South African Reserve Bank
Prudential Authority

Prudential Standard FSG 3

Assessing the Financial Soundness of Insurance Groups Using the Accounting Consolidation 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 Accounting Consolidation (AC) method. An insurance group must have the approval of the Prudential Authority before applying the AC method.

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 where approval to use the AC method has been granted by the Prudential Authority.

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

- *The AC method may only be applied to insurance subsidiaries within an insurance group that are licensed by the Prudential Authority (and the controlling company if it is an insurer licensed by Prudential Authority);*
- *All other entities within the insurance group must be assessed using the Deduction and Aggregation (D&A) method prescribed under FSG 2 (Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method);*
- *The AC method requires calculation of eligible own funds and Solvency Capital Requirement (SCR), for those entities within the scope of the AC method, using a consolidated balance sheet approach;*
- *The consolidated balance sheet approach involves applying the solo-level Financial Soundness Standards for Insurers to a single consolidated balance sheet comprising all entities within the scope of the AC method; and*
- *Eligible own funds and SCR derived by applying the AC method must be aggregated with eligible own funds and SCR for other entities within the insurance group using 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 and which have been granted approval to use the Accounting Consolidation (AC) method to assess group capital adequacy. For clarity, the requirements in this Standard are not applicable to insurance groups that do not have approval to use the AC method.

1.2. Insurance groups that include entities which are outside the scope of the AC method (i.e. entities which are not insurance subsidiaries[1] licensed by the Prudential Authority or a controlling company which is not an insurer licensed by the Prudential Authority) must refer to FSG 2 (Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method) to determine the insurance group's overall group eligible own funds and group Solvency Capital Requirement (SCR).

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.[2] The board of directors must ensure that the insurance group maintains an appropriate level and quality of group own funds commensurate with the type, amount and concentration of risks to which the group is exposed.[3] 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 where approval has been granted to apply the AC method. 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.[4]

2.3. The controlling company'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 used to determine eligible own funds[5] and SCR at the insurance group level (referred to as group eligible own funds and group SCR respectively).

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[1] The term "subsidiaries" in this Standard is defined in accordance with the definition used in International Financial Reporting Standards (IFRS).

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

[3] 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.

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

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

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 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 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

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 Accounting Consolidation Method

4.1. The AC method may apply to the following scope of entities only:

a) Insurance subsidiaries licensed by the Prudential Authority that are part of the insurance group and any entity that is directly held by the insurance subsidiary;[6] and
b) The controlling company of the insurance group, if the controlling company is an insurer licensed by the Prudential Authority.[7]

The scope of entities that the AC method applies to in an insurance group is referred to as the "AC group" in this Standard.

4.2. Under the AC method, the accounting consolidation rules set out in IFRS 10 must be applied to construct a single, consolidated balance sheet of the AC group. The solo requirements set out in the Financial Soundness Standards for Insurers must be applied to this consolidated balance sheet to determine the AC group's eligible own funds and SCR. Using this approach, the AC method effectively treats the AC group as if it were a single entity.

4.3. All other entities within the insurance group (including non-insurance entities and insurance associates in the group) must be excluded from the AC group

[6] For clarity, this includes all subsidiaries in the insurance group that are licensed by the Prudential Authority (not just insurance subsidiaries of the controlling company). Insurance associates that are part of the insurance group (where associates are defined as per the definition in IFRS) are not permitted to be included under the AC method.

[7] A controlling company that is not an insurer licensed by the Prudential Authority must be assessed in group capital adequacy calculations using the Deduction and Aggregation method.

and assessed using the Deduction and Aggregation method (D&A) when calculating their contribution to the insurance group's overall eligible own funds and SCR.

4.4. To calculate overall group eligible own funds and group SCR, the AC group's eligible own funds and SCR (as determined under this Standard) must be aggregated with the eligible own funds and SCR of other entities within the insurance group using the D&A method prescribed in FSG 2 (Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method). That is, in calculating an insurance group's overall eligible own funds and SCR, the AC group's eligible own funds and SCR should be treated as solo own funds and solo SCR respectively (refer to section 4.2 of FSG 2).

4.5. Further details regarding the calculation of the AC group's eligible own funds and SCR are set out in section 5 and 6 below, respectively.

5. Method for Determining Eligible Own Funds of the AC Group

5.1. The determination of eligible own funds of the AC group must be based on applying the valuation requirements in FSI 2 (Valuation of Assets, Liabilities and Eligible own funds) and associated Standards to the consolidated balance sheet of the AC group. That is:

a) Assets and liabilities (other than technical provisions) of the AC group should be valued in line with the requirements set out in FSI 2.1 (Valuation of Assets and Liabilities Other than Technical Provisions);
b) Technical provisions of the AC group should be valued in accordance with the requirements set out in FSI 2.2 (Valuation of Technical Provisions); and
c) Eligible own funds of the AC group should be determined by applying the requirements set out in FSI 2.3 (Determination of Eligible Own Funds).

5.2. As the AC method relies on accounting consolidation rules in IFRS 10 to determine the consolidated balance sheet, all intra-group transactions between entities within the AC group will be automatically eliminated. Further adjustments to determine own funds of the AC group due to intra-group transactions should not be required. However, when aggregating the own funds of the AC group with the own funds of other parts of the insurance group using the D&A method, all intra-group transactions between the AC group and the broader insurance group must be eliminated.

5.3. With respect to technical provisions for the AC group, the best estimate of insurance liabilities of the AC group should be the sum of the best estimate insurance liabilities of the solo entities that make up the AC group, less the part of the best estimate resulting from internally reinsured exposures and other intra-group transactions. Subject to satisfying the principle of proportionality, the risk margin for the AC group may be calculated using the simplification set out in Attachment 1 of this Standard.

5.4. As the AC group must only include insurers licensed by the Prudential Authority, full fungibility and transferability of own funds within the AC group may be assumed when determining the eligible own funds of the AC group. When aggregating the eligible own funds of the AC group with the eligible own funds of other entities within the insurance group under the D&A method, however, an insurance group must look through to the fungibility and transferability of own funds of individual insurers within the AC group (as per the requirements set out in sections 5.5 to 5.8 of FSG 2 (Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method)). For example, any ancillary own funds related to a solo insurer within the AC group may be fully recognised when calculating eligible own funds of the AC group, but must be considered restricted at the overall insurance group level under the D&A method (unless otherwise approved by the Prudential Authority as per section 5.7 of FSG 2).

5.5. In order to be considered eligible own funds for the AC group, the own funds of the AC group must comply with the eligibility limits in relation to tiering set out in section 9 of FSI 2.3 (Determination of Eligible Own Funds).

5.6. Where the AC group includes an insurer that is not subject to the requirements under the Financial Soundness Standards for Insurers (e.g. microinsurers), the valuation requirements specified in section 5.1 above still apply to that insurer for the purposes of determining eligible own funds of the AC group under the AC method.

6. Method for Determining the SCR of the AC Group

6.1. The calculation of the SCR of the AC group must be based on applying the relevant solo insurer capital requirements to the consolidated balance sheet of the AC group. In particular:

a) For insurance groups that have approval from the Prudential Authority to use an Internal Model for all or part of the group capital adequacy calculations, the SCR of the AC group must be calculated using the approved Internal Model which, in turn, must satisfy the requirements of FSI 5 (Calculation of the SCR Using a Full or Partial Internal Model); or
b) For other insurance groups, the SCR of the AC group must be calculated based on applying the Standardised Formula requirements set out in FSI 4 (Calculation of the SCR Using the Standardised Formula) and associated Standards.

6.2. As the AC method relies on accounting consolidation rules in IFRS 10 to determine the consolidated balance sheet, all intra-group transactions between entities within the AC group will be automatically eliminated. Further adjustments to determine the SCR of the AC group due to intra-group transactions should not be required. However, when aggregating the SCR of the AC group with the SCR of other parts of the insurance group using the D&A method, all intra-group transactions between the AC group and the broader insurance group must be eliminated.

6.3. Where the AC group includes an insurer that is not subject to the requirements under the Financial Soundness Standards for Insurers (e.g. microinsurers), the solo insurer capital requirements specified in section 6.1 above still apply to that insurer for the purposes of determining the SCR of the AC group under the AC method.

Other considerations in calculating the SCR of the AC group

6.4. Double-counting of the loss-absorbing capacity of technical provisions must be avoided at the AC 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.

6.5. In the case of an AC 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 AC group level. If potential double-counting exists, this must be appropriately accounted for in the AC group's SCR.

6.6. For insurance groups applying the AC method, the adjustment for potential double-counting at the AC group level may be applied to the AC group through the calculation of the adjustment factor, $AdjSES$, as specified in Attachment 2 of FSI 4.1 (Market Risk Capital Requirement). The application of this adjustment factor to the AC group is likely to be more complex than the application applied at the solo insurer level, given the need to account for participating businesses stemming from different entities.

6.7. The calculation described in section 6.6 for the AC group should assume realistic management actions at the group level which are consistent with management actions at the solo level.

6.8. If an insurer within the AC 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 AC group level. Any adjustment to the calculation of the capital requirement and own funds at the solo level for ring-fenced funds should apply, with necessary adjustments, to the AC group level calculations.

6.9. For example, if at the solo level the only adjustment due to the existence of a ring-fenced fund is the recognition of a profit participation mechanism in relation to the outcome of bi-directional scenarios, the same methodology as applied at the solo level should be adopted at the AC group level. However, in the AC group calculation, the choice between the bi-directional scenarios should be based on the worst-case scenario to the AC group as a whole.

Attachment 1: Possible Simplifications

This Attachment sets out possible simplifications that may be used when calculating eligible own funds and SCR at the AC group level. Use of these simplifications is subject to the insurance group satisfying the principle of proportionality.

A. Calculation of risk margin in technical provisions

1. In the normal course, the risk margin for the AC group should be calculated by applying the requirements in section 14 of FSI 2.2 (Valuation of Technical Provisions) to the consolidated balance sheet of the AC group.

2. Due to the potential complexity involved with this calculation, however, insurance groups may calculate the risk margin for the AC group by using the simplified approach of summing the following:

   a) The risk margin of the controlling company of the insurance group (if the controlling company is part of the AC group); and
   b) The proportional share of the controlling company in the risk margin of the insurance subsidiaries of the AC group.

B. Adjustment for the loss-absorbing capacity of deferred tax assets

1. In the normal course, the calculation of the SCR of the AC group should include an adjustment for the loss-absorbing capacity of deferred tax assets – calculated by applying the requirements set out in Attachment 5 of FSI 4 (Calculation of the SCR Using the Standardised Formula) to the consolidated balance sheet of the AC group.

2. As a simplification, however, insurance groups may choose to calculate the adjustment for the loss-absorbing effect of deferred tax assets at the AC group level ($AdjDT_{group}$) using the following formula:

$$AdjDT_{group} = \sum_i AdjDT_{solo,i} \cdot \frac{SCR_{Pre-DT}^{\mathrm{AC}}}{\sum_i SCR_{solo,i}}$$

Where:

i	=	The index covering all entities within the AC group
$AdjDT_{solo,i}$	=	The adjustment for the loss-absorbing capacity of deferred taxes for the solo entity *i* in the AC group (as calculated under Attachment 5 of FSI 4 (Calculation of the SCR Using the Standardised Formula))
SCR_{Pre-DT}^{AC}	=	The SCR of the AC group prior to the adjustment for the loss-absorbing capacity of deferred taxes at group level
$SCR_{solo,i}$	=	The solo SCR of entity *i*, after any applicable adjustment for potential double-counting of loss-absorbing capacity of technical provisions, but prior to adjustment for the loss-absorbing capacity of deferred taxes

3. If the simplified formula in section 2 above is used, the parameters $AdjDT_{solo,i}$ and $SCR_{solo,i}$ should be net of intra-group transactions.