-life underwriting risk results for a hypothetical insurer domiciled in a non-equivalent jurisdiction, Country X in North Africa.

This insurer only writes property personal buildings insurance, does not make use of reinsurance and has the following underwriting exposures:

Country X	
Total sum insured	500 000
Largest individual risk sum insured	10 000
Past 12 months earned premium	5 000
Project 12 months earned premium	5 500
Claims provisions	2 000

South Africa	
Total sum insured (Gauteng)	100 000
Largest individual risk sum insured	7 000
Past 12 months earned premium	1 000
Project 12 months earned premium	1 100
Claims provisions	300

It was assumed that the valuation date for the hypothetical insurer was 31 December 2022. The insurer has the following asset exposures:

	Asset	LGD	CQS*	Market Value
1	Country X Government bond	45%	12	10 000
2	Country X equity (Listed)	100%	13	5 000
3	Country X cash in a single bank	45%	12	20 000
4	SA Government bond	45%	10	12 000
5	SA equity	100%	12	3 000
6	SA cash in a single bank	45%	10	4 000

*CQS for Government bonds in the table above detailed as sovereign CQSs but appropriate adjustment to account for risk-free criteria is applied in the interpretation specific results.

The following additional assumptions were made regarding the Government bonds:

	Asset	Coupon Rate	Maturity Date	Nominal Value
1	Country X Government bond	8%	31/12/28	11 000
2	SA Government bond	6%	31/12/26	14 000

The above exposures are effective as at 31 December 2022. Government bond coupons are payable semi-annually. The risk-free curve was assumed to be the same for both territories and DMT of technical provisions is 6 months.

Results

Non-equivalent insurer interpretation 1

- Market risk – R13 757
- Non-life underwriting risk – R18 365

Non-equivalent insurer interpretation 2

- Market risk – R9 986
- Non-life underwriting risk – R12 306

Conclusion

As insurance groups become more familiar in the estimation of the group solvency position, we have seen various interpretations emerge in the application of the FSGs.

Interpretations have emerged in the treatment of the controlling company, application of the FAIS act for regulated financial institutions – institutions other than banks, credit institutions or insurers and in the adoption of the FSIs for insurers in non-equivalent jurisdictions.

Through an illustrative example, we demonstrate the impact on market risk and non-life underwriting risk that the different interpretations have when adopting the FSI for insurers in non-equivalent jurisdictions. The results being dependent on insurer specific exposures.

Contact us

Ricardo Govender
Director
Actuarial and Insurance Solutions
Deloitte Africa
rgovender@deloitte.co.za

Carien Swanepoel
Assistant Manager
Actuarial and Insurance Solutions
Deloitte Africa
cswanepoel@deloitte.co.za