

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 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 ruleset 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 reference¹

- 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.
- 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;

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

- 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.

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.²

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).

² 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 reference³

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.

³ Specific QRT references are subject to changes in the QRT.

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 rating⁴ 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 9.9⁵ 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.

⁴ International scale ratings assess the capacity of issuers to meet commitments using a globally applicable scale.

⁵ 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 C2⁶ and C3⁷ 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.

⁶ 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.

⁷ 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 references⁸

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.

⁸ Specific QRT references are subject to changes in the QRT.