South Africa: Insurance industry update

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IN THIS UPDATE:

- Regulatory developments
- Climate scenarios
- Group solvency challenges in non-equivalent countries
- How are the global insurance disruptors doing?

Introduction

In October 2024, Milliman hosted an Industry Update Breakfast with nine participants from the South African insurance industry. The discussions centred on regulatory developments, climate scenarios, group solvency challenges, and insurance disruptors. In this issue of the Milliman Insurance Industry Update, we take a closer look at the topics discussed and highlight some of the key takeaways from the conversations had.

The discussion was conducted under Chatham House rules (i.e., comments are anonymous and non-attributable). We would like to thank those who took part for their time and contributions.

If you want to receive our Industry Update or would like to participate in future discussions, please reach out to us on africa@milliman.com.

Regulatory developments

Local regulatory developments have often been influenced by changes that have occurred abroad. Below we take a closer look at a selection of regulatory developments happening globally, and what is on the radar locally.

PRUDENTIAL

There has been significant activity in Europe with proposed amendments to Solvency II following the comprehensive Solvency II 2020 review. Taking advantage of Brexit, the UK has been busy rolling out Solvency UK, which is based on Solvency II with a handful of adjustments. Please see our presentation at ASSA's Life Assurance Seminar in May 2024 for further detail.

As Solvency Assessment and Management (SAM) was originally based on Solvency II, these recent Europe and UK developments may indicate the direction of future changes to SAM. For now, useful industry discussions and guidance are being led by ASSA's SAM Phase 2 subcommittee.

The Prudential Authority (PA) has also been actively engaging with the industry regarding additional liquidity reporting for insurers. While no implementation date has been set, insurers are advised to evaluate their liquidity risk management frameworks and assess their readiness for more onerous, more frequent stress testing.

CONDUCT

The Conduct of Financial Institutions (COFI) bill has been in the works for several years in South Africa. The Financial Sector Conduct Authority (FSCA) is supporting National Treasury in finalising the bill for parliament, with engagements with the Transition Working Group planned to start in 2025.

The UK has adopted an outcomes-based approach to conduct through the Consumer Duty implemented last year. The aim of this new Consumer Duty was to set higher and clearer standards for consumer protection.

Please see Milliman's recent report on market conduct for a detailed discussion of trends in customer treatment regulation around the globe.

OPERATIONAL/ORGANISATIONAL RESILIENCE

Operational resilience has been a significant focus for regulators in the UK and EU.

In the UK, firms are expected to have identified their important business services, set impact tolerances for these services, and have plans in place to remain within these tolerances by March 2025.

Locally, the PA has focused on the broader topic of organisational resilience, which includes operational resilience as well as other areas such as technology resilience and strategic resilience.

Recent regulatory releases include the Joint Standards on Cybersecurity and Cyber Resilience; IT Governance and Risk Management; and Outsourcing. Please refer to our August 2024 Insurance Update for more detail.

CLIMATE

Climate change has been a large focus again for the PA in 2024. Earlier this year, the PA released guidance notes on climate-related governance and risk practices for insurers as well as climate-related disclosures for insurers.

While not compulsory for insurers to adhere to, a lack of action could force the PA to implement mandatory regulations.

Please refer to our August 2024 Insurance Update for more detail.

Participants discussed how the climate change guidance issued by the PA has assisted insurers in giving them a starting point for managing this complex risk. Mention was also made of how more insightful and detailed industry feedback would be useful for insurers to compare themselves to the market.

PARAMETRIC/INDEX INSURANCE

Parametric insurance, also known as index insurance, provides cover based on a pre-agreed set of conditions or triggers rather than indemnification for actual losses. For example, it can provide drought protection to farmers by making an immediate payout when measured soil moisture falls below a certain predetermined level.

Index-based insurance offers numerous advantages, including reduced underwriting costs at both initial and claims stages, minimal fraud risk, transparent and objective payout conditions, and rapid claims settlements that bypass traditional loss assessments. The structure also reduces moral hazard because payouts are independent of policyholder actions. The objective nature of index triggers makes these products more attractive to reinsurers.

However, because these products don't directly compensate policyholders for actual losses, they may not qualify as “insurance” from a regulatory perspective in certain markets, including South Africa.

Since the 1990s, index-based insurance has evolved and expanded globally – especially in emerging markets. Locally, South Africa has been slower to embrace this alternative insurance product. In 2020, the PA allowed an insurer to test a weather index-based product in the Intergovernmental Fintech Working Group’s regulatory sandbox.

The PA recently approved an interim approach where, subject to PA approval, insurers can offer weather index-based products under the classification of “*business other than insurance business*.” This requires specific approval, and you can expect to be required to still calculate capital requirements in line with a relevant insurance class of business.

We recommend the *Parametric insurance to build financial resilience* report by Generali and the United Nations Development Programme (UNDP) for a comprehensive introductory read on index-based insurance.

Climate scenarios

We recently conducted a climate benchmarking survey with 15 (re)insurance participants from the local market. The results revealed that 60% of respondents are already performing climate scenario analysis, with most employing both quantitative and qualitative methods.

Different approaches, including bottom-up and top-down methods, are necessary for exploring climate scenarios. However, to date, much of the focus has been on bottom-up, long-term climate scenarios. Insurers must recognise that climate risk represents a long-term structural change but also an increased opportunity for short-term uncertainty, given the cross-cutting, systemic, and evolving nature of climate-related risk.

Some insurers have adopted industry climate pathways as a starting point for their own scenario analysis, such as those from the Network for Greening the Financial System (NGFS) and similar Integrated Assessment Models (IAM)-based models. While these scenarios have faced criticism due to gaps and under-calibrations, amongst other factors, participants agreed that they can serve as a useful foundation for getting started on this daunting task. However, participants also commented on the difficulty in translating these scientific pathways into impacts on insurers.

Earlier this year the Institute and Faculty of Actuaries (IFoA) issued a risk alert on climate change scenario analysis, highlighting the danger of systematically underestimating climate-related risks when insurers use identical industry climate scenarios. The alert also stresses the importance of actuaries clearly communicating the limitations and uncertainties of climate scenarios to decision-makers to ensure correct interpretation of results.

The complexities and uncertainties of climate change necessitate insurer-specific scenarios that carefully consider possible impacts on the business. However, participants commented that achieving internal consensus on what the impacts of climate change for your business could look like is challenging.

Climate scenarios specific to your business should not be a one-time, or annual-only, consideration. Regularly discussing plausible climate futures from a top-down perspective at a board level allows members to evaluate the potential effects of climate events on the business and identify the scenarios that are worth considering in more detail using a bottom-up approach.

Participants thought one potential solution to the challenges posed could be the formulation of climate scenarios involving pooled resources across the industry to develop climate scenarios specific for the South African context. This collaborative approach could be more efficient than each insurer independently dedicating resources to this complex issue. However, the importance of adapting any industry scenarios to your specific business structure and strategy remains.

Group solvency challenges in nonequivalent countries

The financial soundness standards for insurance groups (FSGs) require all insurance participations of a controlling company to be included in the scope of group capital adequacy calculations, regardless of materiality.

Challenges arise for groups in calculating a Solvency Capital Requirement (SCR) when they have participations outside of South Africa.

For a non-South African insurer regulated in a non-equivalent jurisdiction, the financial soundness standards for insurers (FSIs) must be applied to determine the insurer's SCR.

The requirement to apply the FSIs to insurers in non-equivalent jurisdictions stems largely from the applicable local regulations resulting in capital requirements that are significantly lower than if regulations consistent with the FSIs were applied. However, applying the FSIs to these insurers may result in unexpectedly large capital requirements for group reporting purposes.

PREMIUM AND RESERVE RISK FACTORS (NON-LIFE)

In calculating the non-life premium and reserve risk capital requirement, the standard deviations prescribed in the FSIs are calibrated to the South African market. The application of these parameters to determine the premium and reserve risk capital requirements to an insurer in a non-equivalent jurisdiction may be inappropriate. Examples include motor third-party liability, which is excluded motor cover in South Africa but is typically included in other markets – this may mean that the reserve risk and/or premium risk volatility factors may be understated.

CATASTROPHE RISK (NON-LIFE)

The FSIs require the catastrophe risk capital requirement to calculate the risk charge for exposures outside of South Africa using method 2 (factor-based), the more conservative method a South African insurer would be required to use in lieu of the required granular data to use the standard method 1. This requirement means insurers in non-equivalent jurisdictions are required to hold a higher catastrophe risk capital requirement compared to if method 1 (or its equivalent) was used.

RISK MITIGATION FOR NON-EQUIVALENT REINSURERS

The FSIs only allow for eligible risk mitigation instruments to be allowed for in calculating an entity's SCR. One of the requirements for eligible reinsurance is for the counterparty to a reinsurance contract to be regulated by the PA or by a jurisdiction considered by the PA to be equivalent.

This requirement can result in large parts of reinsurance programs being deemed ineligible as per the FSIs.

Furthermore, several non-equivalent jurisdictions require insurers to comply with compulsory local reinsurance arrangements. These reinsurance arrangements are often with in-country government-owned entities and are commonly ineligible per the FSIs.

CURRENCY SHOCK

All currencies other than the South African Rand are required to be treated as foreign currencies, per the FSIs.

From a group perspective, this could appear sensible because the entity is based in South Africa and the group is exposed to adverse exchange rate movements against currencies other than the Rand. A mitigating impact however is that the currency shock should be applied to both the assets and liabilities of the insurer.

SPREAD AND DEFAULT RISK ON IN-COUNTRY GOVERNMENT BONDS

The FSIs only allow for South African government exposures (denominated in Rands) to be excluded from spread and default risk. This view of the FSIs means in-country government exposures in non-equivalent jurisdictions attract both a spread and a concentration risk charge.

One participant raised the point that the group SCR can reflect an artificial measure of capital for the group.

CONCLUSION

Group solvency calculations for insurers domiciled in non-equivalent jurisdictions currently result in unexpectedly high capital requirements.

An intriguing possible future development in group solvency reporting could be to allow for insurers in non-equivalent jurisdictions to apply their local capital requirements if they have been calculated in line with Insurance Capital Standards (ICS), as these standards address some of the misalignments considered above.

How are the global insurance disruptors doing?

The insurance industry is viewed by some as being slow to innovate and rife with opportunity for disruption. Areas targeted for transformation span customer acquisition and selection, underwriting and pricing, fraud reduction, customer-insurer alignment, operational efficiency, and claims processing.

This perception has attracted significant investment and entrepreneurial attention over recent years, with several companies attempting to reshape traditional insurance models through technology-driven approaches.

EMERGING THEMES AND MARKET DYNAMICS

The trajectory of insurance disruptors has revealed several key patterns. Many have achieved impressive initial growth through digital-first approaches and innovative customer experiences. Some of this involves the ubiquitous label “artificial intelligence (AI),” and some of this involves actual application of AI.

However, the path to sustainable, profitable operations has proven more complex than initially anticipated.

Common challenges have emerged across different ventures:

- **Customer acquisition costs**: Despite strong initial growth, many disruptors have faced significant expenses in acquiring and retaining customers. It may be that the customers most attracted to innovative or digital-first offerings are not the most attractive customers, at least in some cases.
- **Scale and profitability**: While some have achieved remarkable growth rates, reaching profitable scale compared to established market leaders has proven challenging. The difficulty in retaining good customers while pruning unprofitable customers is a lesson destined to be re-learnt every few years for some insurer in some market.
- **Competitive response**: Traditional insurers have demonstrated adaptability by enhancing their digital capabilities and user experience. Despite the complexity of legacy systems many insurers face, it remains easier to improve a process or customer interaction than it is to build an entirely new insurer and customer base.
- **Regulatory navigation**: Complex insurance regulations continue to act as a significant factor in market entry and ongoing operations. The protection offered to incumbents of a complex regulatory environment can act as a barrier to entry. To an extent this can be the cause of slow innovation within the industry, but it remains a powerful barrier to new entrants.

THE MARKET EVOLUTION

These challenges have shaped how insurance technology ventures have adapted their strategies and business models. What began as a wave of pure disruption has given way to a more pragmatic search for sustainable business models.

Several trends have emerged:

- **Strategic consolidation**: Some disruptors are pursuing scale through strategic acquisitions and market expansion. Scale is needed, but diversification can lead to a loss of focus and a dilution of original core propositions. This search for scale is an inevitable path for many of the developed world insurance markets that are mature.
- **Process innovation focus**: Successful innovations often focus on improving specific processes rather than completely reimagining the insurance paradigm. This likely remains as a significant opportunity for traditional insurers.
- **Distribution evolution**: The value chain is seeing shifts in how distribution channels operate and capture value. Many disruptors have become distributors rather than fully fledged insurers. The underlying products, and even underwriting, are still often an undifferentiated commodity. Inevitably, where products become commoditised, the share of value captured by product providers will decrease.

LOOKING FORWARD

The evolution of insurance disruptors has demonstrated that revolutionary change requires more than bold innovation alone. Success appears to lie in questioning entrenched practices enough to drive meaningful change, while not dismissing the hard-won lessons about building sustainable customer bases and managing risk that have helped insurance markets navigate decades of uncertainty.

Success appears to rely on balancing innovation with fundamental insurance principles:

1. Scale and operational efficiency remain critical success factors
2. Process improvements can deliver significant value even without paradigm shifts
3. Digital distribution, while important, is not a complete solution on its own
4. Regulatory expertise and compliance capabilities cannot be an afterthought

The journey of insurance disruptors has helped accelerate innovation across the industry, prompting both established players and new entrants to reconsider how they can better serve their customers while building sustainable business models.

The question remains, who will make the most of these lessons in driving sustainable growth?

How Milliman can help

- Dealing with regulatory change and approvals
- Determining or reviewing group capital requirements
- Iterative Risk Margin implementation, review, and applications to the PA
- Modelling of life insurance claim variability to inform reinsurance requirements
- Climate risk management support, including the development of decision-useful climate scenarios
- Independent views and reviews of Heads of Actuarial Function, Own Risk and Solvency Assessments (ORSAs), policies, first-line actuarial processes, and for Section 50 transfers
- Analysing non-life claims volatility and assessing potential for insurer-specific parameters (ISPs) to lower capital, or alignment of International Financial Reporting Standard 17 (IFRS17) risk adjustment, SAM standard formula, and actual claims volatility
- Implementation of tried and tested methods for managing complex and emerging risks
- Conversion of Excel spreadsheets into powerful, cloud-based models with all the features of alternative proprietary software using Milliman Mind
- Review of product management, including performance, distribution and retention, risk, Treating Customers Fairly (TCF), and premium reviews

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