South African Reserve Bank

INSURANCE ACT, 2017: STATEMENT ON DRAFT PRUDENTIAL STANDARDS

1. INTRODUCTION

This statement is published in accordance with section 98 of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) in respect of the draft Prudential Standards to be prescribed under section 63 of the Insurance Act, 2017 (Act No. 18 of 2017) ("IA") as listed in paragraph 3 below.

The statement explains the need for, and the intended operation and expected impact of the draft Prudential Standards.

All the Prudential Standards are available on the South African Reserve Bank's website at http://www.resbank.co.za/RegulationAndSupervision/PrudentialAuthority/Pages/default.aspx.

The statement is published by the South African Reserve Bank in anticipation of the establishment of the Prudential Authority on 1 April 2018 and the 1 July 2018-envisaged effective date of the Insurance Act.

2. BACKGROUND

The IA and the draft Prudential Standards provide a consolidated legal framework for the prudential supervision of insurers. Prudential supervision is necessary to promote and enhance the safety and soundness of insurers in order to protect policyholders against the risk that insurers may fail to meet their obligations and to assist in maintaining financial stability.

The IA is framework legislation. It is enabling or empowering. This means that it contains the fundamental policy or underlying principles of legislation that are unlikely to change over time. It provides for the powers necessary to regulate insurers. The IA delegates the power to make secondary legislation to the Prudential Authority.

Secondary legislation in the form of Prudential Standards is therefore necessary for the effective implementation of the IA.

The Prudential Authority, under section 63 of the IA, is empowered to prescribe Prudential Standards on any matter that is required or permitted to be prescribed in terms of that Act.

3. OVERVIEW OF THE DRAFT PRUDENTIAL STANDARDS

General

The IA provides for a number of matters to be addressed in Prudential Standards. These matters relates to governance, financial soundness, disclosure and operational matters. The draft Prudential Standards have been grouped into *Financial Soundness* Prudential Standards and *Governance and Operational* Prudential Standards.

The IA entrenches the principle of *proportionality*, which means that regulatory requirements will be applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurer (and reinsurer) and an insurance group. An insurer's own risk profile will serve as the primary guide to assess the application of the principle. The Prudential Standards have been drafted in a proportionate manner. Dedicated Prudential Standards for insurers, microinsurers, branches of foreign reinsurers, Lloyd's[1] and insurance groups are proposed.

The Prudential Standards are written in *plain English narrative style*. Each Prudential Standard has an information box on the first page to assist the reader in gaining a high-level overview of the scope of the prudential standard. Most Prudential Standards also have attachments that cover detailed specifications.

Structure of the draft Prudential Standards

FINANCIAL SOUNDNESS		
FSI 1	Framework for Financial Soundness of Insurers	Attachment 1: Definitions used in the Financial Soundness Standards for Insurers Attachment 2: Abbreviations.
FSI 2	Valuation of Assets, Liabilities and Eligible Own Funds	
FSI 2.1	Valuation of Assets and Liabilities Other than Technical Provisions	
FSI 2.2	Valuation of Technical Provisions	Attachment 1: Prescribed Lines and Sub-lines of Business Attachment 2: Cash-flow Projections Attachment 3: Adjusting Recoverables for Counterparty Default Risk Attachment 4: Deriving the Risk-free Interest Rate Term Structure for Foreign Currencies Guidance Note FSI GN 2.2: Valuation of Technical Provisions
FSI 2.3	Determination of Eligible Own Funds	Attachment 1: Criteria for Classifying Basic Own Funds as Tier 1

[1] Dedicated Prudential Standards for Lloyd's are proposed as the risk profile of Lloyd's insurance business is typically different from that of other insurers. This is so because of the limited classes of business that Lloyd's underwriters may underwrite, and the structure and characteristics of the Lloyd's insurance market (which is an insurance market in which Lloyd's underwriters join together in syndicates to conduct insurance business).

			Attachment 2: Criteria for Classifying Basic Own Funds as Tier 2 Attachment 3: Criteria for Classifying Basic Own Funds as Tier 3 Attachment 4: Surrender Value Gap Attachment 5: Regulatory Deductions for Ring-fenced Funds
FSI 3		Calculation of the MCR	
FSI 4		Calculation of the SCR Using the Standardised Formula	Attachment 1: Eligibility Conditions for Risk Mitigation Instruments Attachment 2: Providing for Counterparty Default Risk on Risk Mitigation Instruments Attachment 3: Calculating the SCR for Insurance-related Participations in the Same Sector Attachment 4: Calculating the SCR when Ring-fenced Funds are Involved Attachment 5: Adjustment for Loss-Absorbing Capacity of Deferred Taxes
	FSI 4.1	Market Risk Capital Requirement	Attachment 1: Treatment of Specific Instruments Attachment 2: Adjustment for Potential Double-Counting of Loss-Absorbing Capacity of Technical Provisions Attachment 3: Shocks to Apply for Interest Rate Curve Risk Attachment 4: Spread Risk Factors Attachment 5: Adjustments to Standard Concentration Risk Requirements Attachment 6: Qualifying Criteria for Infrastructure Assets
	FSI 4.2	Life Underwriting Risk Capital Requirement	Attachment 1: Simplification for Mortality Risk Attachment 2: Simplification for Longevity Risk Attachment 3: Simplification for Disability-Morbidity Risk Attachment 4: Simplification for Lapse Risk Attachment 5: Simplification for Expense Risk Attachment 6: Simplification for Life Catastrophe Risk Attachment 7: Simplification for Retrenchment Risk

FSI 4.3	Non-life Underwriting Risk Capital Requirement	Attachment 1: Simplifications for First-Party Insurance Structures Attachment 2: Optional Adjustment for Insurance Policies with Risk Sharing Features Attachment 3: Lines and Sub-lines of Business for Non-Life Insurance Attachment 4: Standard Deviation Parameters for Premium and Reserve Risk Attachment 5: Geographical Regions and Zones Attachment 6: Correlation Matrix for Premium and Reserve Risk Calculation Attachment 7: Insurer-Specific Parameters Attachment 8: Capital Requirement for Natural Catastrophe Risk Under Method 1 Attachment 9: Capital Requirements for Man-made Catastrophes Under Method 1
FSI 4.4	Operational Risk Capital Requirement	
FSI 5	Calculation of the SCR Using a Full or Partial Internal Model	Attachment 1: Contents of Validation Policy Guidance Note FSI GN 5: Calculation of the SCR Using a Full or Partial Internal Model
FSI 6	Liquidity Risk Assessment	
FSM 1	Framework for Financial Soundness of Microinsurers	Attachment 1: Definitions used in the Financial Soundness Standards for Microinsurers Attachment 2: Abbreviations Attachment 3: Cell Captive Microinsurers
FSM 2	Valuation of Assets, Liabilities and Eligible Own Funds	Attachment 1: Prescribed Lines of Business
FSB 1	Framework for Financial Soundness of Branches	Attachment 1: Definitions used in the Financial Soundness Standards for Branches Attachment 2: Abbreviations
FSB 2	Valuation of, and limitations on, assets held as security by Branches	
FSB 3	Valuation of Technical Provisions by Branches	
FSL 1	Framework for Financial Soundness of Lloyd's	Attachment 1: Definitions used in the Financial Soundness Standards for Lloyd's Attachment 2: Abbreviations
FSL 2	Valuation of, and limitations on, assets held as security by Lloyd's	
FSL 3	Valuation of Technical Provisions by Lloyd's	Attachment 1: Simplification for Valuing the Best Estimate of Technical Provisions
FSG 1	Framework for Financial Soundness of Insurance Groups	Attachment 1: Definitions used in the Financial Soundness Standards for Insurance

		Groups Attachment 2: Abbreviations
FSG 2	Assessing the Financial Soundness of Insurance Groups Using the Deduction and Aggregation Method	Attachment 1: Treatment of Insurers in Non-Equivalent Jurisdictions
FSG 3	Assessing the Financial Soundness of Insurance Groups Using the Accounting Consolidation Method	Attachment 1: Possible Simplifications
GOVERNANCE AND OPERATIONAL		
GOI 1	Framework for Governance and Operational Standards for Insurers	GOI 1 Attachment 1: Definitions used in the Governance and Operational Standards for Insurers
GOI 2	Governance of Insurers	Attachment 1: Independence Attachment 2: Audit Committee Attachment 3: Risk Committee Attachment 4: Remuneration Committee GOI GN 2.1: Corporate Culture
GOI 3	Risk Management and Internal Controls for Insurers	Attachment 1: Policies for Managing Financial Risks
GOI 3.1	Own Risk and Solvency Assessment (ORSA) for Insurers	
GOI 3.2	Business Continuity Management	
GOI 3.3	Reinsurance and Other Forms of Risk Transfer by Insurers	Attachment 1: Terms and conditions for insolvency and dispute resolution
GOI 4	Fitness and Propriety of Significant Owners and Key Persons of Insurers	Attachment 1: Minimum Competency and Other Criteria for Certain Key Persons
GOI 5	Outsourcing by Insurers	Attachment 1: Definitions of the types of risks
GOI 6	Transfers of Business and Other Significant Transactions by Insurers	
GOI 7	Miscellaneous Regulatory Requirements for Insurers	
GOM	Governance and Operational Standard for Microinsurers	Attachment 1: Policies for Managing Financial Risks for Microinsurers Attachment 2: Own Risk and Solvency Assessment (ORSA) for Microinsurers Attachment 3: Definitions used in the Governance and Operational Standard for Microinsurers
GOB	Governance and Operational Standard for Branches of Foreign Reinsurers	Attachment 1: Governance Attachment 2: Risk Management and Internal Controls Annexure 2.1: Own Risk and Solvency Assessment (ORSA) Annexure 2.2: Business Continuity Management

		Annexure 2.3: Reinsurance and Other Forms of Risk Transfer Attachment 3: Fitness and Propriety of Key Persons Attachment 4: Definitions used in this Standard
GOL	Governance and Operational Standard for Lloyd's	Attachment 1: Governance Attachment 2: Risk Management and Internal Controls Annexure 2.1: Own Risk and Solvency Assessment (ORSA) Annexure 2.2: Business Continuity Management Attachment 3: Fitness and Propriety of Key Persons Attachment 4: Definitions used in this Standard
GOG	Governance and Operational Standard for Insurance Groups	Attachment 1: Definitions used in the Governance and Operational Standards for Groups

Development of the draft Prudential Standards

In order to govern the development of the IA and draft Prudential Standards, a SAM Steering Committee was established in 2009. The SAM Steering Committee then established various Sub-Committees, Task Groups and working groups to provide input on the various components of the legislative framework. The SAM Steering Committee and the various Sub-Committees, Task Groups and working groups are collectively referred to as the "SAM structures".

The stakeholders included in the SAM structures comprise the following:
- National Treasury;
- Financial Services Board ("FSB");
- South African Reserve Bank;
- South African Revenue Service;
- Independent Regulatory Board of Auditors; and
- Professional bodies, industry and industry associations such as insurers, the South African Insurance Association (''SAIA''), the Association for Savings and Investment South Africa (''ASISA''), the Actuarial Society of South Africa (''ASSA''), and the South *African Institute of Chartered Accountants (''SAICA'').*

Since 2009 more than 117 discussion documents & position papers have been published that informed the draft Prudential Standards.

Informal consultation on the draft Prudential Standards

Financial Soundness Prudential Standards

The first draft of the Financial Soundness Standards for Insurers ("FSI') was distributed to the SAM structures in December 2015. These Standards were in main informed by the proposals from the SAM Structures as contained in various Position Papers. In some cases the FSB, for various reasons, decided to diverge from the SAM Structures. Instances where the FSB decided to apply other definitions, methods or calculations include, are, but are not limited to:

- Where the SAM Structures could not reach consensus;
- Where the FSB did not support the SAM Structures' proposals; and
- Where the FSB was of the opinion that additional aspects needed to be considered.

A document "FSB Policy Steer on Financial Soundness Standards" was published in January 2018. This document sets out the SAM Structures' proposals and indicates where the FSB decided not to accept the SAM Structures' proposals. The document also sets out the FSB's rationale for the FSB's decision. This document is available on the website of the South African Reserve Bank's website at http://www.resbank.co.za/RegulationAndSupervision/PrudentialAuthority/Pages/default.aspx.

The Financial Soundness Standards for Insurance Groups ("FSG") were issued to the SAM Structures for comment in May 2016.

The Financial Soundness Standards for Microinsurers ("FSM") were issued to the SAM Structures for comment in July 2016.

The Financial Soundness Standards for Branches of Foreign Reinsurers ("FSB") and the Financial Soundness Standards for Lloyd's ("FSL") were issued to the SAM Structures for comment in September 2016.

A complete suite of revised Financial Soundness Standards (FSI, FSG, FSM, FSB and FSL) were released for informal public comment on the website of the Financial Services Board in November 2016.

Another complete suite of revised Financial Soundness Standards (FSI, FSG, FSM, FSB and FSL) was released for informal public comment on the website of the Financial Services Board in August 2017.

Governance and Operational Prudential Standards

The Governance and Operational Prudential Standards build on the governance and risk management requirements set out in *Board Notice 158 of 2014* and the fit and proper requirements set out in *Board Notice 158 of 2015* issued under the Long- and Short-term Insurance Acts, 1998, and the recommendations and proposals made in the various Position Papers issued by the SAM structures. The Governance and Operational Standards for

Insurance Groups are informed by Position Paper 93 – Group Governance, as proposed by the SAM structures.

The Governance and Operational Prudential Standards also include the requirements of *Directive 159.A.i (LT&ST) – Outsourcing* issued under the Long- and Short-term Insurance Acts, 1998. In some cases the Governance and Operational Standards have also been enhanced with the incorporation of recent international regulatory developments, in particular the revisions made to certain of the International Association of Insurance Supervisors Insurance Core Principles ("IAIS ICPs").

The Governance and Operational Standards for Insurers ("GOI") were released for informal public comment on the website of the Financial Services Board in April 2017.

The revised GOI and Governance and Operational Standards for Groups ("GOG"), Governance and Operational Standards for Microinsurers ("GOM") Insurers ("GOI") were released for informal public comment on the website of the Financial Services Board in August 2017. The Governance and Operational Standards for Lloyd's ("GOL") and the Governance and Operational Standards for Branches of Foreign Reinsurers ("GOB") were released for informal public comment on the website of the Financial Services Board in September 2017.

4. IMPLEMENTATION READINESS AND ECONOMIC IMPACT ASSESSMENT

Quantitative and Qualitative Impact Studies

The Prudential Standards has also been informed by impact studies that have been completed on both the quantitative and qualitative aspects of the Prudential Standards.

Three quantitative impact studies have been completed to test the quantitative financial soundness requirements.

In addition to the quantitative impact studies, there have been two qualitative studies to consider the readiness of the industry to comply with the proposed governance and risk management requirements.

The reports from all quantitative and qualitative impact studies are available on the website of the South African Reserve Bank's website at http://www.resbank.co.za/RegulationAndSupervision/PrudentialAuthority/Pages/default.aspx.

Parallel Run

To prepare the industry for the implementation of the IA and the Prudential Standards, a parallel run has been initiated. The parallel run required insurers to report information under the proposed legislative framework along with the existing reporting required under the Long-term Insurance Act, 1998 (Act No. 52 of 1998) and the Short-term Insurance Act, 1998 (Act No. 53 of 1998). This process started on 1 July 2014, and will continue until the full implementation of the IA and the Prudential Standards. The key benefits from this dual reporting process is that the insurers are able to provide the information that will be expected when the IA and Prudential Standards goes live, and that any remaining issues are dealt with before that date.

Economic Impact Study

In addition to the quantitative impact studies described above, an Economic Impact Study on the impact of the SAM regime was commissioned. This study considered the direct costs and benefits, as well as the potential indirect impacts from changes in behaviour from the introduction of the SAM regime. These results were then used to model the wider economic impact of the introduction of the SAM regime on the South African economy.

The Study concluded that the IA and the Prudential Standards will result in additional costs to the insurance industry. However, these costs will be offset by improvements to the sustainability of the insurance industry and the stability of the financial system as a whole.

A summary of the Economic Impact Study is available on the website of the South African Reserve Bank's website at
http://www.resbank.co.za/RegulationAndSupervision/PrudentialAuthority/Pages/default.aspx.

4. TIMELINE ASSOCIATED WITH THE DRAFT PRUDENTIAL STANDARDS

It is envisaged that the Act and draft Prudential Standards will take effect on 1 July 2018. In order to achieve this date, the following timeline will be implemented:

MARCH	Publication of the draft Prudential Standards for public comment for a period of six weeks
MAY	Submission of draft Prudential Standards to Parliament for 30 days
JUNE	Prescribe Prudential Standards