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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 (FSIs) – 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 insurance sector, and identifies a need for further information and expansion on a specific topic within the FSIs. Prudential standards have the force of law and are used to establish minimum requirements with which insurers must comply, Guidance Notices are regulatory instruments aimed at assisting insurers in complying with the requirements outlined in relevant Prudential Standards for Insurers and have no legal standing, Supervisory Observations aim only to explain, expand on or supplement technical information on a specific topic and have no legal standing.

The Prudential Authority may expand on the topic(s) discussed in this Supervisory Observation from time to time, as the need arises. The Prudential Authority reserves the right to amend any detail in this Technical Supervisory Observation.

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Topic 3: Credit Quality Steps

The Insurance Act (Act No. 18 of 2017) and its Prudential Standards introduced the concept of a Credit Quality Step (CQS). The CQS supports the principle that the board of directors is ultimately responsible for all assumptions and methodologies required in the calculation of the financial soundness of an insurer. The board of directors must consider the credit ratings assigned to assets and counterparties. The CQS is also intended to address the reliance that insurers place on the ratings of credit rating agencies when these ratings are updated on counterparties and assets, and whether a specific counterparty or asset is rated.

This Topic discusses CQS and the expectations of the Prudential Authority from insurers in this regard. The technical derivation of the CQS is not in the scope of this Supervisory Observation.

A. Description

1. A CQS is similar, in nature, to ratings assigned by credit rating agencies and is derived in the context of the international scale local currency rating[1] with 18 steps of descending credit quality.

2. The insurer's view of the historic long-term probability of default of a counterparty or asset should be reflected in the CQS, as described in paragraph 9.9[2] of FSI 4.1 (Market Risk Capital Requirement).

3. A CQS also has an unrated category which should be used when an insurer has not yet assigned a CQS for the counterparty or asset. When an asset or counterparty is unrated, CQS 18 should be used when a particular Solvency Capital Requirement (SCR) factor table does not include the unrated CQS, e.g. calculating the variance of the loss distribution for type 1 exposures as set out in paragraph 9.18 of FSI 4.1. Some SCR modules might prescribe specific treatment of unrated assets or counterparties and insurers should adhere to those requirements.

B. How to assign a CQS

1. Technical derivation is not within the scope of this document, however, paragraph 9.10 of FSI 4.1 requires the insurer to assess the historic default rate and assign it to the appropriate CQS. This treatment and consideration by the insurer is in line with the principle that the board of directors must consider, and not automatically accept another entity's view of default probabilities.

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[1] International scale ratings assess the capacity of issuers to meet commitments using a globally applicable scale.

[2] The calculation of the capital requirements for spread risk and default risk relies on the assignment of credit ratings to instruments. The basis on which credit ratings are assigned in this Standard (and throughout the Financial Soundness Standards for Insurers) is through credit quality steps, which reflect long term historic probabilities of default, rather than external credit ratings. The use of credit quality steps allows for different external and internal ratings to be used in a consistent manner.

2. Paragraphs C2[3] and C3[4] of Attachment 5 of FSI 4.1 set out further considerations about exposures to governments, central banks, multilateral development banks and international organisations.

C. Where CQS is used

1. Assets exposed to credit risk, such as bonds and derivatives, are assigned a CQS and this information is used in the SCR calculation for:

   a. Default risk types 1 and 3;
   b. Spread risk; and
   c. Concentration risk.

2. Equities and other exposures to a counterparty, including reinsurers, are assigned a CQS for the asset or counterparty, and this information is used in the calculation of:

   a. Default risk SCR type 1; and
   b. Concentration risk SCR.

3. Reinsurers are also assigned a CQS for the simplified calculation of the adjustment of reinsurance recoverables, as set out in Attachment 3 section B of FSI 2.2 (Valuation of Technical Provisions). Furthermore, section A of the same attachment requires insurers to derive a probability of default for the reinsurer for use in the adjustment calculation, but this is expected to be the same as the CQS or at least very similar.

D. CQS observations

1. This section sets out some observations by the Prudential Authority that invariably arose from using the approach requiring insurers to derive a CQS.

2. For the same counterparty or asset, a large divergence of CQSs are observed and is more pronounced when the counterparty or asset is unrated. The Prudential Authority does not expect a diverse range of CQSs for the same counterparty or asset.

3. The Prudential Authority observed, for a few cases, that CQSs for local counterparties are greater than the sovereign CQS, which is not expected. Insurers should use the international scale local currency ratings to derive the CQSs, such that local counterparties would normally be assigned a rating that does not exceed that of the sovereign.

[3] For all other exposures, the calculations are the same as for those under section 10 of this Standard, noting that an exposure considered in this section could have a different probability of default than an exposure not considered in this section, even though the assigned credit ratings might be similar for both instruments. In such cases the two exposures might have different credit quality steps.

[4] Where an exposure is denominated in a currency that is different from the counterparty's local currency, the credit quality step should take into account the counterparty's ability to repay foreign currency obligations.

4. Not all insurers complete all the CQS details on all the regulatory reporting sheets that require such detail. For example:

   a. The reinsurance sheets R1 and R1S require CQS detail; and
   b. The effective date and expiry date as required in various sheets of the annual Quantitative Reporting Templates (QRTs), relate to the rating given by a rating agency, and it is not expected that the expiry date would equal the maturity date of the asset, unless the period to the maturity date of the asset is short.

E. QRT references[5]

1. The relevant A1.x and A2.x sheets in the annual solo QRT.

2. R1S and R1 in the annual solo QRT require CQS detail for each reinsurer.

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