# South Africa: Insurance Industry Update

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## Introduction

The first half of 2022 has seen a wide spectrum of changes. From the lifting of the State of Disaster after over two years to rating agencies' upgrade of outlooks for many banks and insurance companies in South Africa. Not all the news on banks and insurers is positive, though.

In this update, we discuss some of the issues encountered in the South African insurance industry over the first half of 2022 and highlight certain regulatory changes and their implications on your business.

## The impact of climate change on investment choices

The US Securities and Exchange Commission (SEC) proposed earlier this year that US-listed companies disclose their climate-related risks and greenhouse gas emissions in public reports. Locally, Standard Bank Group Limited recently announced its pledge to raise ZAR 300 billion by 2026 to help fund renewable energy products. This is only one of several large multinational financial firms to convey its dedication to reducing its carbon footprint in an effort to battle the ongoing climate crisis. When we think of climate change and the associated risks, we often account for physical and long-term risks, such as floods, hurricanes and rising sea levels. That being said, this kind of pledge highlights that the transition risks associated with climate change are not to be underrated.

The transition risks referred to are often those associated with the increasing focus on and determination to achieve a low-carbon, sustainable and green economy to reduce the rate of climate change (or reverse it altogether). Due to changes in public attitude toward certain economic sectors, particularly those known for being heavily reliant on fossil fuels and/or with substantial carbon footprints, the values of assets are likely to change as greater emphasis is placed on renewable energy products. Invested asset classes can be subdivided to identify energy-intensive, fossil fuel-dependent investments, to inform changes in your company's investment strategy.

Transition risk can be inversely related to physical risk, as increasing transition action taken in the short to medium term could lead to lower future physical risks. Acting now can mitigate future physical risks for insurers' own physical assets and investments, align values and actions with Gen Z and others' increasingly clear views on climate responsibility and better protect policyholders' retirement savings for years to come.

The Milliman white paper "Climate risk management opportunities for life insurers" will help you to think about how you could safeguard your business against transition risks and climate change.

## Physical risks from climate change hitting profit and solvency

Globally, climate change has presented itself in the form of extremely cold winters in certain parts of the Northern Hemisphere, as evident by the 17-day power outages experienced in Texas in February last year. More recently, Spain has suffered a record-breaking heat wave, with temperatures exceeding 40 degrees Celsius.

Closer to home, and just over a year after tropical cyclone Eloise wrought havoc over Mozambique's coastline, certain parts of KwaZulu-Natal (KZN) have experienced extreme flooding—twice. These climate change-driven events are expected to increase, in frequency and severity, as the world faces the consequences of decades of unbounded economic growth.

The KZN floods have highlighted the concentration risks of some insurers and reinsurers in South Africa, hitting policies of both personal lines and commercial lines. In addition to the damage to physical property, motor vehicles and contents, insurers found themselves tapping into, and in some cases exhausting, their reinsurance covers for products such as business interruption.

Suppliers of materials needed for indemnity purposes are likely to experience a demand shock as various insurers (and the uninsured) scramble to purchase the materials to recover lost possessions. This added strain to the already stumbling global supply chain involving various vehicle components is likely to result in increasing delays.

## Banking curatorship to add to an eventful insurance curatorship

Ubank is only the fourth South African bank to be put under curatorship in almost two decades. This statistic contrasts against a string of failures in the 1990s to 2002.

In the past, the government took actions that could be viewed as implicitly guaranteeing small retail deposits, ensuring that small depositors in failed banks (such as VBS Mutual Bank in 2018, Saambou in 2002 or Regal Treasury Private Bank in 2001) were paid out. South Africa has, until now, been the only Group of 20 country without an explicit deposit guarantee scheme.

The South African Reserve Bank (SARB) is working to establish the new Corporation for Deposit Insurance (CODI), which will be funded by levies from South Africa's licensed banks, all of which will be required to be members of the CODI. The SARB has committed to funding the CODI's incorporation, predicted to last about five years, but it is likely to take decades to build up the reserves that would be needed to pay out depositors in the event of a big bank failure.

A commitment to funding a protection scheme is different from actually achieving and sustaining it in the medium term. Bank and insurer protection funds have been pillaged in other markets before for other ostensibly good reasons, but with the same result of underfunded protection schemes.

The SARB has recently revealed its plans to redesign the market's and public's notions surrounding bank failures and bailouts. It proposed so-called "bail-ins," whereby holders of debt issued by a failing bank will have their debt converted into equity, thereby buying into the failing bank's future and reducing the failing bank's debt. This, the SARB believes, will reduce expectations of a central bank bailout and reassure the public that deposits with any bank, whether big or small, are always safe, even in the case of a bank failure. Depositors will no longer see themselves as lower-ranking liabilities relative to larger creditors with more bargaining power and this may, in turn, potentially reduce the possibility of bank runs further.

## Yield curve disruptions

The SARB has also noted its concerns surrounding the low level of liquidity in the government bond market. This low level of trading results in high borrowing costs for the government as well as volatile prices when trades do occur.

Government bond auctions often involve primary dealers, whose responsibility is to make and create a market in government bonds. The low levels of liquidity in the government bond market may indicate to the bank (and other market participants) that those primary dealers have reduced capacity to make and create markets in the government bond market.

Insurers have experienced some knock-on effects through disruptions and unusual kinks in the Prudential Authority (PA) yield curve used for regulatory and sometimes International Financial Reporting Standards (IFRS) valuations. Small changes in the set of bonds included in the construction of the yield curve can have drastic impacts.

As a result, insurers are thinking more carefully about the yield curve to be used for IFRS17 reporting.

## COVID-19 waves and assumption changes

Insurers reporting December results have shown significant impacts from the effects of COVID-19 during 2021, but with those impacts a range of generally far more modest provisions and expectations for additional claims in future were published.

Practice still varies widely, including that related to projecting multiple further waves, simple endemic allowances or further allowances (if any). Anecdotal evidence supports the idea that, with higher sums assured, underwritten products may still be experiencing elevated claims, whereas funeral products with lower sums assured seem to have mostly returned to pre-COVID-19 levels of mortality.

After several insurers increased funeral premiums and group life premiums significantly over the last 36 months, changes to underwritten premium rates have been more cautious. Some insurers have effected an average increase by increasing new business rates for unvaccinated policyholders only.

## Recent regulatory developments

The PA issued several "observations," surveys and changes to the regulatory reporting templates.

### SUPERVISORY OBSERVATION: REGULATORY BALANCE SHEET (JANUARY 2022)

A supervisory observation is issued when the PA observes certain trends within the sector and identifies a need for further information and expansion.

The practical status of these observations seems to be uncertain. While the PA has been clear that they are only "observations" and have no power of law, several insurers and actuaries have commented that it is difficult to convince a Head of Actuarial Function or an external audit that any existing practice, where it differs from that outlined in the PA's supervisory observation, can continue.

### Encumbered assets

A Financial Soundness Standards for Insurers (FSI) Technical Supervisory Observation was first issued last year covering the topic of encumbered assets. This resulted in more insurers applying for approval to hold encumbered assets. In some cases, the encumbrance of assets can be the difference between a solvent and an insolvent position. Common encumbered assets include lease right of use assets and collateral, although collateral arrangements arise in many forms and, for many transactions (including repos and scrip lending), the potential for different solvency and liquidity implications arises.

### SAM Own Funds vs. IFRS NAV

The PA has now added a second technical observation: "The Regulatory Balance Sheet." In this observation, the PA discusses that subordinated liabilities and foreseeable dividends are the only two potential reasons why net asset value (NAV), i.e., assets less liabilities, would not equal Basic Own Funds (BOF) for the regulatory balance sheet as reported on sheet OF2 of the regulatory quantitative reporting templates (QRTs). Any other reason for a difference indicates a potential error. Conversely, in the presence of foreseeable dividends or subordinated liabilities and where regulatory NAV equals BOF, this also indicates an error or problem.

### Subordinated liabilities

Subordinated liabilities are reported in the liability section of both the IFRS and Solvency Assessment and Management (SAM) balance sheet. However, subordinated liabilities are excluded as a liability when eligible and, therefore, increase SAM BOF above IFRS NAV.

### Foreseeable dividends

A dividend is foreseeable at the latest when it is declared or approved by the board of directors, regardless of any requirement for formal approval at an annual general meeting (according to FSI 1 Attachment 1).

The PA expects insurers to reasonably foresee or estimate what their dividend payments could be, at least by the submission date of the reporting templates, based on aspects such as dividend policy, experience, judgement and prevailing conditions.

The foreseeable dividends amount will be reported in the asset section of both the regulatory and IFRS balance sheets, as they represent cash or another asset to be distributed. The foreseeable dividends should also be reported under SAM BOF by excluding them from the retained earnings' line. Therefore, in the presence of foreseeable dividends, NAV should not equal BOF under the SAM balance sheet view.

For many insurers paying dividends, the dividend will be foreseeable by the time the annual QRT is submitted. We have seen mixed practices in this regard, but the PA's expectation seems to be for more insurers to be deducting foreseeable dividends in their returns. Foreseeable dividends can also be a meaningful difference between the quarterly and annual QRTs submitted for the same valuation date.

Insurers may choose to report their Solvency Capital Requirement (SCR) cover ratios before and after foreseeable dividends to provide comparability to prior reporting.

## AMENDMENTS TO THE QUARTERLY AND ANNUAL QRTS FOR INSURERS (FEBRUARY 2022)

The PA has released new versions of the annual and quarterly QRTs for insurers. These are effective for all reporting periods from 1 January 2022.

### Quarterly operational risk loss reporting

Currently, operational risk loss events are reported annually to the PA through the SCR4.1 sheet of the annual QRT. The PA is concerned that the time lag between operational loss events and reporting in the annual QRT poses a challenge for the PA to monitor adverse operational risk event trends across supervised insurers.

The PA has, therefore, moved the SCR4.1 sheet from the annual QRT to the quarterly QRT to enable more frequent reporting and monitoring. The PA has also made some refinements, including removing certain fields from the SCR4.1 sheet.

### Capital add-on line item

The PA has added a line to the SCR tab of both the new annual and quarterly QRTs for a capital add-on.

As per Section 37 of the Insurance Act, the PA may impose a capital add-on where the risk profile of the insurer deviates significantly from the assumptions underlying the SCR standard formula, or where the governance framework deviates significantly from the requirements of the Insurance Act.

It is unclear whether any capital add-ons are currently being imposed or if the PA is future-proofing the QRTs. In Europe, national regulators have set capital add-ons for nine solo insurers out of 2,447 in 2020.[1] Two of them were for governance deficiencies and seven for risk profile deviations from the standard formula. Curiously, the capital add-on as a percentage of total SCR ranged from 1% to 86%, with a weighted average of 25%.

[1] EIOPA. Report on the Use of Capital Add-ons During 2020. Retrieved 3 June 2022 from https://www.eiopa.europa.eu/sites/default/files/publications/reports/report-on-the-use-of-capital-add-ons-in-2020_final_0.pdf.

### Line items for approved noninsurance business

The OF2 sheet now includes a line for liabilities related to approved noninsurance business, and the OF4 sheet includes line items for income and expenses related to approved noninsurance business. These changes have been made to both the quarterly and annual QRTs.

In our experience the PA has taken a fairly narrow view of what is considered "insurance business" and therefore often required approvals for "noninsurance business." This change to the QRT supports the idea that many insurers are needing to report components related to noninsurance business.

Even if the last two items are not relevant to your company, you may need to adjust your underlying workbooks given that additional line items (i.e., rows) have been inserted into the respective QRT sheets.

### FINAL AUDIT STANDARDS (DECEMBER 2021)

The PA has published the final Prudential Standards on audit requirements for all insurance entities. The standards set out the information that entities must have audited, reviewed and reported on by their auditors. The Guidance Notice on Audit Requirements (AR GN) provides references to the sections of the annual QRT that should be audited or reviewed. There are no notable changes from the draft standards and guidance note.

## How Milliman can help

If you would like to discuss any of the above, or anything else with us, then please contact us. Milliman can provide a range of services including:

- Insurance strategy on reopening closed lines of business, or expanding into new markets
- Dealing with regulatory change and approvals
- Product performance reviews and changes in light of COVID-19 lessons
- Solo and Group Head of Actuarial Function
- Independent review of actuarial and risk functions
- Own risk and solvency assessment (ORSA) and risk management maturity reviews
- Licence conversion and application assistance
- IFRS17 implementation and advice

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