Solvency Assessment and Management: Pillar I – Sub Committee

Insurance Groups Task Group

Discussion Document 1 (v 10)

Interim measures for Insurance Groups

CONTENTS

1. INTRODUCTION

The recent financial crisis has demonstrated that the failure of one entity within a financial conglomerate may damage or even cause the failure of related entities. As a result, the solo supervision of regulated entities is insufficient to obtain a complete assessment of the risks to which the insurer, policyholders and other affected parties including the economy and potentially the taxpayer in the event of bailouts, may be exposed. The solo supervision of regulated entities is also insufficient to evaluate systemic risk within a financial system locally or even internationally.

The recent financial crisis has also highlighted the need for regulators to give greater attention to the oversight of the operations of financial services groups. A significant number of South African licensed insurers currently operate within a group structure. The financial position and risk profile of the insurer may be affected by its inclusion in a group. The South African financial market is characterised by a large concentration of industry assets being managed by a relatively small number of financial conglomerates.

The Financial Services Board ("FSB") currently performs prudential and market conduct supervision over insurance companies and other financial institutions on a solo basis only. There is currently only informal supervision of some insurance groups that takes place without legislative backing.

2. THE ROAD TO GROUP-WIDE SUPERVISON: WHY AN INSURANCE GROUP SUPERVISORY FRAMEWORK IS NEEDED

The globalisation of financial markets created a catalyst for the development of internationally active financial groups, which have increased in number, complexity and size. These groups provide a range of services, including insurance, banking and investment services. They operate simultaneously across financial sectors against a backdrop of slowly evolving legislation and regulatory framework(s) which, generally speaking, have not kept pace with the rapid changes in financial markets.

Failures in supervision have highlighted the deficiencies in traditional supervisory frameworks, where oversight was restricted to the legal/solo entity. This is particularly important for groups that operate in multiple jurisdictions and conduct cross-sector activities and where the home supervisor may have been unable to efficiently supervise the legal entity because of operational influences from other parts of the group.

The recent financial crisis has highlighted just how embedded groups are within financial and economic systems. Governments and central banks in a number of jurisdictions had to implement emergency crisis resolution measures to stabilise and mitigate the potentially damaging effects of the failure of large financial groups on their respective economies. The adoption of group-wide supervision has emerged as a critical tool to help ensure that groups are effectively regulated and conduct their operations in both a prudent and financially sound manner.

It is important to note that the Tripartite Group of Bank, Securities and Insurance Regulators ("the Joint Forum") identified a number of supervisory issues in their 1995 publication,[1] which are still relevant today.

These issues underscore the need for group-wide supervision and include:

[1] A report by the Tripartite group of Bank, Securities and Insurance Regulators, July 1995

a. developing a group-wide supervisory framework which regulates the legal entities within the group and also assesses the group as a whole;

b. mitigating group contagion effects which can prompt potential insolvency or contravene regulatory requirements in relevant jurisdictions;

c. identifying risk concentration and intra-group transactions, which present substantial credit risk;

d. determining group capital adequacy;

e. determining the fitness and propriety of the group's board of directors, shareholders and senior management;

f. ensuring that the group has appropriate risk management and internal controls suited to its nature, size and complexity;

g. accessing prudential information on the group so as to effectively supervise the legal entities and the group as a whole; and

h. eliminating supervisory arbitrage.

The International Association of Insurance Supervisors ("IAIS") published its Issues Paper on group-wide solvency assessment and supervision in March 2009, which reiterated the concerns identified by the Joint Forum in its 1995 publication. While there are many possible benefits for an insurer being part of a group, the potential negative effects and risks associated with large groups present a compelling argument supporting the need for group-wide supervision.

The IAIS recently revisited and updated its Insurance Core Principles ("ICPs") taking into account all former issue papers, guidance, and standards published by the IAIS. It is expected that these revised ICPs will be adopted at the annual general meeting of the IAIS in October 2011. The ICPs particularly relevant for this discussion document are ICP 3 on Information sharing, ICP 23 dealing with group-wide solvency assessment and supervision and ICP 25 dealing with supervisory cooperation and coordination.

3. WHY THE FSB NEEDS TO IMPLEMENT A GROUP-WIDE SUPERVISORY REGIME

Despite the complexities surrounding group-wide supervision, it is important for the FSB to form a comprehensive view of the overall risk exposure of South African insurance groups, and financial conglomerates, especially as they affect the regulated entities operating within South Africa. Additionally, this group wide view will enable the FSB to better assess the financial position of regulated insurers, and assist in mitigating any potentially adverse systemic impact on the South African financial system, and the wider economy.

The International Monetary Fund ("IMF") and the World Bank regularly assesses South Africa's regulatory and supervisory regime in terms of a financial stability assessment programme ("FSAP").The FSAP benchmarks the South African regulatory and supervisory regime against international standards. In the case of insurance regulation and supervision, these international standards are contained in the IAIS ICPs.

One of the major shortcomings of the current regulatory and supervisory regime for insurers, as noted in the 2010 FSAP, is the lack of a group-wide regulatory and supervisory regime.

The FSB is committed to adopting a group-wide regulatory and supervisory regime so as to align South African insurance supervision with requirements of the IAIS and international best practice.

4. PURPOSE OF THE PAPER

The SAM Insurance Groups Task Group ("task group") has developed this paper on proposed interim measures that need to be considered by the FSB, the SAM governance structures and the legislative drafter in preparing a regulatory and supervisory framework to supervise insurance groups.

This paper considers a variety of sources, including the Solvency II directive, EU Directive on Insurance groups, the discussion paper of the Australian Prudential Regulatory Authority ("APRA") on conglomerate groups as well as best practices laid down by the IAIS in the form of principles, standards and guidance papers culminating in the Standard on Group-wide Regulatory Requirements. Consideration was also given to the Group-wide Supervisory Framework ("GSF") issued by the IAIS and which is now incorporated into the revised IAIS ICP 23.

This paper also highlights additional research that the task group will conduct in order to ensure Solvency II equivalence in respect of the final SAM proposals. These will be in addition to the interim measures.

5. INTERNATIONAL STANDARDS: IAIS INSURANCE CORE PRINICIPLES

Since its inception in 1994, the IAIS has developed a number of principles, standards and guidance papers to help promote the global development of well-regulated insurance markets. A further objective of the IAIS under the by-laws is to contribute to broader stability of the financial system.

The IAIS is currently revising the ICPs and corresponding standards and guidance papers. With regard to the revision, the following ICPs were clustered together and are applicable to insurance groups:

Subject	**2003 ICPs**	**New ICP** **Draft February 2011**
Insurance groups and cross-sector issues	ICP 5 – Supervisory cooperation and information sharing	ICP 3 - Information exchange
	ICP 17 – Group-wide supervision	ICP 23 - Group-wide supervision
		ICP 25 – Supervisory cooperation and coordination

ICP 24 on Macro-prudential supervision and market analysis and ICP 26 on Cross-border cooperation and coordination on crisis management will not be dealt with in this paper. These ICP's will be dealt with within the SAM structures in the development of the final measures on insurance group supervision.

Below the task group highlights the fundamental requirements as listed in the new ICPs:

ICP 3

ICP 3 establishes the fundamental requirements for supervisory cooperation and information sharing. The fundamental requirements are based on the following:

- The supervisor must have the legal authority and power to obtain and exchange supervisory information in respect of legal entities and groups, including relevant non-regulated entities.
- The supervisor must have the legal authority and power, at its sole discretion and subject to appropriate safeguards, to exchange information with other relevant supervisors. The existence of an agreement or understanding on information exchange must not be a prerequisite for information exchange.
- The supervisor proactively exchanges material and relevant information with other supervisors. The supervisor informs other supervisors within their jurisdiction and the supervisors of group entities in other jurisdictions or sectors in advance of taking any action that it might reasonably consider will affect those group entities. Where prior notification is not possible the supervisor informs other relevant supervisors as soon as possible after taking action.
- The supervisor has a legitimate interest and a valid purpose related to the fulfillment of supervisory functions in seeking information from another supervisor.
- The supervisor responds in a timely and comprehensive manner when exchanging relevant information and in responding to requests from supervisors seeking information.
- Strict reciprocity in terms of the level, format and detailed characteristics of information exchange is not required by the supervisor.
- Before exchanging confidential information, the supervisor ensures that the party receiving the information is bound by confidentiality requirements.
- The supervisor is generally willing to permit information exchanged by it to be passed on to other relevant supervisors or their bodies in the jurisdiction of the recipients that have the necessary confidentiality requirements.
- The supervisor receiving confidential information from another supervisor uses it only for the purposes specified in any request for that information. Any other use of the information, including exchanging it with other parties, is agreed by the originating supervisor prior to the use of that information.
- The supervisor and any individual acting for it (presently or in the past) involved in the receipt and exchange of confidential information is required by legislation to protect the confidentiality of such information. Wrongful disclosure of confidential information is subject to penalties.
- In the event that the supervisor is legally compelled to disclose confidential information it has received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to passing on is not given, the supervisor uses all reasonable means to resist such a demand or protect the confidentiality of the information.

ICP 23

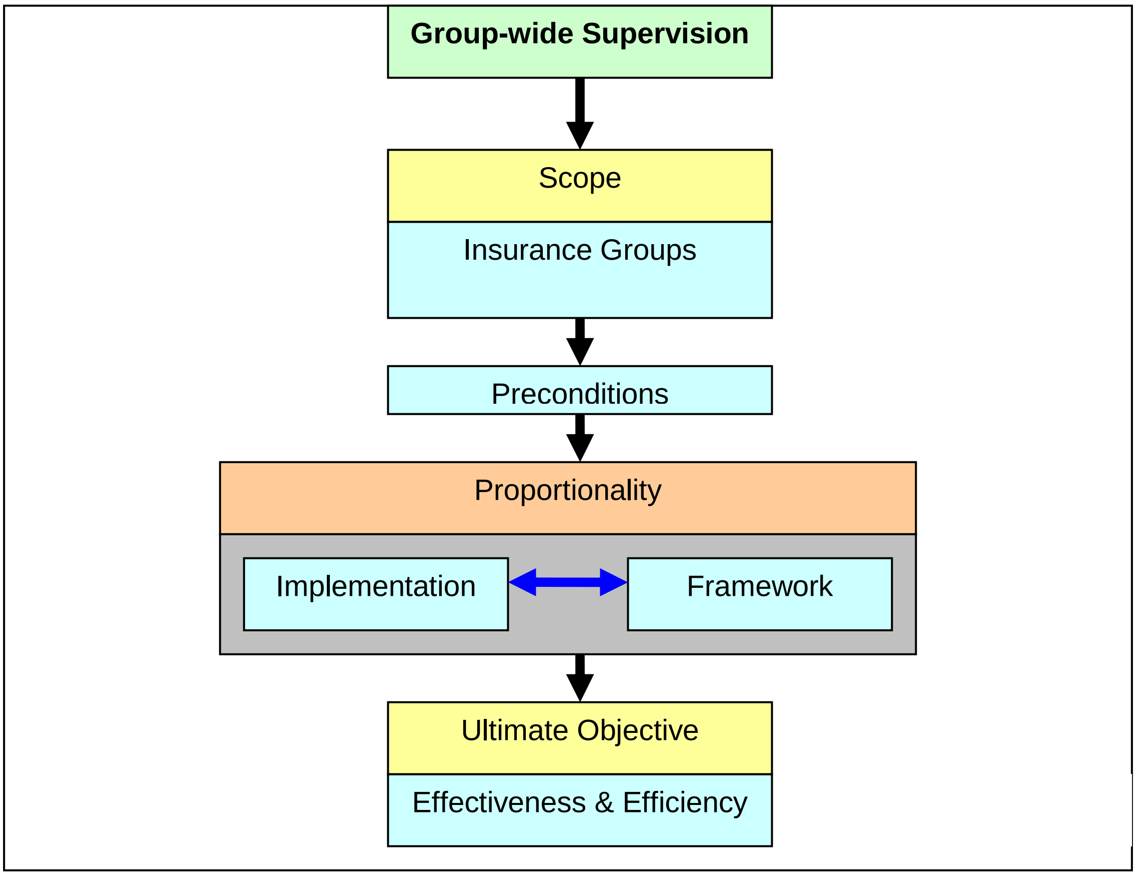
ICP 23 establishes the fundamental requirements for supervision on a group-wide basis. The fundamental requirements are based on the following:

- Where an insurer is part of a group, the supervisor, in co-operation with other supervisors as necessary, identifies the scope of the group to be subject to group-wide supervision.
- The identified group, regarded as an insurance group for the purpose of group-wide supervision by insurance supervisors, covers all relevant entities.
- In deciding which entities are relevant consideration should be given to, at least:
    - Operating and Non-operating holding companies (including intermediate holding companies);
    - Insurers (including sister or subsidiary insurers);
    - Other regulated entities, such as banks and / or securities companies;
    - Non-regulated entities (including parent companies, their subsidiary companies and companies substantially controlled or managed by entities within the group); and / or
    - Special purpose entities.

Taking into account at a minimum, the following elements related to the insurance activities:

- (Direct or indirect) participation, influence and / or other contractual obligations;
- Interconnectedness;
- Risk exposure;
- Risk Concentration;
- Risk Transfer; and / or;
- Intra-group transactions and exposures.

- The lack of legal authority and / or supervisory power of a supervisor are not a reason for narrowing the identified scope of a group.
- The scope of the group for the purpose of group-wide supervision is flexible in order to take account of any (potential) material and relevant changes in / or outside of the group, such as those regarding the structure, activities or macro-economic environment.
- The supervisor requires that the structures of the insurance group be sufficiently transparent so that supervision of the insurance group will not be hindered.
- The supervisor establishes an effective and efficient group-wide supervision framework, as illustrated by the diagram below:



A more detailed discussion of the group-wide supervision framework is included in the section dealing with the standard on group-wide Regulatory Requirements and Guidance on Group-wide Supervision Framework.

ICP 25

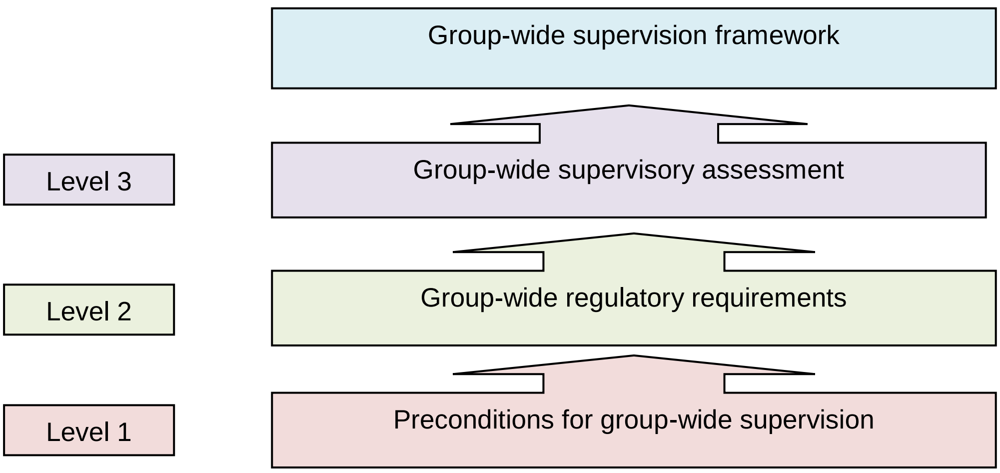
ICP 25 establishes the fundamental requirements to ensure that the supervisor cooperates and coordinates with other relevant supervisors subject to confidentiality requirements. The fundamental requirements are based on the following:

- The supervisor takes steps to put in place adequate coordination arrangements with involved supervisors on cross-border issues on a legal entity and a group-wide basis in order to facilitate comprehensive oversight of such legal entities and groups.
- Insurance supervisors cooperate and coordinate with relevant supervisors of other sectors as well as central banks and government ministries.
- Involved supervisors determine the needs for a group-wide supervisor and agree upon the supervisor to take that role (including a situation where a supervisory college is established).
- The designated group-wide supervisor takes the responsibility for initiating discussions on suitable coordination arrangements, including a supervisory college and to act as the key coordinator or chairman of the supervisory college, where it is established.
- The designated group-wide supervisor is able to understand the structure and operations of the group. Other involved supervisors understand the structure and operations of parts of the group at least to the extent they could affect the operations in their jurisdictions and how the operations in their jurisdictions may affect the group.
- Coordination agreements include effective procedures for information flows between involved supervisors on an ongoing basis and in emergency situations, for communication with the head of the group, for convening periodic meetings of involved supervisors and for the conduct of a comprehensive assessment of the group.
- There is appropriate flexibility in the establishment of a supervisory college – both when to establish and the form of its establishment – and other coordination mechanisms to reflect their particular role and functions.
- The designated group-wide supervisor establishes the key functions of supervisory colleges and other coordination mechanisms.
- The designated group-wide supervisor takes the appropriate lead in these responsibilities of group-wide supervision. A group-wide supervisor takes into account the assessment made by the legal entity supervisors as far as relevant.

<u>The Group-wide Supervision Framework</u>

The Group-wide Supervision Framework (“GSF”) is included in ICP 23 that deals with Group-wide Supervision. The ultimate objective of group-wide supervision is to promote effective supervision of insurance groups. The establishment of the GSF is expected to facilitate appropriately streamlined, consistent and effective group-wide supervision – supporting a supervisory framework that preserves the standards of protection of policyholders and maintains the soundness of each insurer and overall financial stability, as well as avoiding unnecessary overlaps and material deficiencies, and unnecessary burden for the industry.

The GSF takes primarily a structured and functional approach, and is a means of viewing the Insurance framework through a group-wide supervision lens. Illustratively it can be summarised as follows:



Level 1 Preconditions

Preconditions need to be established for group-wide supervision to be effective and serve as a foundation for the GSF model. Specific preconditions with regard to group-wide supervision need to be considered:

- The supervisor should have the necessary supervisory power, legal authority, capacity and capabilities, including the skills, resources and experiences to carry out group-wide supervision;
- The supervisor should have the ability and willingness to cooperate with other relevant supervisors on a cross-border and / or cross-sector basis, including information sharing, in a secure environment based, on mutual trust, understanding and confidence; and
- A clear identification of an insurance group for group-wide supervision.

Level 2 Group-wide regulatory requirements

At a minimum, the group-wide supervision framework includes, as a supplement to legal entity supervision:

- Extension of legal entity requirements, as applicable according to the relevant ICPs, on:
    - Solvency assessment (group-wide solvency);
    - Governance, risk management and internal controls (group-wide governance);
    - Market conduct (group-wide market conduct)

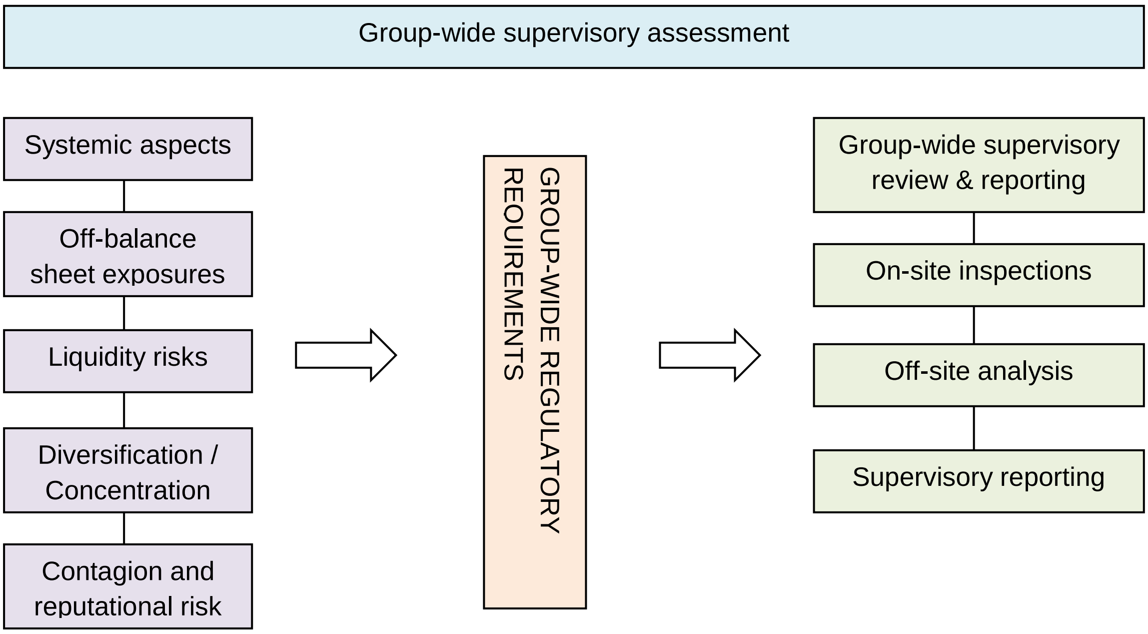
- Requirements related to group-wide supervision on:
    - Complexity of group structure;
    - Cross-border / cross-sectoral issues;
    - Interplay with legal entity supervision; and
    - Non-regulated entities.

Annexure A expands on the level 2 requirements and shows the components that have been identified as important elements of the GSF and depicts the relationship between preconditions for group-wide supervision, group-wide regulatory requirements and group-wide supervisory assessment.

Level 3 Group-wide supervisory assessment

The supervisor provides for a group-wide supervisory assessment of an insurance group's adherence to the group-wide regulatory requirements.

The following figure illustrates clear linkages between supervisory risks, group-wide regulatory requirements and group-wide supervisory assessment (manifested in on-site inspections, off-site analysis and supervisory reporting):



6. EU DIRECTIVE ON SOLVENCY II: PRINCIPLES (LEVEL 1 TEXT)

The outline of the relevant Solvency II Level 1 text principles includes:

- Supervision of individual insurance and reinsurance undertakings remains the essential principle of insurance supervision. It is therefore necessary to determine a group-wide supervisory regime and define through the use of definitions and other measures which undertakings fall under the scope of supervision;
- Group supervision should take into account insurance holding companies and mixed-activity insurance holding companies to the extent necessary;
- It is necessary to calculate solvency at group level for insurance and reinsurance undertakings forming part of a group;
- Risk concentrations and intra-group transactions could affect the financial position of the group; the supervisory authority should therefore be able to exercise supervision over such risk concentrations and intra-group transactions.
- The group-wide supervisory regime should assign a group supervisor in the case of cross-border and / or cross-sector groups. The rights and duties of the group supervisor should comprise appropriate coordination and decision-making powers.
- Relevant information should be shared by all of the supervisors involved in the group-wide solvency regime.
- All relevant supervisors involved in group-wide supervision should be involved through a college of supervisors. The activities of the supervisory college should be proportionate to the nature, scale and complexity of the risks inherent in the business of all undertakings that are part of the group.

The above principles are relevant for the proposed interim measures.

7. MAPPING PRINCIPLE DIFFERENCES BETWEEN IAIS ICPs AND THE EU SOLVENCY II DIRECTIVE

The following table lists the main items referenced from the IAIS ICPs and the level 1, Solvency II text. The criteria are aligned to the GSF but not necessarily in the same order as the GSF.

Criteria	IAIS ICPs	Solvency II, level 1 text
Preconditions - Legal authority; - Proportionality – nature, scale, complexity	✓	✓
Scope of Supervision - Definition of an insurance group; - Entities within the scope of supervision	✓	✓
Group-wide regulatory framework - Group structure requirements; - Group-wide solvency; - Group-wide governance; - Group-wide market conduct; - Reporting requirements	✓	✓ *
Supervisory approach: - Risk-based approach; - Supervisory review & reporting	✓	✓ *
Information exchange, cooperation and coordination with other supervisors	✓	✓

***Certain of the criteria are not explicitly addressed within the Solvency II level 1 text.**

There are no material differences between the Solvency II level 1 text, the IAIS ICPs and the ultimate objective of the GSF.

8. OTHER RELEVANT JURISDICTIONS: APRA

The Task Group found it appropriate to principally consider the Australian Prudential Regulatory Authority ("APRA") as the most relevant jurisdiction.

It is APRA's intention to observe the core principles of the IAIS. In order to observe ICP 23, APRA demonstrates that they supervise APRA regulated entities on both a group and a solo basis.

APRA has been developing a tiered approach to the supervision of financial entities that is appropriate to the supervision of insurance groups and, in particular, to the assessment of capital adequacy of those groups. The levels at which supervision would apply are:

- **Level 1** Solo - APRA's existing framework, in which supervision is applied to individual APRA-authorised general insurers on a solo basis;
- **Level 2** Industry Groups – Consolidated general insurance groups that incorporate all general insurers, both domestic and international, within the group. The group may be headed by an APRA-authorised insurer or an APRA-authorised non-operating holding company; and
- **Level 3** Financial Conglomerates - Conglomerate groups involving Australian general insurers and other financial entities (including life insurers). This level would encompass the entire conglomerate group headed by an APRA-regulated entity and containing APRA-authorised institutions operating in more than one regulated industry.

Level 2 Industry group

The objective of APRA's Level 2 general insurance group supervision is to ensure that groups which contain authorised general insurers are financially sound and that group activities and inter-relationships do not adversely affect the financial soundness of those authorised general insurers within the group. This is designed to reduce the risk of financial contagion across members of the group and enhance the protection of Australian policyholders as a result.

Group supervision is undertaken on a consolidated basis across a Level 2 general insurance group, which includes subsidiaries located outside Australia. It is not APRA's intention to require overseas subsidiaries of an Australian general insurance group to meet Australian prudential standards on a solo basis.

In assessing the capital adequacy of the group:

- Responsibility for capital management rests with the Board of Directors of the parent entity;
- The capital base is assessed on a group basis. The effect of intra-group transactions and risk concentrations is assessed at the group level; and
- Material subsidiaries operating in other industries, unrelated to the general insurance business, are deconsolidated from the Level 2 general insurance group and their value is excluded from the Level 2 group's capital base.

A group-wide risk management framework is required which includes reinsurance management, business continuity management and policies relating to outsourcing arrangements. The requirements are based on the principles applying to Level 1 general insurers but are appropriately modified for application at the group level. The Level 2 group would also need to appoint a Group Auditor and Group Actuary.

Level 3 Financial conglomerates

In terms of Level 3, conglomerate groups will be supervised at both Level 2 and Level 3. In general, APRA will apply Level 3 supervision to conglomerate groups containing two or more material entities that are either APRA-regulated entities operating in different industries, or a combination of at least one APRA-regulated entity and at least one material non-regulated entity.

APRA's decision to apply Level 3 supervision will have regard to whether the group's structure allows for effective supervision and whether the additional requirements of group supervision will enhance the protection of the beneficiaries of APRA-regulated entities; the decision will be guided by high-level principles.

9. MAPPING ANY DIFFERENCES BETWEEN IAIS ICPs AND THE APPROACH FOLLOWED BY APRA

APRA'S group-wide supervisory Level 2 and Level 3 regimes are aligned to the fundamental requirements under ICP 23.

10. ASSESSMENT AND RECOMMENDATIONS ON THE APPROACHES FOLLOWED BY THE IAIS, THE EU DIRECTIVE (LEVEL 1 TEXT) AND APRA.

10.1 Preconditions

10.1.1 Legal Authority

IAIS principles:

ICP 3 read together with ICP 23 establishes the fundamental requirements for a group-wide supervisory regime. A supervisor must have the legal authority and power to perform group wide supervision.

Solvency II Level 1 text:

The legal framework for the supervision of insurance groups was already set within Solvency 1, the EU Directive on Insurance groups and financial conglomerates.

APRA:

The foundation of APRA's approach to Level 2 supervision was the introduction of a prudential framework for the supervision of general insurance groups.

Recommendation:

In its effort to ensure that its regulatory and supervisory regime is aligned with international standards, the FSB has stated its intention to implement an interim group-wide supervisory regime through the SAM governance structures. The Long-term and Short-term Insurance Acts must be amended to provide for:

- The necessary supervisory powers and legal authority to carry out group-wide supervision; and
- The ability to cooperate and coordinate with other relevant supervisors on a cross-border and / or cross-sector basis, including information sharing.

10.1.2 Proportionality

IAIS principles:

Proportionality is inherent within the principles of IAIS. ICP 23 concludes that the scope of the group for the purpose of group-wide supervision must be flexible in order to take account of any (potential) material and relevant changes in or outside of the group, such as those regarding the structure, activities or macro-economic environment.

The GSF, and its application in practice, is also proportionate to the nature, scale and complexity of the risks to which an insurance group is exposed. GSF must facilitate the effective and appropriate supervision of insurance groups to promote the maintenance of fair, safe and stable insurance markets for the benefit and protection of policyholders.

Solvency II Level 1 text:

Proportionality is inherent within the Solvency II framework. The proposed group-wide supervisory regime should not be too burdensome to "smaller" groups. The principle should apply for both the requirements imposed and in exercising supervisory powers.

APRA:

The group-wide supervisory regime is risk-based and as such it will be fit for purpose to reflect the nature, scale, and complexity of the risk to which an insurance group is exposed. In applying this regime, every effort will be made to identify all reasonably foreseeable risks and to analyse the impact they might have on the insurance group.

Recommendation:

The task group's recommendation is aligned to all of the above. The group-wide regulatory and supervisory regime should be risk-based and must reflect the nature, scale and complexity of the risks to which an insurance group is exposed. It is further proposed that under certain conditions and upon application certain insurance groups (excluding financial conglomerates or groups where there is more than one insurer) be exempted from group-wide supervision.

10.2 Scope of Supervision

10.2.1 Definition of an insurance group

IAIS principles:

A group is considered to be an insurance group for the purpose of group-wide supervision if there are two or more entities of which at least one is an insurer and one has significant influence on the insurer. The significance of influence is determined based on criteria such as participation, influence and / or other contractual obligations, interconnectedness, risk exposure, risk concentration, risk transfer and / or intra-group transactions.

Some insurance groups are financial conglomerates. The definition of what comprises a financial conglomerate is currently under review by the IAIS, but a working definition is the one developed by the Joint Forum (of which the IAIS is a founding member) which describes a financial conglomerate as a group of companies under common control or dominant influence, including the financial holding company, which conducts material financial activities either:

- In at least two of the regulated banking, securities or insurance sectors; or
- In one of these regulated sectors and one other unregulated financial sector to the extent that these financial activities in that sector are not subject to group wide / consolidated supervision by sectoral frameworks.

Solvency II Level 1 text:

The definitions in the Solvency II Level 1 text, differentiate between insurance groups and mixed activity insurance groups.

An insurance group consist exclusively or mainly of insurance and / or reinsurance activities. The definition refers to at least one insurance or reinsurance undertaking.

A mixed activity insurance group is a financial group whereby insurance activities are not the main business but form part of the financial group. The definition refers to at least one insurance or reinsurance undertaking.

APRA:

According to APRA, a level 2 group is defined as a consolidated group that applies to groups headed by a deposit taking entity or a general insurer. According to APRA, a level 3 financial conglomerate is defined a conglomerate group containing APRA-regulated entities with material operations across more than one APRA-regulated industry and/or in unregulated entities.

Recommendation:

The task group is proposing the same definition as defined by the IAIS.

Insurance group

A group is considered to be an insurance group for the purpose of group-wide supervision if there are two or more entities of which at least one is an insurer and one has significant influence on the insurer. The significance of influence is determined based on criteria such as participation, influence and / or other contractual obligations, interconnectedness, risk exposure, risk concentration, risk transfer and / or intra-group transactions. The scope of the group will be limited to those entities falling under the ultimate holding company in South Africa.

Although the task group is departing from recommending the definitions under Solvency II, the definition under insurance group and mixed activity insurance groups is aligned to meanings of the definition for insurance groups under IAIS.

Some insurance groups may be financial conglomerates. The task group proposes using a definition of financial conglomerates consistent with that currently proposed by the Joint Forum.

Financial Conglomerate

An insurance group is considered to be a financial conglomerate if it consists of a group of companies that conducts insurance activities plus financial activities either:

- In at least one of the other regulated financial sectors; or
- In at least one non-regulated financial sector to the extent that the financial activities in that sector are not subject to group wide/consolidated supervision by sectoral frameworks.

It is proposed that the regulatory and supervisory framework applied to insurance groups will, in accordance with the proportionality principle, differ depending on the type of insurance group, which can be summarised as follows:

Category 1: Solo plus (consisting of one insurer and one or more non-financial entities);

Category 2: Pure insurance group (consisting of two or more insurers, possibly also including one or more non-financial entities);

Category 3: Financial conglomerates[2], consisting of either/or:

- At least 1 insurer + 1 or more other financial regulated entity[3];

[2] Financial conglomerates may also include one or more non-financial entities.

[3] Financial regulated entities include all financial institutions defined in the Financial Services Board Act, Act 97 of 1990, as well as banks, non-bank credit providers and medical scheme administrators.

- At least 1 insurer + 1 or more financial non-regulated entity[4].

Annexure B sets out illustrated cases of group structures that will be captured under the scope of an insurance group.

Within an insurance group, there may also be an insurance sub-group. An insurance sub-group is defined as a subset of the group that includes all the insurance entities within the group. The group-wide regulatory framework outlined in this paper may be applied at insurance sub-group level.

10.2.2 Entities within the scope of supervision

IAIS principles:

The identified group, regarded as an insurance group for the purpose of group-wide supervision by insurance supervisors, covers all relevant entities. In deciding which entities are relevant consideration should be given to, at least:

- Operating holding company ("OHC") and Non-operating holding companies ("NOHC") (including intermediate holding companies);
- Insurers (including sister or subsidiary insurers);
- Other regulated entities, such as banks and / or securities companies;
- Non-regulated entities (including parent companies, their subsidiary companies and companies substantially controlled or managed by entities within the group); and / or
- Special purpose entities.

Taking into account at a minimum, the following elements related to the insurance activities:

- (Direct or indirect) participation, influence and/or other contractual obligations;
- Interconnectedness;
- Risk exposure;
- Risk Concentration;
- Risk Transfer; and / or;
- Intra-group transactions and exposures.

Solvency II Level 1 text:

The Solvency II level 1 text defines a group as a group of undertakings that:

- Consist of a participating undertaking, its subsidiaries and the entities in which the participating undertakings or its subsidiaries hold a participation, as well as any other undertakings managed on a unified basis or subject to common management.

- Is based on the establishment, contractually or otherwise, of strong and sustainable financial relationships among those undertakings, provided that one of those undertakings effectively exercises, through centralized coordination, a dominant influence over the decisions, including financial decisions, of other undertakings that are part of the group.

The directive defines participation as the ownership, direct or by way of control of 20% or more of the voting rights or capital of an undertaking. Further to this, the definition includes any holding of voting rights or capital in an undertaking over which, in the opinion of the supervisor, significant influence is exercised.

[4] Financial non-regulated entities include, for example, property syndications.

APRA:

APRA's definition of a group includes entities that are subsidiaries, associates as prescribed within International Financial Reporting Standards ("IFRS"). APRA also references to influence and control.

Companies Act/Banks Act

The task group has given consideration to the provisions of the Companies Act and the Banks Act and decided that they are too limited and do not take into account mutual insurance companies.

Recommendation:

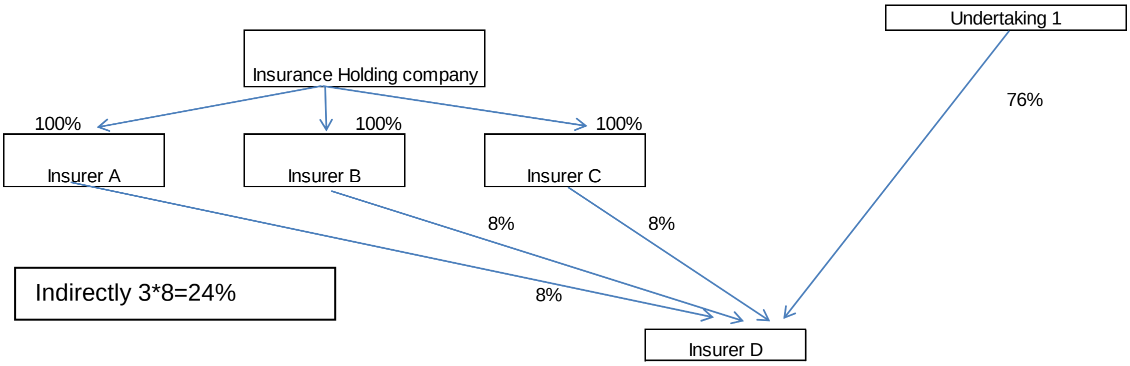
The task group recommends adopting the IAIS principles with minor amendments. The starting point will be the identification of a group based on IFRS Accounting principles except in the case of mutual insurers.

<u>IFRS principles</u>

Inclusion of entities within the definitions in accordance with IFRS principles on consolidated accounts:

- Subsidiary is an entity in which the group has the power to govern the financial and operating policies in which the group has more than 50% of the voting rights or economic interest.
- Associates included in a group are those in which the group has between 20% and 50% economic interest, thereby providing significant influence. If the holding is less than 20% the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated.
- The assessment of significant influence should be consistent, as far as possible, with the consolidated accounts. In other cases, entities that do not fall within the scope of the IFRS principles should be benchmarked against the following materiality concepts:
    - any entity that is significant to the group's capital position or its financial standing;
    - an entity that is operationally important to the insurance group but does not currently fall within the definition of an insurance group or mixed activity insurance group. Examples may include entities such as a central hub that provides essential information technology services to the group, but is not a subsidiary or an associate; or
    - any entity that has the potential to create risks that, if realised, could produce significant losses for the group.

A holding of 20% or more of the voting rights or economic interest will indicate significant influence. If the holding is less than 20% the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated. For example in the diagram below the insurance holding company would be presumed to exercise significant interest over Insurer D through its 24% indirect holding:



IAIS principles

In deciding which entities are relevant, consideration should be given to, at least:

- NOHC (including intermediate holding companies) incorporated in South Africa;
- Insurers (including sister or subsidiary insurers);
- Other regulated entities, such as banks and / or securities companies;
- Non-regulated entities (including parent companies, their subsidiary companies and companies substantially controlled or managed by entities within the group); and / or
- Special purpose entities.

(Note that insurers, other regulated entities, non-regulated entities and special purpose entities would include both South African entities and entities outside South Africa, which fall under the NOHC incorporated in South Africa).

Taking into account at a minimum, the following elements related to the insurance activities:

- (Direct or indirect) participation, influence and / or other contractual obligations;
- Interconnectedness;
- Risk exposure;
- Risk Concentration;
- Risk Transfer; and / or;
- Intra-group transactions and exposures.

Significant Influence is evidenced in one or more of the following ways:

- Representation on the board of directors;
- Participation in the policy-making process;
- Material transactions between entities;
- Interchange of managerial personnel;
- Management on a unified basis; and potential voting rights.

The Registrar shall have the right to determine the scope of insurance group supervision. The Registrar may include or exclude entities where he/she is of the view that either excluding or including those entities might be inappropriate or misleading with respect to the objectives of insurance group supervision.

The Registrar may at any time because of a change in the significant amend the scope of the insurance group.

10.3 Group-wide Regulatory Framework

Entities that are included within the scope of group-wide supervision should not be misconstrued as being directly subject to group-wide regulatory requirements. An insurance group as a whole should be subject to group-wide supervision, but it does not necessarily mean that all quantitative and qualitative supervisory requirements that are applied on an insurance legal entity should equally be applied to other entities within the group or to the insurance group as a whole.

It is recognized internationally that there are two approaches to group wide supervision namely a direct and an indirect approach. The direct approach to group-wide supervision is defined as a supervisory approach to non-regulated entities which entails licensing or authorisation of entities in an insurance group which do not themselves conduct insurance business.

The indirect approach to group-wide supervision is defined as a supervisory approach to non-regulated entities which relies on exercise of supervisory powers through a regulated entity in the group as part of the supervision of that entity.

In many jurisdictions the supervisory approach to non-regulated entities tends to be a hybrid one; for instance, non-financial group entities may be supervised using an indirect approach, while holding companies may be directly regulated.

It is proposed that the regulatory framework for insurance groups in category 1 be based on an indirect approach whilst for categories 2 and 3 the direct approach be applied. In particular, the direct approach will require the establishment of a regulated NOHC for category 2 and 3 insurance groups or insurance sub-groups, to which group-wide regulatory and supervisory requirements will apply.

Annexure C sets out how the regulatory and supervisory approach may differ depending on the category of insurance group or insurance sub-group.

10.3.1 Group structure

For effective group-wide supervision, it is important for the supervisor to adequately understand the insurer's group structure, as a complex non-transparent group structure could hinder effective group-wide supervision.

The structure of the group to which the insurer belongs should not impair the insurer's stability and solvency. Accordingly, an insurance group should maintain a transparent group structure in order not to impede effective group-wide supervision.

IAIS principles:

The supervisor requires that the structures of the insurance group be sufficiently transparent so that the supervision of the insurance group will not be hindered. For effective group-wide supervision, it is important for the supervisor to understand the insurer's group structure appropriately.

An insurance group should make and keep its group structure transparent in order not to impede effective group-wide supervision.

Solvency II Level 1 text:

The Solvency II level I text does not specifically refers to group structures but it is not mutually excluded from the IAIS principles.

APRA:

The structure of any group should be sufficiently transparent to enable the regulator to ascertain where the various business lines are conducted, the risk profile of the group and its individual parts and the way in which internal risk management is organised and conducted for the group and for individual entities. Supervision will take into account the individual structure and character of each group.

Recommendation:

The recommendation is aligned with the scope under APRA:

The structure of an insurance group should be sufficiently transparent to enable the Registrar to ascertain where the various business lines are conducted, the risk profile of the group, its individual constituents and the way in which internal risk management is organised and conducted for the group and for individual entities. Supervision will take into account the individual structure and character of each group. The Registrar should also have the powers to require an insurance group to change its structure if it is too complex or hinders the Registrar's ability to do group wide supervision effectively

<u>Non-Operating Holding Company</u>

IAIS principles:

Consideration is given to both OHCs and NOHCs (including intermediate holding companies). There is no explicit requirement for the authorisation of holding companies.

Solvency II Level 1 text:

The Solvency II level I text bases governance and supervision through the insurance legal entity.

APRA:

The Australian law provides for the authorisation of NOHCs. The authorisation of NOHCs gives APRA the power to require appropriate governance at holding company level and hold the holding company accountable for the activities of the group.

Recommendation:

The task group recommends the same approach as APRA and believes that group-wide governance should be conducted through an authorised NOHC within South Africa. This application is in line with the approach adopted by the Bank Supervision Department ("BSD") in respect of banking groups as outlined under the Banks Act. It also provides for a more direct and transparent approach to group supervision.

The main benefits of authorising a NOHC is that it will achieve an easier application of fit and proper, internal control and risk management requirements if governance, strategic direction and senior management are concentrated at NOHC level. It will also enhance information access, supervisory review and supervisory enforcement.

An exception would most likely be made for Category 1 insurance groups (i.e. only one insurer and one or more non-financial entities), which would tend to be supervised on a solo basis, but with a regulatory requirement that the solo insurer provides information to the supervisor on group exposures and risks (i.e. an "indirect" approach to supervision of the insurance group, alternatively described as "solo plus").

The following is proposed:

> The holding company of an insurance group or insurance sub-group should be an FSB authorised NOHC in South Africa. The intention of group supervision does not extend to the solo supervision of the holding company but rather to holding the holding company accountable for the financial position and operations of the group.
>
> By extending some of the current requirements in the two Insurance Acts applicable to the registered insurers, to also apply to the NOHC. This can include the fit and proper requirements for directors, senior management and heads of control functions in respect of, amongst others, personal character qualities of honesty and integrity, competence, qualifications, continued professional development and experience. It can also include notifications of appointees or resignations of appointees, the requirement for approval of certain capital or debt instruments issued by the NOHC and the winding-up or judicial management of the NOHC.
>
> The Registrar shall have the right to determine if the authorisation of a NOHC will be necessary for insurance groups or sub-groups.

Registering a NOHC for insurance groups will require a range of regulatory & supervisory powers including:

- reporting requirements;
- group governance risk management and internal control requirements;
- onsite inspections; and
- enforcement and intervention powers.

To achieve the above objectives the following is suggested to the drafter with regard to authorising NOHCs:

- Registration of holding companies at the levels suggested above;
- Aligning the registration of holding companies with sections 37 - 39 and 41 - 49 of the Banks Act. This will also be in line with the current application under the Long-term and Short-term Insurance Acts for the registration of a holding company of solo insurers. These sections mainly deal with:
    - Control over holding company; and
    - Change in shareholding.

<u>Acquisitions</u>

The task group did not separately detail the regulatory tools with respect to changes to group structure in terms of acquisitions as prescribed under IAIS, Solvency II level 1 text and APRA as no specific requirements are laid down. The recommendations below were made after taking into account the requirements under the Banks Act, 1990.

Recommendation:

Pre-approval will be necessary for the acquisition of material insurance and / or other financial regulated and non-regulated entities within insurance groups.

Pre-notification will be necessary for the acquisition of non-material entities within insurance groups.

A quantitative threshold, based in principle on balance sheet data, can be used to define materiality. In exceptional cases the Registrar may complement the criterion based on the balance sheet total by the income structure and/or off-balance sheet activities.

10.3.2 Group-wide solvency

IAIS principles:

According to ICP 23, a group-wide solvency assessment involves assessing whether management of risk and capital for the group is adequate, especially to the extent that the group conducts activities that may adversely affect the financial / solvency position of insurance entities within the group. It covers other important issues such as investments in affiliated entities, intra-group transactions, risk exposures and double gearing of capital.

Solvency II Level 1 text:

The Solvency II level I text uses as a basis for group solvency supervision the requirement that eligible own funds must be at least equal to the group solvency capital requirement.

APRA:

APRA requires that an insurance group must hold a surplus of eligible capital over required capital, net of any adjustments, to ensure adequate capital is held to cover risks within the group.

Recommendation:

The following is proposed to be included as an interim measure for the group-wide solvency and is aligned with the principles underlying IAIS standards, Solvency II and APRA:

The NOHC of an insurance group or insurance sub-group must at all times ensure that the insurance group or insurance sub-group maintains its business in a financially sound condition by managing its affairs in such a way that the aggregate of the qualified capital of the group does not at any time amount to less than the aggregate of the required capital determined, after the elimination of investments in one another.

Failure to maintain a financially sound group-wide solvency will result in appropriate regulatory actions and/or enforcement or sanctions.

The following definitions should also be included relating to assessing group-wide solvency:

Qualifying capital: means the capital of group entities to be described in subordinate legislation.

Capital requirement: means the capital requirement of group entities as determined in terms of the rules and regulations of the Regulator responsible for the solo supervision of the entity.

Investment: means a capital investment by one group entity in another to be described in subordinate legislation.

The insurance group solvency requirement is not intended to replace the solvency requirements of the solo entities; however, it does assist in evaluating whether the amount and quality of capital is appropriate given the level of risks present within the insurance group.

Assets and liabilities of group entities will be determined in terms of the rules and regulations of the Regulator responsible for the solo supervision of the entity.

In the assessment of capital adequacy on a group-wide basis, there are accounting and other measurement issues that need to be addressed. The situation where an insurance company owns shares in another insurance company is fairly common. “Creation of capital” (false creation) may occur, for example, where a parent issues debt and down streams the funds to create equity in a subsidiary. In addition, less transparent or inappropriate means may be used to develop double gearing and internal creation of capital.

To assess capital adequacy on a group-wide basis, two main approaches are usually followed:

These are:

1. The accounting consolidation method - This approach aims to calculate the capital requirement at a group level treating the group as a “single entity”, and determines whether this requirement is sufficiently covered by capital elements at the group level. This method uses group consolidated accounts. This method could potentially take diversification benefits into account from a group context.

2. The deduction and aggregation method – This method sums the solo capital requirements and aims to calculate the relevant adjustments to avoid double or multiple gearing of capital. Excess or deficits of capital existing at the level of each entity in the group, i.e. on a solo basis, are aggregated (with relevant adjustments being made for internal holding) in order to measure surplus (or deficit) at group level.

The main difference between the deduction and aggregation method and the accounting consolidation method is that the former shows the capital separately for each material entity within the group. The accounting consolidation method is a consolidated result of the group and does not show the breakdown of capital at each solo entity.

It should be noted that the deduction and aggregation does not allow for diversification. The accounting consolidation method allows for diversification in certain cases.

Solvency II potentially allows for diversification between insurers within the same group under the consolidation method but does not allow for diversification between different types of financial entities (for example between banks and insurers) even under the consolidation method. It is important to note that to date no regulators have allowed reduced capital for diversification. Regulators have generally felt that as a group increases in size and complexity, the "group risk" in the form of interconnectedness and contagion risk exceeds the potential diversification benefits. The common challenge for regulators is to find a way of quantifying the "group risks" so that these can be evaluated against the potential diversification benefits and accordingly whether groups should have a net increase or decrease in regulatory capital.

IAIS principles:

No preference for either of the two methods.

Solvency II Level 1 text:

The Solvency II level I text recommends the accounting consolidation method as the default method with the alternative method being the deduction and aggregation method. There is however no clear preference among the European Union ("EU") members regarding the choice of method. **Annexure D** sets out the methods preferred by the various EU members.

APRA:

No preference for either of the two methods.

Recommendation:[5]

The task group recommends the deduction and aggregation method for the interim measures.

The following was taken into account in support of the recommendation of the deduction and aggregation method:

1. The BSD of the South African Reserve Bank uses the deduction and aggregation method. It is important that the FSB follow the same process as the BSD as a number of the significant insurers operate within bancassurance structures. BSD have been supervising on a group basis since 2001 and this method has worked well for them as they find it transparent and are able to review the financial condition of material banks and insurers clearly using this method.

2. Group internal models. None of the SA banking groups currently uses a "true group internal model" that aggregates different industries (banks and insurers) across geographic boundaries. South African banking groups make use of partial groups internal models.

3. A number of major global regulators use the deduction and aggregation method.

4. A number of the SA insurers are planning expansions into the rest of Africa. The deduction and aggregation method will clearly identify the non-South-African subsidiaries that are likely to continue calculating capital using pre-Solvency II measures.

[5] In terms of final SAM measures, the task group has been allocated the responsibility of further evaluating the potential capital effects of the D&A method as against the AC method. This issue has been flagged in the task group's issue log for further research, debate and consideration.

5. The deduction and aggregation method is more transparent than the accounting consolidation method.

The disadvantages of using the accounting consolidation method:

1. Research has shown that in cases of distress and financial crises the correlations on which much of the diversifications are based usually reduce substantially. As a result it may not accurately reflect the situation of an insurance group in case of financial distress;

2. There is no natural way of allocating required capital to the different legal entities, i.e. it is difficult to use the consolidated model for determining the capital requirement of the legal entities of the group; and

3. There is inadequate information on the economic positions of the group's legal entities, including non-regulated entities.

Capital add-on

Group-wide supervision involves assessing all material risks within the insurance group, including those arising from non-regulated entities. Non-regulated entities, which are not subject to prudential oversight, may conduct activities that introduce risks to the insurance group's financial position.

IAIS principles:

There are several risks that may arise from the existence of non-regulated entities within or connected to an insurance group. Four main areas in which non-regulated entities could pose major sources of risks are contagion effects, financial position, governance and supervisory reach[6]. These are highlighted in the table below:

Risks from non-regulated entities	
Contagion	Reputational risks – Operations and market conduct of non–regulated entities can affect the reputation of the group as a whole.
Financial position	Difficulty in assessing the financial position of a group due to the risks that non-regulated entities pose to the group, which risks are not adequately reflected in the group capital.
Governance	Group structures – Lack of transparency of operations and high risk activities that could be carried out via non-regulated entities.
Supervisory reach	Lack of adequate information to monitor all parts of the group.

The IAIS recommends addressing risks stemming from non-regulated entities through capital measures by increasing capital requirements in order that the group holds sufficient capital to take account of risks arising from non-regulated entities. If the activities of the non-regulated entities have similar risk characteristics to insurance activities, it may be possible to calculate an equivalent capital charge. Another approach might be to deduct the value of holdings in non-regulated entities from the capital resources of the insurance legal entities in the group.

[6] IAIS Guidance paper on the treatment of non-regulated entities in group-wide supervision

Solvency II Level 1 text:

The imposition of a capital add-on is exceptional in a sense that it should be used only as a measure of last resort, when other supervisory measures are ineffective or inappropriate. The term exceptional is defined in context of a specific situation.

APRA:

APRA does not include a capital add-on requirement for material non-regulated entities but accounts for it by deconsolidating their values from the group capital i.e. ring-fencing is used.

Recommendation

Interim measures: It is important that the objective of the evaluation of non-regulated entities be highlighted in legislation. The objective is not the regulation or supervision of non-regulated entities but rather the evaluation of the risks associated with non-regulated entities and their potential impact on the policyholders of the regulated and supervised entities.

Where the insurance group solvency as calculated and recommended in paragraph 10.4 does not reflect all the risks including those risks posed by non-regulated entities to the insurance group or insurance sub-group, the Registrar after consultation with an insurance group may add an additional capital requirement to reflect those risks.

Default: The Registrar has the right after consultation with the insurer to impose a capital add-on where the risks including those posed by the non-regulated entities are not adequately taken into account in the group capital adequacy or deduct the value of holdings in non-regulated entities from the capital resources of the insurance legal entities in the group.

Intra-group transactions (“IGTs”) & Risk concentrations (“RCs”)

IGTs occur where subsidiaries within the insurance group depend on the parent and / or other subsidiaries to provide some comfort and or obligations to the regulated entities. IGTs allow the insurance group and its subsidiaries to maximise efficiencies of capital utilisation, and meet funding performance obligations. These transactions can also give rise to a number of complex issues, and supervisors need to have a clear understanding of the structure of these transactions, the links between different parts of the insurance group, and the resultant effects upon the insurance group’s solvency.

IGTs can present risks with serious implications for the insurance group, for example where the insurance group uses these transactions to generate internal creation of capital or to inflate its solvency position through double gearing. Instances can arise where the insurance group internalises its risks (such as through reinsurance and retrocession arrangements) causing a spiraling effect of increased insurance risks within the insurance group.

Solvency II defines RCs as all risk exposures with a loss potential which are large enough to threaten the solvency or the financial position of insurance and reinsurance undertakings.

The Financial Conglomerate Directive (“FCD”) goes further than the above definition to define risk exposures as exposures that may be caused by insurance risk, counterparty risk, credit risk, investment risk, market risk, other risks, or a combination or interaction of these risks.

The definition refers to all exposures which may affect the solvency of the regulated insurance entities arising from undertakings in the same insurance group as well as risks outside the insurance group.

RCs refer to exposures with the potential to produce:

(i) losses large enough to threaten a financial institution's health or ability to maintain its core operations; or
(ii) a material change in an institution's risk profile.

RCs are viewed in the context of single or loosely related drivers of risk that may have different impacts on an insurance group that must then be integrated in assessing the overall risk exposure of the group.

The level of IGTs and RCs highlights the interconnectedness and concentration risks of a group and the level of potential contagion risk.

IAIS principles:

ICP 23 highlights the importance of governance, risk management and internal controls over IGTs and RCs. At a minimum, group-wide supervision of insurance groups or insurance sub-groups should include adequate policies on and supervisory oversight of IGTs and RCs, including intra-group guarantees and possible legal liabilities.

Solvency II Level 1 text:

The Commission of European Insurance and Occupational Pension Supervisors ("CEIOPS") advises that the principles for the supervision of IGTs and RCs under Solvency II should be consistent with the current Insurance Group Directive and FCD.[7]

APRA:

APRA follows best practice defined under IAIS principles dealing with IGTs and RCs.

Recommendation:

The proposal from the task group is to define IGT as per the definition in the Solvency II text.

The definition states that the scope of supervision includes transactions between:

- An insurance undertaking and a related undertaking within the same group.
- An insurance undertaking and a natural and legal person linked to the undertaking within the same group.

> IGT means any transaction by which an insurance undertaking relies either directly or indirectly on other undertakings within the same group or on any natural or legal person linked to the undertakings within that group, for the fulfilment of an obligation, whether or not contractual, and whether or not for payment.
>
> An IGT must be carried out at arm's length for the protection of policyholders. Where transactions are not carried out at arm's length these transactions need to be disclosed to the supervisor and fully motivated why they were not concluded at arm's length.

[7] Directives 1998/78/EC, 2002/87/EC

RCs are defined as all risk exposures with a loss potential which are large enough to threaten the solvency or the financial position of insurance and reinsurance undertakings

The Registrar may question or limits values placed on IGTs or RCs or impose a capital add-on if the capital requirement does not fairly reflect the risk associated with IGTs and RCs posed by other group entities.

The following types of IGTs will be subject to supervision:

- Loans;
- Guarantees and off-balance sheet transactions;
- Elements eligible for the solvency margin;
- Investments;
- Reinsurance transactions and retrocession operations; and
- Share cost agreements, which include profit-sharing arrangements;
- Dividends and interest payments;
- Transfer of own funds from parent undertakings to other related undertakings;
- Payments of fees and commission;
- Reinsurance costs;
- Transactions involving intra-group special purpose vehicles;
- Agreements for the centralised management of assets and liquidity in the group; and
- Agreements for the centralised management of operational functions.

With regard to the reporting of IGTs and RCs, the BSD requires banking entities to report IGTs that exceed 1% of group qualifying capital and RCs in respect of 10% or more of group qualifying capital.

Establishing thresholds is necessary to trigger reporting requirements at group level. Solvency II states that the development of appropriate thresholds on the reporting of IGTs and RCs shall be based on solvency capital or technical provisions or both. Establishing thresholds based on the solvency capital requirement is consistent with the FCD. [8]

The task group proposes the use of reporting templates used by the BSD and the FSA in which IGTs in excess of 1% of group capital and RCs in excess of 10% of group capital should be reported to the supervisor regularly. Reporting of IGTs and RCs should be done at the level of the group. Reporting may be also necessary where any IGTs and RCs jeopardise the solvency or financial position of an insurance undertaking, at the discretion of the Registrar.

10.3.3 Group-wide governance

Ensuring that insurance groups have appropriate governance, risk management and internal controls suitable for their nature, size and complexity; and determining appropriate fit and proper requirements for the group's board of directors, shareholders and senior management will in main be addressed within the final SAM measures.

[8] In terms of final measures, the supervision of IGTs and RCs is placed firmly within the group pillar II requirements on system of governance. The reporting requirements, particularly in respect of ORSA, should include a description of how a group's governance system accounts for IGTs and RCs

The task group however proposes that where a governance framework or control function or a part thereof is provided by the NOHC to the registered insurers within that insurance group, the proposed governance requirements applicable to the solo insurers will apply (with the necessary amendments) to the NOHC.

10.3.4 Group-wide market conduct

Group-wide market conduct is concerned with how insurers within a group and/or the group as a whole conduct their business activities, especially as they involve the fair treatment of policyholders and appropriate disclosures to the public. Market conduct issues may relate to reputational and contagion risk. These issues will be addressed in the final SAM measures, incorporating recommendations arising from the Treating Customers Fairly ("TCF") process.

10.3.5 Reporting requirements

IAIS principles:

ICP 23 requires insurance groups to have reporting systems in place that adequately meet supervisory requirements. Relevant, comprehensive and adequate information needs to be disclosed on a timely basis in order to give market participants a clear view of the business activities, performance and financial position of insurance groups. This will enhance market discipline and understanding of the risks to which an insurance group is exposed and the manner in which those risks are managed.

Solvency II Level 1 text:

CEIOPS considers that all information required at a solo level, either within the public disclosure or the reporting requirements, should also be provided at group level within the group public disclosure Therefore, all requirements set out for solo insurance undertakings also apply to insurance groups' in respect of reporting and disclosure.

APRA:

The reporting requirements for insurance groups have been given legal effect through General Insurance Reporting Standards determined under the Financial Sector (Collection of Data) Act 2001.

Recommendation:

The task group proposes insurance group returns similar to the group returns used by the FSA and BSD. The proposed insurance group return is based on the major regulatory tools as discussed in this paper.

The proposed insurance group return will be completed on a bi-annual basis and will be unaudited. On an annual basis each insurance group will be required to submit an audited return.

The proposed insurance group return will include the following statements:

- Mapping;
- Capital Adequacy;
- Intra-group exposures;

- Counterparty exposures; and
- Fit & Proper

10.4 Supervisory Approach

The supervisory approach to be followed will not replace solo supervision but will be an extension of solo supervision. The task group, in this case, considered how IAIS best practice for solo insurers could be extended to insurance groups.

Risk-based approach

The FSB introduced a new prudential supervisory framework to facilitate proactive supervision of solo entities in line with global trends, known as risk-based supervision. The framework promotes the early identification and ongoing management of all risk types including systemic and organisational risks allowing the FSB to focus its supervisory attention based on the risk profile of insurers.
The prudential supervisory framework for solo insurers will be adopted as the basis for insurance groups. The framework will be adapted to take into account group risks.

In line with guidance emerging from the Financial Stability Board, in particular the work on supervisory intensity with respect to systemically important groups, the FSB's supervisory framework will be adapted to encompass a more close and continuous approach to the supervision of domestic systemically important insurance groups.

Supervisory review and reporting

The FSB has an integrated, risk-based system of supervision that uses both off-site monitoring and on-site visits (collectively referred to as supervisory review and reporting) to examine the business and risks associated with each insurer.

The FSB needs to maintain a framework for continuously monitoring and supervising insurance groups based on on-going communication with the group, financial and statistical reporting, market analyses as well as any other appropriate information.

As is the case for solo insurers, legislation should also provide the FSB with wide-ranging powers to conduct on-site visits to insurance groups to gather information deemed necessary to perform its duties.

On-site visits will enable the FSB to obtain information and detect risks and associated problems that cannot be obtained or detected through off-site monitoring. In particular:

- In the case of insurance groups, for example, identifying deficient governance, risk management and internal controls, and unnecessarily complex group structures, the FSB will be able to interact with senior management to understand and identify problems that the may not be apparent through off-site analysis;
- The FSB will have interactions with the board of directors of the insurance group, to adequately assess the extent to which they meet fit and proper requirements; and
- The FSB will identify activities that could potentially breach rules and regulations and take appropriate action.

The FSB will undertake on-site visits of groups on a coordinated basis.

Recommendation:

> The task group proposes that the supervisory approaches followed for solo supervision of insurers be extended for insurance groups. The FSB should clearly identify "group risks" that exist in addition to risk associated with solo entities. The FSB risk based framework should be appropriately adjusted for group supervision.
>
> The supervisory approach should also be proportionate to the nature, scale and complexity of insurance groups, i.e. risk-based. Continuous monitoring at group level by way of off-site analysis and on-site visits are also recommended as an extension of solo supervision.

10.5 Information Exchange, Cooperation and Coordination with other Supervisors

Information exchange with other supervisors

An important component of a well-structured group-wide supervision regime is the ability and authority to exchange key information between supervisors. The FSB has within its legislative framework the ability to cooperate and share information with supervisors from other jurisdictions through its established information gateways.
Additional mechanisms available to the FSB include Memorandums of Understanding, Multilateral Memorandums of Understanding and supervisory colleges[9].

IAIS principles

The principles highlighted under ICP3 are as follows:

- The supervisor must have the legal authority and power to obtain and exchange supervisory information in respect of legal entities and groups, including relevant non-regulated entities of such groups.
- The supervisor must have the legal authority and power, at its sole discretion and subject to appropriate safeguards, to exchange information with other relevant supervisors. The existence of an agreement or understanding on information exchange must not be a prerequisite for information exchange.
- The supervisor proactively exchanges material and relevant information with other supervisors. The supervisor informs other supervisors within their jurisdiction and the supervisors of group entities in other jurisdictions or sectors in advance of taking any action that it might reasonably consider will affect those group entities. Where prior notification is not possible the supervisor informs other relevant supervisors as soon as possible after taking action.
- The supervisor has a legitimate interest and a valid purpose related to the fulfillment of supervisory functions in seeking information from another supervisor.
- The supervisor assesses each request for information from another supervisor on a case by case basis.
- The supervisor responds in a timely and comprehensive manner when exchanging relevant information and in responding to requests from supervisors seeking information.
- Strict reciprocity in terms of the level, format and detailed characteristics of information exchange is not required by the supervisor.

[9] In general "the term supervisory colleges" refers to multilateral working groups of relevant supervisors that are formed for the collective purpose of enhancing effective consolidated supervision of a cross-border or cross-sector insurance group on an ongoing basis.

- Before exchanging confidential information, the supervisor ensures that the party receiving the information is bound by confidentiality requirements.
- The supervisor is generally willing to permit information exchanged by it to be passed on to other relevant supervisors or their bodies in the jurisdiction of the recipients that have the necessary confidentiality requirements.
- The supervisor receiving confidential information from another supervisor uses it only for the purposes specified in any request for that information. Any other use of the information, including exchanging it with other parties, is agreed by the originating supervisor prior to the use of that information.
- The supervisor and any individual acting for it (presently or in the past) involved in the receipt and exchange of confidential information is required by legislation to protect the confidentiality of such information. Wrongful disclosure of confidential information is subject to penalties.
- In the event that the supervisor is legally compelled to disclose confidential information it has received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to passing on is not given, the supervisor uses all reasonable means to resist such a demand or protect the confidentiality of the information.

Solvency II Level 1 text:

Within a group-wide supervisory framework within Solvency II, a permanent platform for cooperation and coordination should be dedicated to enhance the exchange of information among supervisory authorities involved. It should aim at facilitating exchange of information, views and assessments among supervisors in order to allow for a more efficient and effective group and solo supervision and timely action.

APRA

The prudential framework for insurance groups and conglomerates does not deal with information exchange with other supervisors.

Recommendation:

The task group proposes that for information exchange the drafter will incorporate the principles underlying ICP3 in either the current Long-term Insurance and Short-term Insurance Acts respectively or if more relevant within the FSB Act (where not already incorporated).

In addition the relevant MOUs and or MMOUs will be signed with relevant supervisors.

Cooperation and coordination with other supervisors

With the implementation of an insurance group supervisory regime it will be necessary to cooperate and coordinate with other supervisors on either a cross-border or cross-sector basis.

IAIS principles

The principles highlighted under ICP25 are as follows:

- The supervisor takes steps to put in place adequate coordination arrangements with involved supervisors on cross-border issues on a legal entity and a group-wide basis in order to facilitate comprehensive oversight of such legal entities and groups.

- Insurance supervisors cooperate and coordinate with relevant supervisors of other sectors as well as central banks and government ministries.
- Involved supervisors determine the needs for a group-wide supervisor and agree upon the supervisor to take that role (including a situation where a supervisory college is established).
- The designated group-wide supervisor takes the responsibility for initiating discussions on suitable coordination arrangements, including a supervisory college and to act as the key coordinator or chairman of the supervisory college, where it is established.
- The designated group-wide supervisor is able to understand the structure and operations of the group. Other involved supervisors understand the structure and operations of parts of the group at least to the extent they could affect the operations in their jurisdictions and how the operations in their jurisdictions may affect the group.
- Coordination agreements include effective procedures for information flows between involved supervisors on an ongoing basis and in emergency situations, for communication with the head of the group, for convening periodic meetings of involved supervisors and for the conduct of a comprehensive assessment of the group.
- There is appropriate flexibility in the establishment of a supervisory college – both when to establish and the form of its establishment – and other coordination mechanisms to reflect their particular role and functions.
- The designated group-wide supervisor establishes the key functions of supervisory colleges and other coordination mechanisms.
- The designated group-wide supervisor takes the appropriate lead in these responsibilities of group-wide supervision. A group-wide supervisor takes into account the assessment made by the legal entity supervisors as far as relevant.

Solvency II Level 1 text:

The Solvency II level 1 text, views supervisory cooperation and information exchange as necessary inputs to achieving effective group-wide supervision. Several key features are identified for the efficient operation of a supervisory college. These include:

- flexibility and appropriateness, reflecting the nature, scale and complexity of the insurance group;
- it should be a permanent feature of a group supervision regime;
- it should promote common understanding and agreement in its decision-making;
- it should facilitate mutual trust and confidence amongst its members;
- it should have in place formal information sharing and confidentiality agreements; and;
- it should be self-reviewing with a view to continuous improvement.

Solvency II assigns a key role to a group supervisor, whilst recognizing and maintaining an important role for the solo supervisor.

All insurance groups subject to group-wide supervision should have a group supervisor appointed from among the supervisory authorities involved. The rights and duties of the group supervisor should comprise appropriate coordination and decision-making powers.

APRA

The prudential framework for insurance groups and conglomerates does not deal with information exchange with other supervisors.

Current practices:

A working bilateral framework between the FSB and the BSD of the SARB is in place. With regard to major South African systemically significant financial services groups, either the FSB or the BSD serves as the lead regulator. The BSD serves as the lead regulator where the holding company of the insurance group is a banking entity or bank controlling company. Where the holding company is an insurance entity the lead regulator is the FSB.

The working framework is governed by a memorandum of understanding ("MoU") to initiate dialogue on issues not only relating to the major financial services groups but also other joint enforcement matters and other systemic issues.

The FSB also participates in international supervisory colleges where the lead supervisor is a foreign regulator and the FSB acts as the home supervisor.

Recommendation:

The task group proposes the following considerations in assessing who should be the group-wide supervisor for insurance groups with regard to cross-sector supervision:

The Registrar will be the default group-wide supervisor for all insurance groups in South Africa. The exception is financial conglomerates which includes banks where an insurer is not the controlling company. The BSD will serve as the group-wide supervisor in cases where a bank is the controlling company.

11. IMPACT OF THE APPROACHES ON EU 3RD COUNTRY EQUIVALENCE

Although Solvency II is being developed in the EU for EU insurers, the new regime will have ramifications for insurance companies [10]worldwide, including South-Africa.

In July 2010, CEIOPS issued Consultation Paper 81 (CP81) outlining its draft advice to the European Commission (EC) on Solvency II equivalence assessments for 3rd country supervisory regimes. After receiving feedback from the industry, CEIOPS issued its final advice in August 2010 which incorporated resolutions on the comments received.

In the final advice, CEIOPS provided guidance to the EC regarding which 3rd-country supervisory regimes should be included in the first wave of equivalence assessments. They were charged by the EC to first identify the 3rd-country jurisdictions where it would be most desirable to have an early determination on equivalency, before the introduction of Solvency II, based on their importance to the European insurance marketplace. CEIOPS then recommended which of the jurisdictions identified should be assessed in the first wave, after looking into the current state and proposed developments in the regulatory framework of each. CEIOPS recommended the regulatory regimes of Switzerland, Bermuda, Japan and the USA as important to the insurance markets of the EU for the first wave.

On 19 January 2011 the EC published the draft text of the Omnibus II Directive ("Directive"). The directive makes a number of proposed adjustments to the existing Solvency II directive, not least in the replacement of CEIOPS by European Insurance and Occupational Pensions Authority ("EIOPA").

[10] Insurance companies also include reinsurers.

With regard to 3rd country equivalence, the directive includes transitional arrangements for 3rd country regimes in order to provide them with sufficient time to adopt and implement an equivalent solvency regime. The transitional arrangements will therefore deem a 3rd country equivalent until assessed.

Under the Solvency II framework, regulatory regimes of 3rd countries will be assessed on two levels of equivalence:

- Group solvency calculation: ability to use local regulatory capital amounts in the Solvency II capital calculation; and
- Group supervision: reliance on the 3rd country for group supervision, i.e., European supervisors need only consider individual entities within their jurisdictions on a stand-alone basis

Holding company domiciled in Europe with a South-African subsidiary: Article 227: Group Solvency calculation

Article 227 of the Solvency II Directive refers to the group solvency of an undertaking which is a participating undertaking in a 3rd country insurance undertaking. The equivalence assessment applies solely for the purposes of the deduction and aggregation method under Article 233 (alternative method for the calculation of group solvency).

Equivalency for Solvency II will affect the aggregation of the capital requirements at group level. Equivalence for South-Africa would mean that the risk-based calculation under SAM could be consolidated directly into the Solvency II assessment of the aggregated group capital requirement. However, if equivalence is not granted this would not be possible. Rather, a Solvency II based calculation will have to be performed on the South-African business.

Holding company domiciled in South-Africa with European subsidiary: Article 260: Parent undertakings outside the EU

Article 260 of the Solvency II Directive refers to the assessment of equivalence of 3rd countries' group supervision. It is therefore essential to ensure before exempting a group from supervision at European level that the group supervision regime in the jurisdiction where the head of the group is situated is at least equivalent to Solvency II.

Any European subsidiary will need to calculate its stand-alone capital requirement using the Solvency II methodology regardless of the final decision on equivalency. However, the issue of equivalency may have an impact on the corporate structure and ultimate supervision of the subsidiary.

European supervisors have the power to require the establishment of a European insurance holding company to create a subgroup consisting of all entities domiciled in Europe. A lead European supervisor would then regulate this newly created sub-group and enforce a solvency capital requirement calculation for the group.

However, there may be benefits to establishing a European holding company for many multinational groups regardless of equivalence. Such a restructuring to form a group of related entities could create the opportunity to work with a unified group of supervisors with a single point of view, rather than having to deal with individual supervisors separately. It may also bring the potential for diversification benefits across European operations, thus reducing the overall group capital requirement.

Overarching principles relating to equivalence assessments

An overarching principle of SAM is that the proposed regime should achieve 3rd country equivalence. The assessment for equivalence will be an ongoing process and will be carried out with the objective of ensuring that South-Africa's solvency regime can demonstrate an equivalent level of policyholder and beneficiary protection.

The underlying criteria for meeting 3rd country equivalence is that the regulatory framework is fully risk-based. The equivalence assessment made by the EC will focus on the principles adopted by regulatory frameworks, rather than the parameters used in Solvency II - it is principles driven and is not simply a rules based box ticking exercise.

The assessment of whether the criteria used to assess 3rd country equivalence will be based on the substance of the requirements as well as how those requirements are implemented and enforced in practice.

The assessment will also take into account whether the supervisory system of the 3rd country also contributes to financial stability and a fair and stable market.

There are a number of overarching principles that will underpin equivalence assessments, and these are set out below:

- Equivalence assessments aim to determine whether the 3rd country supervisory system provides a similar level of policyholder/beneficiary protection;
- Supervisory cooperation & professional secrecy is a key, determinative element of a positive equivalence finding. CEIOPS will aim to ensure that appropriate professional secrecy and confidentiality requirements are in place;
- Equivalence is a flexible process based on principles and objectives. When pursuing the assessment of a specific principle and objective, a positive equivalence finding does not require that every indicator is fulfilled;
- Equivalence incorporates the proportionality principle. As such, a proportionality principle in the application of regulatory provisions in 3rd country jurisdictions (contingent upon the nature, scale and complexity of the risks inherent in the business) should not in itself be an obstacle or a prerequisite to the recognition of equivalence.

Summary of detailed principles

The table below sets out the detailed principles and objectives that 3rd country group supervisory regimes will be required to meet in order to be assessed as equivalent:

Principle	**Objective**
1.Powers and responsibilities of a group supervisor	Supervisors must be provided with the necessary means and have the relevant expertise, capacity and mandate to achieve the main objectives of supervision, namely the protection of policyholders and beneficiaries. Furthermore the supervisor must be fully empowered to enable the effective carrying out of its responsibilities. The supervisor must have a range of actions available, based on supervisory law, in order to apply appropriate enforcement or sanctions where problems in relation with the functioning of the group are identified. Supervisors of insurers within a group must be able to form a

	comprehensive view of the overall business strategy, financial position, legal and regulatory position and the risk exposure of the group as a whole which will enable supervisors to assess and react to the prudential situation of the group.
2.Group supervision	The supervisory regime should have a framework for determining which undertakings fall within the scope of supervision at group level.
3.Supervisory cooperation, exchange of information and professional secrecy	To ensure co-ordination, proper exchange and use of information between supervisors involved in the supervision of insurers.
4.Group solvency assessment	To ensure that the assessment of the financial position of the undertaking is based on sound economic principles. This implies in particular that all investments are managed in line with the prudent person principle approach, establish technical provisions with respect to all insurance obligations, that capital requirements are covered by own funds of sufficient quality. There should be sufficient information on the constitution of own funds to ensure that the group supervisor is able to apply the technical principles to the group solvency assessment. The calculation methods shall lead to a result at least equivalent to one of the two methods – consolidated method or deduction aggregation method.
5.System of governance	The supervisory regime shall require an effective system of governance across the group which provides for a sound and prudent management of the business. In particular, an adequate organisational structure with clear responsibilities and an effective system of ensuring the transmission of information should be an integral part of the system. The establishment and maintenance of adequate risk management, compliance, internal audit and actuarial functions is expected.
6.Business change assessment	To ensure the acceptability of any proposed changes to the business from an operational, management and supervisory perspective.
7. Supervisory colleges	Effective co-ordination and co-operation procedures, going beyond the simple exchange of information, are in place to facilitate group supervision.

Interim measures

The interim measures for insurance groups already pave the way in addressing most of the detailed principles.

Subsidiaries in Africa and other non EU subsidiaries

Where South African insurance groups have subsidiaries elsewhere in Africa or any non EU subsidiaries, the equivalence assessment will be on the basis of group supervision arrangements under SAM, rather than an assessment of the regulatory regime in each of those other jurisdictions.

Although members of the task group accept the above principles there are a number of practical issues that have been flagged and recorded in the issue log. These practical issues will be further researched and debated. The advice of BSD will also be sought in this regard as the same broad issue applies to African bank subsidiaries of SA banks. It is noted that the capital calculation and accounting of insurers is in some respects more complicated than banks.

Liaison with the European Commission (“EC”)

The FSB will liaise with the EC as to attaining a 3rd country equivalence assessment once substantial progress has been made in developing SAM.

Before liaising with the EC, the SAM regime will need to be assessed in respect of the overarching principles that will underpin equivalence assessments. These principles will have to be tested on the full SAM supervisory regime which goes further than just insurance group supervision.

There is no reason at this stage to believe that SAM will not meet the overarching principles that will underpin equivalence assessments.

12. THE WAY FORWARD TO THE FINAL MEASURES

The task group will need to revisit the interim measures and adopt the work done by the different task groups within the SAM structures to produce final measures for insurance groups. The task group will also conduct research regarding the following principles:

- Group Internal models: where there might be diversification of risks across insurance licences and insurance groups seeking to reduce regulatory capital as a result;
- Group risks that need to be appropriately included in the consideration of group regulatory capital;
- Diversification and capital reduction in the context of the deduction and aggregation method versus the accounting consolidation method;
- Third country equivalence with regard to Insurance groups;
- The detailed CEIOPS reporting templates and insurance group risk concentrations and inter group transactions and their potential impact on risk based capital; and
- Group structures.

13. CONCLUSION

In its effort to ensure that its regulatory and supervisory regime is aligned with international standards, the FSB continuously needs to monitor international developments. In addition to the interim proposals, the task group will undertake additional work streams focused on developing the final SAM measures in respect of Insurance groups.

Although the proposals advanced in this paper reflect the task group’s current proposals on implementing a group-wide supervisory regime, there are a number of issues that are still being debated in the international arena that warrant careful consideration. Flexibility is thus required to ensure consistency with international regulatory best practice.

Ultimately, the FSB proposes to adopt group-wide supervision regime through the enactment of primary and subordinate legislation. The legislation should provide the necessary certainty and transparency with regard to the issues that have been highlighted in this paper.