PRUDENTIAL STANDARDS, GUIDANCE NOTES AND SAM PHASE II

Presentation for:

2016 SAM Workshop

By: Jo-Ann Ferreira and Jooste Steynberg

November 2016

Agenda

- Prudential Standards
  - Update on progress
- Guidance Notes
  - List of potential areas for guidance
  - Next steps
- SAM Phase II
  - List of potential areas for future work

Prudential Standards

Prudential Standards: Overview

- **Financial Soundness Standards (FS)**
  - FSI: Insurers
  - FSG: Insurance groups
  - FSM: Microinsurers
  - FSL: Lloyd’s
  - FSB: Branches of foreign reinsurers
- **Governance Standards (GR)** **Replaces BN 158 of 2014 & Outsourcing Directive**
  - Same split as for Financial Soundness Standards
- **Auditing Standards (AU)**
  - AU1: Auditing requirements
  - AU2: Duties and functions of auditor
- **Reporting Standards (R)**
  - Same split as for Financial Soundness Standards

Prudential Standards: Overview

- **General Standards (G)**
  - G1: Microinsurance business thresholds
  - G2: Insurance business excluded from or included in the application of Bill
  - G3: Registration of shares in name of nominee
  - G4: Reinsurance Arrangements
- **Fit & Proper Standards (FP)** **Replaces BN 158 of 2015**
  - FP1: Fit & Proper framework
  - FP2: Directors, senior managers, heads of a control functions and auditors
  - FP3: Trustees of trusts of Lloyd’s or a branch of a foreign reinsurer
  - FP4: Significant owners

Prudential Standards: Consultation to date

Round 1

• FSI (Insurers)	– Dec2015
• FSG (Insurance Groups)	– May 2016
• FSM (Microinsurers)	– July 2016
• GS4 (Reinsurance arrangements)	– September 2016
• FSB (Branches)	– October 2016
• FSL (Lloyd's)	– October 2016

Prudential Standards: Consultation to date

Round 2 – November 2016

- FSI, FSG, FSM, FSB and FSL

Round 2 – end 2016

- Governance Standards
- General Standards

Round 3 – final formal consultation

- After enactment of Insurance Bill, but before commencement
- In accordance with FSR Bill process

Formal consultation

- Publish for comment –
  - a draft of the regulatory instrument
  - a statement explaining the need for & the intended operation of the regulatory instrument
  - a statement of the expected impact of the regulatory instrument
- Period for comments must be at least six weeks
- Once comments considered, submit to Parliament for 30 days while in session
- Copies to FSCA, SARB, NCR & CMS

Formal consultation

- If draft Prudential Standard will materially change – process to be repeated
- Urgency provided for, but not for initial set of Standards
- Report on consultation to be published together with final Standard
- Final Standard to be published in NT Register

Guidance Notes

Guidance Notes

Currently available:

- GN FSI 2.2 Technical Provisions
  - Chapter 1: Applying the Principle of Substance Over Form
  - Chapter 2: Determining Contract Boundaries
  - Chapter 3: Possible Simplifications for Calculating the Risk Margin
  - Chapter 4: Instances When Technical Provisions can be Calculated as a Whole
  - Chapter 5: Applying the Principle of Proportionality
  - Chapter 6: Possible Simplifications for Life Insurance
  - Chapter 7: Possible Simplifications for Non-life Insurance
  - Chapter 8: Possible Simplifications for Reinsurance Recoverables
  - Chapter 9: Expenses Used in Assumptions

Currently available – continued:

- GN FSI 5 Internal Models
  - Chapter 1: Statistical Quality
  - Chapter 2: Validation Tools
  - Chapter 3: Internal Model Documentation

Guidance Notes

List of potential future areas for guidance:

- Informed by
  - Task Group suggestions
  - Comments from Round 1 consultation
  - FSB deliberations
- Likely to be a living document…

Guidance Notes

List of potential future areas for guidance:

- Themes
    - Expenses
    - Credit – CQS, default
    - NLUR
    - Assets – encumbrance, AHI, contingent assets
    - Segmentation – LoB, MCR, homogeneous groups

Guidance Notes

DESCRIPTION
Assigning a credit quality step to a counterparty, with specific reference to unrated counterparties. Guidance on Credit Ratings to use for Counterparty Default Risk, perhaps a prescribed list.
Guidance on allowing for a geographical diversification for CAT risk, e.g. if business is well spread across Africa.
The returns log files are sometimes ambiguous regarding certain inputs. Better guidance on, for instance, the calculations in the TP2.2S sheets as well as the movement sheets.
Application of credit default risk (including credit default risk applicable to Lloyd's Syndicates). Guidance should be provided for both man-made and natural catastrophe scenarios and should include the application of collateral.
What expenses to include in determining the ULAE.
How to apply proportionality, e.g.: ▪ Where a policy can't be segmented into its components and only a small portion of the policy falls into a more risky class – how/when can it be decided not to classify the full policy in the more risky segment? ▪ If exposure data is not known for the full book, must the factor based method be used for the "missing" part or when can the known information be grossed up (using method 1) to allow for the full exposure?

Guidance Notes

DESCRIPTION
Allowance for non-proportional reinsurance (especially for premium and reserve risk)
Man-made catastrophe scenarios: move illustration of scenarios currently in DD78 to guidance.
When to use factor-based method (when is data not enough, what elements of data are needed to be enough to use method 1 etc.).
Determining the “insurer specific factor” for terrorism catastrophe risk.
How to allow appropriately for risk mitigation such as stop loss reinsurance.
Guidance on assigning policies to homogeneous groups.
Guidance on distinguishing between product lines and product types.
Guidance on classifying products for MCR calculation.
Guidance on determining the Annual Expenses for linked business.
Guidance on classification of short term investment instruments (such as FRNs); and to which investment risk sub-module these are applicable.

Guidance Notes

DESCRIPTION
CIC mapping table.1717
Risk margin calculation and different currencies.
Risk-free yield curve derivation (extrapolation and observed points).
What to be included or excluded in expenses.
Consistent application of contract boundaries.
Definition of linked and non-linked insurance and the need to make it consistent throughout the technical specifications.
The inclusion or exclusion of intragroup loans in the valuation of participations. Not strictly a technical provisions issue.
The iterative calculation for risk margins.
The treatment of net negative balances under IFRS and whether these should be shown on the assets side as an asset on the QRT sheets. This would also list as a negative technical provision on the SAM side.

Guidance Notes

DESCRIPTION
For pure linked insurers, guidance on which sections of each FSI should be considered.
Guidance for what is considered encumbered assets.
Asset holding intermediaries: which participations may qualify and how to manage the notional balance sheet consolidation.
Contingent liabilities, and insurance versus non-insurance type contingent assets.
Illiquidity premium and the requirement about selling the related assets.
Recoverables: which payments in relation to compensation of insurance events should be included.
The impact of underwriting on the determination of the contract boundary.
When determining the applicable tiering for Own Funds and considering the petition for insolvency and whether it is technical or accounting insolvency.
What should be considered as foreseeable dividends when determining the Basic Own Funds.
Single Equivalent Scenario for underwriting risk, which could principally be similar to Single Equivalent Scenario for market risk.

Guidance Notes

DESCRIPTION
UMAs and collecting agencies cash in bank and whether it should be type 2 or type 3 depending on risks exposed to.
The specification of the allowance for management action depending on whether the stress is the result of an insurer-specific vs. industry-wide event.
Group business into line that attracts the highest capital charge.
How to allocate a policy to a line of business where the policy does not clearly cover one specific risk.
Marine: guidance for largest and second largest exposures.
How to apply credit default risk. For example, in determining whether the horizontal or vertical stress is the more onerous.
Calculation of expense ratio for the volume measure when considering ISP
How to allow for EPIFC in an Internal Model.
Chapter 9 3 (c) : Expanding the existing guidance to consider the following: • What about past costs that were recurring but will no longer be paid; • What about fees that will not be paid if the valuation assumptions are realised? E.g. performance based investment management charges, performance bonuses for management.

Guidance Notes

Next steps?

- Drafting of guidance notes – 2017 Q1
- Consult with TG – 2017 Q2
- Issue to industry – 2017 Q2 - Q4
- Living document

SAM Phase II

SAM Phase II

SAM Phase II list

- A bridge between:
  - Task Group proposals – Final Position Papers
  - Financial Standards – mostly FSI, FSG, FSB
  - Where it is the intention to follow the TG proposals, but deemed not in scope of Phase 1 for various reasons

SAM Phase II

Doc reference	Summary of issue	Reason
FPP76	The current adjustment for the loss-absorbing capacity of technical provisions is only applied to with profits funds. There are other products which exhibit very similar loss-absorbing capacity to with profits business. The scope should be extended to cover these products. The simplification set out in FPP76 attempts to allow for the extent of an insurer's asset liability matching, but becomes increasingly inaccurate (overstating capital required) as the matching position improves and the risk reduces. An improved simplification should be investigated.	Time constraints in terms of developing and testing formulae
DD78	Recalibration of premium and reserve risk factors – the current calibrations were based on old segmentation and were calibrated to IFRS earned premium. Revised parameters should be calibrated to final segmentation and to SAM earned premium.	Insufficient time to collect necessary data; late changes to segmentation

SAM Phase II

Doc reference	Summary of issue	Reason
DD78	A number of changes to the catastrophe underwriting risk sub-module were proposed in DD78. For now, it has been agreed that the QIS 3 approach should continue to be used, as the data required for the proposed approach may not be available (e.g. highest risks within a 200m radius).	Various, including the fact that not all insurers have sufficiently granular and reliable details on risk locations to calculate maximum exposure in given radius.
PP111	PP111 has set out a proposal to include cash instruments in the spread risk sub-module, but has also commented on two alternatives proposed to the working group. If the working group's proposal is not adopted, then the issue should be revisited with a view to determining whether the alternative put into place adequately addresses the concerns raised by the working group.	

SAM Phase II

Doc reference	Summary of issue	Reason
Various	Treatment of linked insurers – need to ensure level playing field for linked business when compared to similar products offered through traditional vehicles (e.g. consistent treatment of zero, short and one year contract boundaries)	
FPP 46	The treatment of the illiquidity premium and the risk associated with allowing this premium has not reached consensus. FSB steer has resulted in the capital requirement being based on the assumption that the illiquidity premium is lower than assumed in the best estimate technical provisions calculation. Coupled with the restrictions already placed on the assumption used in technical provisions, this results in capital requirements, particularly for annuity business, that are disproportionately high for a theoretically well-matched portfolio.	FSB steer; limited data available to quantify potential impacts

SAM Phase II

Doc ref	Summary of issue	Reason
	There are certain liabilities and contingent liabilities that may be exposed to the same risks as technical provisions. Examples include post-retirement medical aid obligations and defined benefit obligations, both of which are exposed to longevity risk. There is an argument for saying that a true “full balance sheet” approach would involve stressing these liabilities in the SCR calculation. However, there is also an argument that the SCR is intended to protect policyholders rather than other stakeholders, and also that requiring such a recalculation for insurers when other employers do not need to provide capital for these risks would be unfair. The potential impact of such a calculation has not been quantified in order to determine whether the risk is material, and whether this materiality would change in adverse market conditions.	Insufficient data to reliably assess potential impact
DD95	Concerns were raised within the SCR Task Group regarding the appropriateness and robustness of the liquidity risk assessment.	Time constraints in terms of developing and testing formulae

SAM Phase II

Doc ref	Summary of issue	Reason
	Illiquidity premium and how it is to be shocked	The measurement, capping and shocking of the illiquidity premium / matching adjustment is complex and has several second order impacts. It will require too much time and consultation to decide any changes before SAM is scheduled to go live.

SAM Phase II

- Other issues
  - Comments from Round 2 and 3
  - FSB steer
  - Analysis, review and new information
- Post-implementation issues

Questions?