South African Reserve Bank
Prudential Authority

Prudential Standard FSG 2

Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method

Objectives and Key Requirements of this Prudential Standard

This Standard sets out the details for assessing the financial soundness of insurance groups under the Deduction and Aggregation (D&A) method. The D&A method is the default method to be used by insurance groups in calculating their group eligible own funds and group Solvency Capital Requirement (SCR).

Ultimate responsibility for the prudent management of financial soundness of an insurance group rests with the board of directors of the controlling company of the insurance group. The board of directors must ensure that the insurance group has systems, procedures and controls in place to monitor the financial soundness of the insurance group on an ongoing basis, including compliance with this Standard.

The key principles and requirements in relation to the assessment of group capital adequacy under the D&A method include:

- *The capital adequacy of the insurance group must be assessed by aggregating adjusted solo own funds and solo SCRs of entities within the group, with intra-group transactions eliminated to avoid double-counting;*
- *The measure of solo own funds and solo SCR to be used in group calculations will depend on the type of entity and holding, and may be based on regulatory capital requirements that apply in other sectors (for non-insurers);*
- *The determination of group eligible own funds must consider potential restrictions on the availability of certain own funds, including the fungibility and transferability of own funds across the insurance group; and*
- *No diversification benefits between entities are recognised under the D&A method.*

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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, except insurance groups that have been granted approval by the

Prudential Authority to solely use the Accounting Consolidation (AC) method to assess group capital adequacy.

1.2. For the avoidance of doubt, insurance groups that have been granted approval to use the AC method to assess group capital adequacy must still apply the requirements of this Standard to any entities that are outside the scope of the AC method. For the purpose of applying the Deduction & Aggregation (D&A) method, the insurance group must treat the group of entities within the scope of the AC method as a single entity.

1.3. Where the scope of the insurance group includes an insurance sub-group that is also subject to group supervision (as per section 1.10 of FSG 1 (Framework for Financial Soundness of Insurance Groups)), the insurance group may treat that sub-group as a single entity when applying the D&A method.

2. Roles and Responsibilities

2.1. Ultimate responsibility for the prudent management of the financial soundness of an insurance group rests with the board of directors of the controlling company of the insurance group.[1] 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.[2] 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.

2.2. The board of directors must have in place systems, procedures and controls to monitor financial soundness at the insurance group level on an ongoing basis, including compliance with this Standard. The board of directors must without delay notify the Prudential Authority of any deteriorating circumstances that could lead to a breach, within the following three months, of the requirements set out in this Standard.[3]

2.3. 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[4] and Solvency Capital Requirement (SCR) at the insurance group level (referred to as group eligible own funds and group SCR respectively).

2.4. 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

[1] All references to the board of directors in this Standard refer to that of the controlling company of the insurance group.

[2] 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.

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

[4] The head of actuarial function may rely on the controlling company's auditors for the valuation of assets and liabilities other than technical provisions.

performance of its responsibilities that may cause the insurance group to be not financially sound.

2.5. 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

Transition provisions

3.2. Any hybrid capital instrument and subordinated liability not issued or guaranteed by the controlling company of the insurance group that was issued prior to the commencement date of this Standard may be regarded as fungible and/or transferable until that instrument or liability is varied, renewed or expires.

4. Key Principles Underlying the Deduction and Aggregation Method

4.1. Under the D&A method, the capital adequacy of the insurance group is assessed by aggregating the adjusted own funds and adjusted SCRs of the controlling company, with the adjusted solo own funds and adjusted solo SCRs of the controlling company's participations.[5] The aggregation of adjusted solo own funds and SCRs for the participations must be based on the proportional share of the controlling company's economic interest in the participations.

4.2. When applying the D&A method, any insurance sub-groups designated by the Prudential Authority under section 1.10 of FSG 1 (Framework for Financial Soundness of Insurance Groups) should be treated as a single participation of the controlling company. Where the AC method is applied to a sub-group of the overall insurance group, that sub-group of entities within the scope of the AC method must also be treated as a single participation of the controlling company for the purpose of assessing the overall insurance group's capital adequacy.

4.3. The solo own funds and solo SCRs to be used in the insurance group calculation will differ by type of entity. A summary of the solo own funds and solo SCR measures to be used in group calculations for different types of entities is set out in the table below. The table sets out the solo own funds and solo SCR measures to be counted towards group own funds and group SCR prior to any adjustments for intra-group transactions or other possible restrictions on own funds at group level.

[5] The term "adjusted" is used with respect to solo own funds and solo SCR here due to the need to eliminate the effect of intra-group transactions and other possible restrictions on own funds. Sections 5 and 6 of this Standard provide further details of these adjustments.

Measures of solo Own Funds and solo SCR by type of entity		
Type of entity	***Own Funds***	***SCR***
South African insurer licensed by the Prudential Authority	Solo own funds as determined under FSI 2.3 (Determination of Eligible Own Funds)	Solo SCR as determined under FSI 4 (Calculation of the SCR Using the Standardised Formula) or, for insurers with Internal Model approval, FSI 5 (Calculation of the SCR Using a Full or Partial Internal Model)
Non-South African insurer regulated in an equivalent jurisdiction	Solo capital resources as determined under local regulatory requirements in the equivalent jurisdiction	Solo capital requirement as determined under local regulatory requirements in the equivalent jurisdiction
Non-South African insurer regulated in a non-equivalent jurisdiction	Refer to Attachment 1	Refer to Attachment 1
Controlling company which is not an insurer licensed by the Prudential Authority[6]	Adjusted Net Asset Value as calculated on the basis of valuation requirements for participations in sections 5.4 and 5.5 of FSI 2.1 (Valuation of Assets and Liabilities Other than Technical Provisions)	The capital requirement derived by applying the stress prescribed in section 6.11 of FSI 4.1 (Market Risk Capital Requirement) or zero where the Adjusted Net Asset Value of the entity is less than zero. Alternatively, a look-through approach may be applied to the assets held by the controlling company and the application of the relevant market risk stresses set out in FSI 4.1 (Market Risk Capital Requirement).
Regulated financial institution[7] – banks and credit institutions	Regulatory capital resources as per the Basel framework	Regulatory capital requirements as per the Basel III framework
Regulated financial institution[8] – institutions other than banks, credit institutions or insurers	Regulatory capital resources as per the relevant sectoral rules. Where the regulated institution has no specific capital resources requirement under sectoral rules, the regulated institution should be treated	Regulatory capital requirements as per the relevant sectoral rules. Where the regulated institution has no specific capital requirement under sectoral rules, the regulated institution should be treated

[6] If the controlling company is an insurer licensed by the Prudential Authority, its solo own funds and solo SCR are determined by the requirements applicable to insurers (i.e. the first row in the table).

[7] "Regulated financial institutions" refer to an entity subject to regulation or supervision by a designated authority as defined in section 250 of the Financial Sector Regulation Act, 2017 and subject to prudential requirements.

[8] Ibid.

Measures of solo Own Funds and solo SCR by type of entity		
Type of entity	***Own Funds***	***SCR***
	as a “non-regulated entity”.	as a “non-regulated entity”.
Non-regulated entity[9]	Adjusted Net Asset Value as calculated on the basis of valuation requirements for participations in sections 5.4 and 5.5 of FSI 2.1 (Valuation of Assets and Liabilities Other than Technical Provisions). Insurance groups may apply to the Prudential Authority to use an alternative method for calculating the own funds.	The capital requirement derived by applying the stress prescribed in section 6.11 of FSI 4.1 (Market Risk Capital Requirement), or zero where the Adjusted Net Asset Value of the entity is less than zero. Insurance groups may apply to the Prudential Authority to use an alternative method for calculating the SCR.

4.4. The treatment of different types of entities in the table above applies to the controlling company and its participations. Entities where the insurance group has no significant influence (e.g. entities where the insurance group has a holding of less than 20%) must be treated as an equity investment for the purposes of group calculations. That is, such investments must be recognised as an asset on the insurance group’s balance sheet, and the relevant equity risk stresses must be applied to that asset when calculating the group SCR.

4.5. If a participation within the insurance group holds own funds less than its capital requirement at the solo level, the full deficit must be taken into account in the group calculation (i.e. the group SCR calculation must add back, in full, the deficit in capital resources).

4.6. The Prudential Authority may require a different measure of solo own funds or solo SCR from those specified in sections 4.3 to 4.5 above where it believes it would be appropriate to do so for an insurance group.

4.7. Further details regarding the steps needed to calculate group eligible own funds and group SCR under the D&A method, including adjustments needed for intra-group transactions and other possible restrictions on own funds, are set out in sections 5 and 6 of this Standard.

5. Method for Determining Group Eligible Own Funds

5.1. When applying the D&A method, the eligible own funds of the insurance group (group eligible own funds) must be calculated according to the steps set out below.

Step 1 – Eliminate intra-group transactions

5.2. In order to eliminate the potential for multiple usage of own funds or double gearing[10] between entities within the insurance group, the effect of all intra-

[9] Including Special Purpose Vehicles and intermediate holding companies.

group transactions on the solo own funds of each entity within the insurance group (as determined under sections 4.3 to 4.5 above) must be eliminated.[11]

5.3. Intra-group arrangements that must be eliminated from the solo own funds used in the group calculation include intra-group:

a) Loans;
b) Guarantees and off-balance sheet transactions;
c) Capital investments;
d) Reinsurance;
e) Cost-sharing arrangements;
f) Risk-transfer transactions; and
g) Other transactions.

5.4. The method for eliminating the effect of intra-group transactions from solo own funds will typically involve removing the value of the arrangement from the balance sheets of both entities in the transaction, then recalculating the solo own funds of each entity excluding these amounts.[12] For example, the effect of intra-group loans can be eliminated from the solo own funds calculations by both the borrower and lender first removing the value of the loan from their respective balance sheets.

5.5. Insurance groups may apply to the Prudential Authority to use an alternative method for the elimination of intra-group transactions.

Step 2 – Assess restrictions on the availability of certain group Own Funds

5.6. There may be restrictions on the availability of certain solo own funds that must be considered when assessing the availability of own funds at group level. In particular, insurance groups must consider the fungibility and transferability of all own funds recognised at solo level before including these in group own funds. In this regard:

a) Fungibility refers to the ability of own funds to absorb losses of any kind within the insurance group, taking into account whether the own funds are dedicated for a specific purpose; and
b) Transferability refers to the ability of one entity within the insurance group to transfer assets to another entity within the insurance group.[13]

5.7. Own Funds that are non-fungible or non-transferable across the insurance group must not be considered to be fully available at group level. However, such solo own funds may be recognised as group own funds up to the point where the solo own funds equal the solo SCR (after elimination of intra-group transactions).

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[10] Double gearing may occur if one entity in a group invests in a capital instrument that counts as regulatory capital for another entity in the group. Multiple gearing may occur if a series of such transactions exist. Double gearing and other types of transactions that may result in intra-group creation of capital should be identified and removed from the calculation of group eligible own funds.

[11] Where there is an insurance sub-group that is treated as a single entity, all intra-group transactions between the insurance sub-group and the broader insurance group must be eliminated when applying the D&A method.

[12] The elimination of intra-group transactions does not apply to entities where the group has no ownership in the entity, i.e. shareholding or economic interest.

[13] While the two concepts of fungibility and transferability are linked, they are nevertheless distinct. Own funds may be transferable but not fungible, and vice versa.

5.8. Unless otherwise approved by the Prudential Authority, own funds that should be regarded as non-fungible and/or non-transferable include:

a) Own funds that may be restricted due to legal or regulatory requirements (refer to section 5.9 below);
b) Ancillary own funds[14] and encumbered assets[15] of participations within the insurance group (such own funds are typically only available to absorb losses of the relevant participation and not the wider insurance group);
c) Hybrid capital instruments and subordinated liabilities that are not issued or guaranteed by the controlling company of the insurance group; and
d) Own funds related to deferred tax assets.

5.9. Own funds that may be restricted due to legal or regulatory requirements include those own funds that are:

a) Dedicated to absorb only certain losses as prescribed by national legal or regulatory requirements (e.g. ring-fenced funds);
b) Unable to be transferred to any other entity within the insurance group due to national legal or regulatory requirements (e.g. exchange controls); or
c) Otherwise unable to be made available to the insurance group within a maximum period of nine months.

Step 3 – Aggregate adjusted solo Own Funds

5.10. The amount of adjusted solo own funds for each entity within the insurance group (i.e. after adjustments for intra-group transactions in Step 1 and potential restrictions on certain own funds in Step 2) must then be aggregated. The aggregation must be taken as the sum of:

a) The adjusted own funds of the controlling company; and
b) The adjusted solo own funds of each participation in the insurance group whereby for each participation, the relevant adjusted solo own funds are pro-rated by the insurance group's economic interest in the relevant participation.[16]

Step 4 – Apply eligibility limits

5.11. In order to be considered group eligible own funds, the available group own funds (i.e. the amount of own funds calculated after performing Steps 1 to 3) must comply, in aggregate, with eligibility limits as set out in section 9 of FSI 2.3 (Determination of Eligible Own Funds).

5.12. For the purpose of applying eligibility limits at the insurance group level, where an insurance group excluded certain own funds under Step 2 due to a lack of fungibility or transferability in own funds, the own funds eligible for the insurance group will be recognised in increasing levels of tiering. There must

[14] Refer to FSI 2.3 (Determination of Eligible Own Funds) for further details regarding ancillary own funds. Ancillary own funds may only be recognised in (solo) own funds if approved by the Prudential Authority.

[15] Refer to FSI 2.1 (Valuation of Assets and Liabilities Other than Technical Provisions) for details regarding encumbered assets.

[16] For less than 100%-owned participations, the share that is owned by third-parties should not be included in group own funds where the third-party has the option to return its shareholding.

be no upgrading of solo own funds (i.e. increasing the tier of own funds) in any of the steps applied to calculate group eligible own funds.

5.13. The insurance group must determine solo eligible own funds (although not used in calculating group eligible own funds) for each entity within the insurance group in order to assess the quality of capital at a solo level after performing Steps 1 to 3. The solo level eligibility limits related to tiering that apply for different types of entities within the insurance group are set out in the table below.

Type of entity	***Eligibility limits related to tiering***
South African insurer licensed by the Prudential Authority	Eligibility limits as specified in section 9 of FSI 2.3 (Determination of Eligible Own Funds)
Non-South African insurer regulated in an equivalent jurisdiction	Eligibility limits as specified in the relevant local regulatory requirements in the equivalent jurisdiction
Non-South African insurer regulated in a non-equivalent jurisdiction	Eligibility limits as specified in section 9 of FSI 2.3 (Determination of Eligible Own Funds)
Controlling company which is not an insurer licensed by the Prudential Authority	Eligibility limits as specified in section 9 of FSI 2.3 (Determination of Eligible Own Funds)
Intermediate holding company	Eligibility limits as specified in section 9 of FSI 2.3 (Determination of Eligible Own Funds)
Regulated financial or credit institution (excluding insurers)	Eligibility limits as specified in relevant sectoral rules, where applicable. If no tier limits exist in the relevant sectoral rules, the tier limits specified in section 9 of FSI 2.3 (Determination of Eligible Own Funds) should apply.
Non-regulated entity	Eligibility limits as specified in section 9 of FSI 2.3 (Determination of Eligible Own Funds)

6. Method for Determining the Group SCR

6.1. The group SCR must be calculated as the sum of:

a) The SCR of the controlling company, after adjusting for intra-group transactions as set out below; and
b) The solo SCRs of each participation in the insurance group, after adjusting for intra-group transactions as set out below, pro-rated by the insurance group's economic interest in the relevant participation.

6.2. In order to prevent the double-counting of risk charges under the D&A method (e.g. market, underwriting and operational risk charges), adjustments must be applied to the solo SCRs to eliminate the effect of any intra-group transactions in the aggregated group SCR.

6.3. Intra-group arrangements that must be eliminated from the solo SCRs used in the group calculation include those types of transactions set out in section 5.3 of this Standard.

6.4. The method for eliminating the effect of intra-group transactions from the solo SCRs of entities within the insurance group will depend on the specific nature of the arrangement. For example:

a) For investments in participations, the investor's SCR should be adjusted to remove the equity capital requirement associated with the participation holding.
b) For intra-group loans, the SCR of the lender should be adjusted to remove the counterparty default risk charge associated with the risk that the borrower does not repay the loan.[17]

Other considerations in calculating the group SCR

6.5. Double-counting of loss-absorbing capacity of technical provisions must be avoided at the insurance group level as it is at the solo insurer level. Double-counting may arise when the impact of management actions on technical provisions is counted more than once when calculating the SCR using the Standardised Formula.

6.6. In the case of an insurance group that includes several licensed insurers, the head of actuarial function for the controlling company must consider whether there is potential double-counting of loss-absorbing capacity of technical provisions at the group level (i.e. where the effect of assumed management actions may have been counted more than once when determining group SCR). Double-counting at the group level under the D&A method may arise, for example, where management actions involving support from the controlling company are assumed at the level of individual insurers more than once, but would not be available to each individual insurer simultaneously.

6.7. If potential double-counting exists, the insurance group must make appropriate adjustments to the group SCR calculation by applying an add-on for the potential double-counting. This add-on, including its derivation, must be reported to the Prudential Authority.

6.8. If an insurer within the group has an arrangement that is considered to be a ring-fenced fund at the solo level, as defined in Attachment 4 of FSI 4 (Calculation of the SCR Using the Standardised Formula), that arrangement must also be considered to be a ring-fenced fund at the insurance group level. Under the D&A method, any adjustment to the calculation of the capital requirement at the solo level for ring-fenced funds should automatically apply to the group calculation, with no further adjustments required.

[17] Under the Standardised Formula, the application of a modular approach to the calculation of the overall SCR (including the recognition of diversification benefits between certain risk categories) means that a recalculation of relevant components of the SCR will be required to account for intra-group transactions. The adjusted solo SCRs cannot simply be calculated by deducting the specific risk charges related to the intra-group transaction.

Attachment 1: Treatment of Insurers in Non-Equivalent Jurisdictions

This Attachment sets out the treatment of insurance participations domiciled in non-equivalent jurisdictions that are within the scope of the insurance group.

1. All insurance participations of a controlling company will be required to be included in the scope of group capital adequacy calculations regardless of materiality, unless approved by the Prudential Authority to be excluded.

2. For the purposes of assessing group capital adequacy, the solo own funds and solo SCRs of all insurance participations in non-equivalent jurisdictions must be assessed using the Financial Soundness Standards for Insurers in South Africa. Insurance groups may apply the simplifications contained within the Financial Soundness Standards for Insurers when calculating the solo SCRs of insurance participations in non-equivalent jurisdictions.

3. If an insurance group is unable to meet the requirements of the Financial Soundness Standards for Insurers for its insurance participations in non-equivalent jurisdictions, the controlling company may apply to the Prudential Authority to use an alternative method. Approval by the Prudential Authority to use an alternative method will depend on a number of factors including:

    a) The materiality and strategic importance of the insurance participation to the overall group;
    b) The nature and extent of constraints in being able to perform calculations consistent with South African requirements;
    c) The extent of differences between local capital requirements in the non-equivalent jurisdiction and South Africa; and
    d) Any risk-based capital requirement that may be assessed by the insurance group (e.g. using an economic capital model) in relation to the insurance participation.

4. The factors mentioned in section 3 of this Attachment will take into account whether a participation is strategically important. A participation will be regarded as strategically important if:

    a) The participation uses the brand or name of the South African parent or a brand/name that is closely associated with the South African parent;
    b) The South African parent has provided explicit guarantees, commitments, letters of comfort or cross-default commitments to the participation;
    c) The South African parent has management and/or board control over the participation;
    d) The South African parent consolidates the financial results of the participation in its accounts; or
    e) The participation has a significant market share or influence in its local market or markets in the case of cross-border operations.

5. Any approval granted by the Prudential Authority to apply an alternative method for insurance participations in non-equivalent jurisdictions will not be permanent. The Prudential Authority will agree with the insurance group an appropriate transitional plan to satisfy compliance with section 2 of this Attachment for those insurance participations that are not assessed using equivalent solo insurer requirements to South Africa.