South Africa: Insurance industry update

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Introduction

The year 2023 wasn't an easy one. It has now been confirmed as the hottest year on record. Globally, earthquakes, fires and storms resulted in 74,000 deaths and extensive insured and uninsured property damage. Escalating military conflicts and disruptions to Red Sea maritime trade threatened to turn back progress in restoring supply chain predictability.

New variants of COVID-19 raised the threat of a 'tripledemic,' at least in the Northern Hemisphere with COVID-19, influenza and RSV coinciding during winter conditions. This is likely the new normal state of affairs and did not result in large spikes in deaths over typical seasonal patterns.

In South Africa, insurers are struggling to persuade employees back to the office even as they push for electricity independence from Eskom in order to keep those office lights on.

Insurance executives, taking a break from dealing with IFRS 17 reporting and diesel costs, might be thinking about the progress in National Health Insurance (NHI) legislation approval, new political parties, disruption from 2024 election promises and possibly more disruptive 2024 election results.

Increasing failures of port, rail and road infrastructure won't provide a respite from difficult economic conditions and high unemployment. Insurers, particularly in the underwritten life product space, are being squeezed between low margins and low volumes. Funeral product providers, outside of the bancassurance space, face

continued pressure, resulting in merger and acquisition (M&A) activities to find scale or sales effectiveness.

Insurers are excited about the opportunities from artificial intelligence (AI) and machine learning. Many have been exploring new tools, including large language models (LLMs), chatbots, simplified underwriting processes, fraud identification and claims-stage underwriting. The introduction of new tools, e.g., Python in Excel and Microsoft Copilot, open new avenues to efficiencies for insurers, whilst raising questions of who has the skills to check, maintain and provide assurance over these new technologies.

We expect 2024 to be a year of settling into new reporting, adjusted political realities, a slowly changing competitive landscape and some internal changes to insurers' operating models. Insurers which made changes to product and pricing in 2023 will want to see how customers respond before planning major additional changes in 2024.

As the air clears after the elections (there are 64 planned globally, covering 49% of the population and including neighbours and influential countries like the US, the UK, India and the EU), we expect to see some bolder strategic steps.

The industry as a whole maintains its robustness, solvency and liquidity. In 2023, fortunately, no new curatorships emerged, although some persist, mired in legal battles. Here's to hoping that 2024 proves to be a positive year for the South African insurance sector.

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Product, performance and embedded value (EV) in an IFRS 17 world

Milliman South Africa hosted a webinar on 27 October 2023 entitled 'Product, Performance and EV in an IFRS 17 World.' A

brief bullet-point summary of some key areas discussed is included below.

Key areas of subjectivity giving rise to differences include:

- Choice of coverage units and discounting thereof
- Risk adjustment methodology and calibration
- Grouping, onerous contract definitions and product cross-subsidies
- Expense attribution and spreading of acquisition expenses
- Choice to use other comprehensive income

Reconciling IFRS 17 NAV to EV can be complex. Important adjustments to consider include:

- Contractual service margin (CSM), including removing the tax on this CSM
- Non-attributable expenses
- Risk adjustment vs risk discount rate and cost of required capital
- Short contract boundary business
- Non-insurance business
- Intangibles

Similarly, adjustments when reconciling between SAM own funds and EV include:

- SAM risk margin vs EV cost of required capital
- Short contract boundary business
- Non-insurance business

Concluding remarks:

- EV will likely still be produced for many South Africa life insurers for at least 2 to 3 years.
- Listed insurers may be de-rated by analysts and the market.
- There will be only a limited product impact in the short term, but eventually the change in measures will change incentives and management focus. This in turn will result in changes in products to optimise for value (or management remuneration) in line with new measurement standards.
- EV will be even more important for M&A as a consistent and coherent measure of value.
- Determination of non-attributable expenses will remain a contentious issue indefinitely.

For access to the full webinar recording, please reach out to africa@milliman.com.

Levelling the playing field: Increasing microinsurance waiting periods

The Financial Sector Conduct Authority (FSCA) published a draft exemption notice. In this notice they propose to provide microinsurers with an exemption from Rule 2A.6.1 of the Policyholder Protection Rules (Long-Term Insurance), 2017 (LT PPRs).

This rule limits the waiting period for a microinsurance policy to the shorter of either one-quarter of the term of the policy, or 6 months. In isolation, this rule would allow a microinsurer to impose a 6-month waiting period if the term of the policy is 2 years or longer. However, Rule 2A.4.1 restricts the term of microinsurance policies to 12 months. Ultimately, this implies that microinsurers can only impose a maximum waiting period of 3 months, whilst traditional insurers can offer funeral policies with a 6-month waiting period.

The proposed exemption is subject to the condition that microinsurers can only impose a maximum waiting period of 6 months, which will match the flexibility that traditional insurers have.

Lower premiums are a key selling point in the lower income market at which microinsurance policies are targeted towards. Longer waiting periods reduce adverse selection and all early duration claims. This may allow traditional insurers to lower their premiums, which may give traditional insurers a competitive advantage as they can impose longer waiting periods for funeral policies.

This outcome is better than the current approach of providing exemptions to individual microinsurers on a case-by-case basis. This may have contributed to an uneven playing field, confusion of customers, and concentrated adverse selection and fraud for the microinsurers that remained on the 3-month waiting period.

Overall, implementing this exemption will better align the regulatory framework to promote market development and competition. The LT PPRs will need to be amended to implement a longer-term solution, but as explained in the FSCA Three-Year Regulation Plan, the FSCA will refrain from altering the LT PPRs for now.

AI applications and model failures

Among the endless and exciting possible applications of AI comes an alarming class action complaint against UnitedHealthcare, the largest insurance company in the United States. The complaint alleges that the insurer is deliberately misusing an AI model with a staggering 90% error rate to wrongfully deny critical health care to elderly patients.

While the adoption of AI, particularly LLMs like ChatGPT, has become prevalent in the insurance industry for tasks such as claims processing and customer interactions, it's crucial to acknowledge the technology's nuances. AI, when prompted by users, may generate content which is incorrect, biased or discriminatory.

ChatGPT, among other LLMs, features disclaimers which highlight these challenges, emphasising the need for responsible usage. Recognising the potential risks, insurers are taking proactive steps to ensure the safe deployment of AI.

It's imperative for insurers to be transparent about the capabilities and limitations of AI, actively addressing concerns related to confidentiality and data security. By implementing robust measures to ring-fence AI usage, the industry aims to harness the benefits of technology whilst prioritising the safeguarding of sensitive information.

Despite the negatives, there are many lively discussions into how AI can be used, particularly in repetitive, mundane, time-consuming, manual work easily susceptible to human error. A recent paper presented at the Actuarial Society of South Africa Convention has highlighted an area already being explored in compliance in how ChatGPT can be used to identify and summarise emerging risks by scanning various online sources. Sparking similar interest, questions are also being asked around how AI can continuously monitor the regulatory environment and send relevant summarised updates to actuaries, bringing more efficiency to the workplace.

In other news, LLMs can be used at every stage of the claim process for a non-life motor insurance claim. This is from extracting information, populating claim reports and routing them to the appropriate team. They can also produce structured reports for adjusters to review, cross-check submitted claims against policy terms and conditions, and help spot errors or fraudulent claims before routing claims to an automated payment process.

Understanding the consequences of FICA and POPIA violations

The Financial Intelligence Centre Act (FICA) of 2001 and the Protection of Personal Information Act (POPIA) of 2013 were enacted to safeguard the interests of customers and promote business integrity within financial institutions.

The Prudential Authority (PA) is responsible for the anti-money laundering and countering the financing of terrorism (AML/CFT) supervision of banks, mutual banks and life insurers.

Partially driven by an effort to remove South Africa’s greylisting by the Financial Action Task Force, the PA is pursuing compliance and prosecutions for non-compliance with renewed vigour. As insurers are themselves negatively affected by greylisting (e.g., investment returns, bond yields, exchange rates, operational complexities), they should be keen to do their part to remove greylisting. In practice, compliance can be operationally complex and expensive.

In 2023, two noteworthy events occurred where the South African Reserve Bank (SARB) levied administrative sanctions on African Bank Limited and Grindrod Bank Limited for failing to comply with the FICA's provisions. These sanctions followed incidents that took place in 2020. African Bank Limited was found in violation of several provisions, including customer due diligence, cash threshold reporting and employee training obligations, leading to a hefty fine of R19.75 million. Grindrod Bank Limited's infractions resulted in fines totaling R10.73 million. The PA has confirmed that both banks have since implemented remedial measures to rectify their non-compliance and control failures.

As breaches of the POPIA's provisions gradually come before South African courts, it's crucial for businesses to comprehend the potential consequences. Beyond damaging a company's reputation, offenses can attract a maximum penalty of R10 million or a prison sentence of up to 10 years. The Information Regulator has already imposed a R5 million fine on the Department of Justice and Constitutional Development for data breaches which occurred approximately two years ago.

It is imperative for companies to establish and maintain robust compliance systems to navigate these regulatory landscapes effectively, safeguard their operations, and uphold their commitment to customer protection and business integrity.

Risk margin relief for EU and UK insurers

The Solvency II 2020 review process reached a key milestone in December 2023 when European legislators agreed to a set of changes to Solvency II. These included reducing the risk margin cost of capital rate from 6% p.a. to 4.75% p.a. The expected effective date for insurers is 1 January 2026.

Various concerns with the current Solvency II risk margin methodology and assumptions were raised during the review process along with a range of proposed amendments. For more detail, please refer to the European Insurance and Occupational Pensions Authority (EIOPA) Consultation Paper and Milliman August 2022 briefing note on Solvency II 2020.

Development of the UK’s new prudential regime ‘Solvency UK’ has gained momentum following the UK’s exit from the European Union. This is based on a set of reforms to Solvency II. Changes to the risk margin have been recently approved with an effective date of 31 December 2023. The changes consist of a reduction in the cost of capital rate to 4% p.a. but also a risk-tapering factor for life (re)-insurance obligations to allow for non-independence of risks over time. The risk-tapering adjustment was also on the table for the Solvency II review but was not included in the final agreed change. Please see Milliman’s briefing note on Solvency UK for more detail.

These changes are expected to provide significant capital relief to European and UK insurers. South Africa’s local prudential regime (SAM) originally adopted Solvency II’s risk margin methodology and assumptions without any changes.

We don’t expect a change in South African cost of capital rate in the near term because:

1. The solvency pressures that led to decrease in risk margins in Europe have not been raised here to the same extent.
2. Higher interest rates in South Africa decrease the impact of long-duration risk margin contributions.

3. Any review process by the PA would require some years to complete and be implemented.

The biggest issue around risk margins for South African insurers remains iterative vs non-iterative risk margins for risk business with significant lapse risk.

PA update: Government bond curve review

The PA published a position paper containing a recent review of the PA government bond curve.

The Insurance Act (2017) mandates the PA to publish a government bond curve which must be used as the risk-free interest rate term structure when calculating technical provisions. Exceptions can be granted to insurers who apply to the PA to use an alternative curve. Regulatory guidance on this subject is prescribed in FSI 2.2.

The review of the published PA curve discussed in this position paper is split into two main components: a review of the constituent data set (which includes the criteria used for instruments to be included) and a review of the methodology.

The data set used to construct the PA curve consists of South African government bonds with durations from 1 to 30 years, currency deposit rates, implied forward rates and currency swaps.

The methodology review included a detailed evaluation of alternative curve construction methodologies—highlighting the relative merits of these compared to the PA's current methodology of linear interpolation and extrapolation.

This position paper is the first time the methodology has been formally documented, which now enables insurers to replicate the PA curve as well as produce values more frequently than monthly.

The recommendations of the position paper include:

- A revision to the nominal ultimate forward rate, but otherwise no changes to the framework underlying the data set.
- Continued use of the current curve construction methodology, given its merit of simplicity relative to other options considered. The data set will continue to be monitored frequently to determine if any additional changes need to be made.

How Milliman can help

- Due diligence and buy- or sell-side support for M&As
- Insurance strategy on reopening closed lines of business, or expanding into new markets
- Dealing with regulatory change and approvals
- 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
- Microinsurance products, distribution and licencing
- New licence applications

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