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SOUTH AFRICAN RESERVE BANK
Prudential Authority

Supervisory Observation

Financial Soundness Standards for Insurers – Technical Supervisory Observation

Objectives of this Technical Supervisory Observation

The Financial Soundness Standards for Insurers (FSI) – Technical Supervisory Observation aims to assist stakeholders in understanding the rationale for a specific topic in the FSIs. A Supervisory Observation is issued when the Prudential Authority observes certain trends within the sector, and identifies a need for further information and expansion. Prudential Standards have the force of law and are used to establish minimum requirements with which insurers must comply, Guidance Notices provide guidance, Supervisory Observations only aim to explain, expand on or supplement technical information on a topic.

The Prudential Authority may expand on the topic(s) discussed in this Supervisory Observation from time to time as the need arises. The content of any Supervisory Observation is always subject to legislation. The Prudential Authority reserves the right to amend any detail in this FSI Technical Supervisory Observation.

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Topic 1: Encumbered assets

Paragraphs 4.5 and 4.6 of FSI 2.1 (Valuation of Assets and Liabilities Other than Technical Provisions), read with section 36(6)(i)(v) of the Insurance Act, 2017 (Act No. 18 of 2017) (the Act) sets out the legislation relevant to encumbered assets. This Topic aims to explain the current view of the Prudential Authority regarding what an encumbered asset is, and furthermore what the Prudential Authority considers when deciding if and how an insurer may recognise the encumbered asset.

The Topic expands on the Prudential Authority's position with generic examples on the treatment of encumbered assets. Insurers should contact the Prudential Authority for case-by-case assessment of their transactions or set of transactions.

A. Why does encumbered assets represent a challenge?

1. The encumbered assets issue is not primarily about the riskiness of the asset or the risk that the transaction or set of transactions is or may be exposing the insurer to, but only about the availability of the assets to cover the insurer's losses whenever they may occur.

B. What is an encumbered asset?

1. Description: various definitions for encumbered assets exist and typically suggest that an asset could be encumbered if a company (or person) has an asset or recognises an asset on its balance sheet, but for different reasons the asset is not entirely within the control of the company. This lack of control could be attributed to a situation where, for example, consent is required from another party before the asset may be used, sold or allocated. The Act, in section 1, defines encumber as follows:

   encumber means any pledge, restriction or limitation (including any contractual obligation that must be fulfilled before a contractual right may be exercised) that limits access to, or the use or disposal of, an asset.

2. To determine whether an asset is encumbered, the following enquiries are generally made:

   a. Does the insurer legally own the asset or does it only recognise the asset on its balance sheet?
   b. Does the insurer hold the asset on behalf of another company and is the use of the asset prohibited other than for the benefit of the other company or security against the non-performance of that company? or
   c. Is the consent of another party required before the insurer can withdraw, sell, transfer or otherwise use the asset?

   For all the above, policyholders should not be considered as another party.

3. Typically, the asset being considered would be on the balance sheet of the insurer. This is true for assets owned by the insurer. However, due to certain International Financial Reporting Standards (IFRS) requirements, assets can be reported on the balance sheet of the insurer, but legally be owned by someone else. For example, the asset sold in a repurchase transaction is legally owned by the buyer (not the insurer), but remains on the balance sheet of the insurer with the recognition of an associated liability.

C. Recognition of an encumbered asset

1. Paragraph 4.6 of FSI 2.1 implies that the Prudential Authority, upon successful application of an insurer to encumber an asset, will indicate how the asset should be recognised. The asset could be recognised in full, subject to a specified limit or not recognised at all.

2. The recognition of an encumbered asset does not override the principles of how to value assets and liabilities as set out in FSI 2.1, which in general follows IFRS and if possible to use a method that will produce a fair value. Instead, the recognition of an encumbered asset considers how much of the encumbered asset should be recognised on the regulatory (i.e. SAM) balance sheet. Any de-recognition of an encumbered asset must be applied as part of the own funds eligibility process, as set out in FSI 2.3 (Determination of Eligible Own Funds).

3. The recognition of an encumbered asset overrides one of the criteria for a capital instrument to be classified into a tier, as set out in paragraph 5.1 of FSI 2.3 – which is that the instrument should be free of encumbrances. By definition, an encumbered asset does not meet this criterion, but the recognition allowance given by the Prudential Authority is deemed to override this specific criterion.

4. In most cases, the Prudential Authority allows the encumbered asset to be recognised, but limits this recognition to the liability that is relevant to or associated with the transaction. An example is the repurchase transaction liability, as described below.

A programme of transactions

5. In many cases, the transaction that leads to encumbered assets is not a once-off occurrence, but rather a part of a programme of recurring or multiple transactions. The programme can be described as a strategy that the insurer employs to manage risks or to maximise the return on its investments. Examples of programmes are derivatives, securities lending and leases.

6. When a programme is applicable, the insurer should provide the Prudential Authority with all the details regarding the programme. In this way, the Prudential Authority can assess the programme and determine the allowance for the programme rather than the individual transaction. In doing so, the Prudential Authority permits an allowance limit relevant to the programme, for

example, to allow securities lending up to a specific percentage of the portfolio used for securities lending.

7. The recognition of the encumbered assets follows the usual recognition steps for the individual encumbered asset.

D. Treatment of specific types of encumbered assets

1. The treatment of encumbered assets can perhaps be best explained by describing the salient features of some types of transactions or sets of transactions. This section intends to assist in the understanding of encumbered assets and not to create a rule-set for the general treatment of encumbered assets. The Prudential Authority will, on a case-by-case basis, consider and assess the merits of each case.

2. Margin accounts – often required for derivative transactions, a margin account consists of initial and variation margins. When the margin account is recognised as an asset on the balance sheet of the insurer, an encumbered asset could be present, with the following features:

   a. Why is a margin account asset regarded as encumbered? Because the monies cannot be used for purposes other than mitigating the risk of the derivative transaction.
   b. How is a margin account asset recognised? Full recognition is possible, but limited to the value of the associated liability.
   c. Programme allowance: potentially limits allowance to a percentage of the assets that are referenced for the purpose of the use of derivatives.

3. Repurchase transactions – the insurer enters into a transaction or set of transactions where the buyer purchases an asset from the insurer and enters into another transaction or set of transactions to sell it back to the insurer. Known as repos, when it is executed as one transaction, or it could be different transactions, which is sometimes referred to as sell and buy-back transactions. The asset sold remains on the balance sheet of the insurer and an encumbered asset is present, with the following features:

   a. Why is an asset subject to a repurchase transaction encumbered? The insurer does not own or control the asset.
   b. How is an asset subject to a repurchase transaction recognised? Full recognition, but limited to the value of the associated liability, which is usually the repurchase transaction liability raised on the balance sheet.
   c. Programme allowance: Considering a percentage of the total assets that could be used for repurchase transactions.

4. Foreign branch of a local insurer – the requirements for a branch set by a foreign jurisdiction's regulator could require that an amount be held in trust, often in the foreign jurisdiction's location. The regulator may also require that an amount outside of the trust be held as a buffer or other similar reason. The following features are observed:

   a. Why are the assets of the trust encumbered? Any withdrawal from the trust must be done with the consent of the trustee, which puts the assets not entirely in the control of the insurer. The amount outside of the trust, if required by the foreign jurisdiction's regulator, is entirely outside of the control of the insurer and usually does not back any liabilities.

b. How are the assets of the trust recognised? Full recognition, but limited to the value of the associated liability, which is usually the policyholders' liabilities and can include the Solvency Capital Requirement. No recognition for the amount outside of the trust, if required by the foreign jurisdiction's regulator.

5. Securities lending transactions – in an effort to increase the yield on securities, the insurer lends the securities to another party that earns the right, title and interest of these securities for the duration of the contract. This other party often posts collateral to the insurer. The following features are observed:

   a. Why are securities encumbered? The insurer does not own or control the securities. The collateral received cannot be used for any other purpose, but to reduce the default risk of the counterparty and must be repaid otherwise.
   b. How are securities recognised? Full recognition of the securities lent. Full recognition of the collateral, but limited to the value of the associated liability, which is usually the liability raised on the balance sheet due to the collateral.
   c. Programme allowance: Considering a percentage of the total securities that could be used for lending.

6. *En commandite* partnership transactions – often used in private equity deals, the insurer enters into a partnership where it commits to an amount that could be called upon by the general partner of the partnership at certain predefined times. The invested portion of the committed amount would typically back policyholders' liabilities, but the remaining balance does not. The remaining balance is sometimes classified as either commitments in progress or as an undrawn commitment or both. The following features are observed:

   a. Why are *en commandite* partnership assets encumbered? The invested commitment, the commitments in progress and undrawn capital, whichever is relevant, are encumbered as the insurer cannot withdraw or refuse a call from the general partner without the general partner's consent or unless it finds a replacement investor.
   b. How are *en commandite* partnership assets recognised? Full recognition, but subject to more research about commitments to be commissioned by the Prudential Authority.
   c. Programme allowance: Considering a percentage of the total policyholders' investments that could be used for *en commandite* partnerships.

7. Leases, previously referred to as finance and operating leases – in the normal course of business insurers, like any other company, could enter into lease agreements. For the insurer, as the lessee, IFRS 16 requires both the leased asset, also known as the right-of-use-asset, and an associated lease liability

to be recognised on the insurer's balance sheet. The asset on the balance sheet covers the associated lease liability and therefore cannot be included in own funds. The following features are observed:

a. Why are lease assets encumbered? The insurer does not own the assets, although it does use them and control them.
b. How are lease assets recognised? Full recognition, but limited to the value of the associated liability.
c. Programme allowance: Where different types of assets are leased and/or leased in tranches or years, the recognition test should be done per asset type per tranche or year, whichever is applicable.

8. Reinsurance deposits – a common practice by reinsurers to deposit money to a ceding insurer to assist the insurer and often just continuing a practice that was used to meet a requirement under the previous regime. From the ceding insurer's point of view, the deposit is presented as a liability on its balance sheet and the cash received is the encumbered asset. The following features are observed:

a. Why are reinsurance deposits encumbered? The deposits are in the insurer's bank, but cannot be used for any other purpose.
b. How are reinsurance deposits recognised? Full recognition, since the asset is fully covered by the associated liability.
c. Programme allowance: In this case known as a reinsurance arrangement, approval would usually be without a limit.

E. QRT reference[1]

1. Section 44 of the Act requires insurers to provide information for supervisory purposes to the Prudential Authority, which is complied with by the submission of the relevant QRTs.

2. Insurers should report the value and high-level details of encumbered assets on sheet A7.2 of the annual solo version of the QRT.

3. The encumbered assets and associated liabilities should be reported as applicable and appropriate as for all other assets and liabilities. This applies to the annual and quarterly QRTs.

4. The deductions – when no recognition is applied or where the recognition is limited – should be entered in row 63 of sheet OF3. This approach applies to the annual and quarterly QRTs.

F. Application form IF007

1. Application form IF007 is available on the Prudential Authority website.

[1] Specific QRT references are subject to changes in the QRT.

2. The insurer should expand on the following:

   a. What is on the IFRS balance sheet for the transaction or set of transactions for assets and also for any potential associated liabilities;
   b. Include what may be included in the Notes to the IFRS balance sheet;
   c. Give description of the sub-set of assets to which the transaction or set of transactions apply;
   d. Any requirements or restrictions imposed by other regulations on the assets; and
   e. Where applicable, the programme that the insurer uses to manage and govern the set of transactions that might lead to encumbrance plus the future business plans for the programme.

G. Legal implications

1. It is a contravention of the Act to have encumbered assets without the express approval of the Prudential Authority, as set out in paragraph 4.5 of FSI 2.1.

   a. The view of the Prudential Authority on whether an asset is encumbered or not is the determining factor. If an insurer is unsure whether they have encumbered assets, then such insurer should contact its supervision analyst.
   b. Any transactions that were already in place when the Act became effective on 1 July 2018, still requires approval by the Prudential Authority. Such transactions need not be reversed, but the insurer should contact its supervision analyst without delay and follow the application process. However, an unsuccessful or limited application may require the insurer to reverse or unwind the relevant transactions.

2. The requirements only apply to insurers, which excludes the controlling company of an insurance group.

3. An insurer with an asset holding intermediary (AHI) should also comply since the AHI's assets and liabilities are recognised on the balance sheet of the insurer.