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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 2: The Regulatory Balance Sheet

The regulatory balance sheet is an important reference when the Prudential Authority considers the financial soundness of an insurer. Although it might have similarities with the statement of financial position (i.e. balance sheet) prepared in accordance with financial reporting standards, the regulatory balance sheet reflects the valuation of assets and liabilities as required by the Prudential Standards and with information as required by the regulatory reporting templates.

The regulatory reporting templates' sheet OF2 requires insurers to report details of the balance sheet on both the regulatory and International Financial Reporting Standards (IFRS) bases as well as the details about basic own funds before regulatory adjustments. This sheet calculates two balances for the regulatory balance sheet that are referenced in this Topic:

- Assets less liabilities or net asset value (NAV); and
- Basic own funds before regulatory adjustments (BOF).

The definition of basic own funds as set out in FSI 1 (Framework for Financial Soundness of Insurers) is NAV plus subordinated liabilities less regulatory adjustments.[1]

This Topic considers the only two potential reasons why NAV would not equal BOF for the regulatory balance sheet, which are foreseeable dividends and subordinated liabilities. Any other reason for a difference indicates a potential error or problem. Conversely, in the presence of foreseeable dividends or subordinated liabilities and where NAV equals BOF, this also indicates an error or problem.

A. Subordinated liabilities

1. In the regulatory context, subordinated liabilities can be described as liabilities that rank lower than policyholders' liabilities, such that these liabilities are not repayable unless sufficient assets are available to cover policyholders' liabilities and the Solvency Capital Requirement (SCR). For example, subordinated bonds issued by the insurer or subordinated loans received by the insurer.

2. In the context of insurance, subordinated liabilities can be recognised as capital on the regulatory balance sheet if they adhere to the criteria set out in FSI 2.3 (Determination of Eligible Own Funds).

3. The Prudential Authority expects reporting of subordinated liabilities on sheet OF2 as follows:

   a. Subordinated liabilities are to be reported in the liability section of both the regulatory and IFRS balance sheets, as they are liabilities; and
   b. Subordinated liabilities are to be reported in the BOF section of the regulatory balance sheet, when eligible for recognition as a basic own fund item (see paragraph 2 above).

[1] Regulatory adjustments include foreseeable dividends.

4. It follows from paragraph 3 above that in the presence of subordinated liabilities, NAV should not equal BOF for the regulatory balance sheet and that BOF will not be the same for the regulatory and IFRS balance sheets.

5. The Prudential Authority has observed with concern that most insurers with subordinated liabilities are not reporting as described above.

B. Foreseeable dividends

1. FSI 1 defines foreseeable dividends in Attachment 1 as:

   A dividend is foreseeable at the latest when it is declared or approved by the board of directors regardless of any requirement for formal approval at an annual general meeting.

2. Insurers are required to reduce their BOF with the amount of dividends that are foreseeable to be paid as set out in paragraph 6.2c) of FSI 2.3.

3. The definition and the requirement imply the Prudential Authority's intent that BOF should be available for the duration for which the SCR is calculated, which is one year.

4. The intent of the requirement is that any dividends that might be paid should not be recognised as available BOF. Even though the payment date or the exact amount are not known at the reporting date, it is in most cases reasonable to expect that such payment would be made after an insurer's business processes have been concluded, based on the amount recommended by the board of directors. These processes include the finalisation of the insurer's financial accounts, board meetings and its annual general meeting (AGM).

5. It is expected that the insurer's AGM will approve the board recommended dividend, if any, and only then will the payment amount be precisely known. This could be before or after the reporting template submission date, but definitely after the reporting date.

6. The regulatory framework, however, uses the concept of foreseeable dividends and the Prudential Authority expects an insurer to reasonably foresee or estimate what its dividend payment could be, at least by the submission date of the reporting templates, basing its decision on aspects such as:

   a. Dividend policy – it is common practice to have a stated dividend policy that is used to manage investors' expectations. Such a policy gives the insurer's broad framework of how it calculates and pays dividends.
   b. Experience – unless it is a new insurer, the insurer should know from experience if it typically pays dividends and typically how such dividends are calculated.
   c. Judgment – it is reasonable to expect that the insurer will have the fit and proper key persons that are able to use judgment to estimate what foreseeable dividends could be.

d. Prevailing conditions – the Prudential Authority expects that insurers will also consider the prevailing conditions of the market and of the insurer when making the foreseeable dividends estimate. These conditions can be different for each insurer, but could include:

   i. The insurer's capital plans – such plans can override an insurer's normal dividend decisions by instead holding back a dividend payment to fund such plans. If so, the Prudential Authority expects that such plans be described in the own risk and solvency assessment (ORSA) to justify the low or no foreseeable dividends; and
   ii. Recent developments – manifested or increased likelihood of shocks to the market or underwriting, regulatory changes, corporate actions or business plans. The Prudential Authority expects the insurer's ORSA to evidence these developments.

7. The Prudential Authority expects the reporting of foreseeable dividends on sheet OF2 as follows:

   a. It is expected that the foreseeable dividends amount will be reported in the asset section of both the regulatory and IFRS balance sheets, as they represent cash or another asset to be distributed.
   b. The foreseeable dividends should also be reported in the basic own funds section for the regulatory balance sheet by excluding them from the retained earnings entry line.

8. It follows from paragraph 7 above that in the presence of foreseeable dividends, NAV should not equal BOF for the regulatory balance sheet and that BOF on the regulatory balance sheet should be less than the NAV for the IFRS balance sheets all else being equal.

9. The Prudential Authority has observed with concern that most insurers with foreseeable dividends are not reporting as described above.

C. QRT reference[2]

1. The regulatory balance sheet entries for NAV and BOF can be found on sheet OF2 cell G89 and cell G127 respectively.

2. Insurers must report their subordinated liabilities in the liabilities section of sheet OF2 in rows 73 to 75, and if eligible for inclusion as a basic own fund item, then report in the basic own funds section of sheet OF2 in rows 121 to 123.

3. Foreseeable dividends are not reported explicitly in the QRT. However, the reference of the applicable cell that should be amended is G105.

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