

# SAM Common Errors: General Issues

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## Introduction

The introduction of Solvency Assessment and Management (SAM) to the South African insurance market has brought with it both rewards and challenges. This series of articles looks at some of the challenges that insurers face in the completion of regulatory returns and that have been observed in the Comprehensive Parallel Run (CPR). More specifically, these articles will:

- Outline challenges experienced by insurers in the completion of the Quantitative Reporting Template (QRT)
- Highlight areas where insurers may be applying incorrect standards in the calculation of the Solvency Capital Requirement (SCR)
- Identify areas where the standard formula, accompanied with slightly different business practices, could result in different capital requirements for similar (if not identical) risks

This series of articles will address these issues for both Life and Non-Life insurers. This article deals with the common issues faced by both Life and Non-Life insurers.

## Treatment of reinsurance

### FOREIGN REINSURANCE

We have seen wide differences in how foreign reinsurance is treated. The prudential standards (Attachment 3 of FSI 2.2) state that: “Recoverables from counterparties that are foreign reinsurers located in jurisdictions that are not on the Prudential Authority’s equivalence list must not be recognised.”

The list of equivalent countries refers mainly to the United States and countries that are part of the European Union. Insurers will need to be wary of reinsurance placed in other countries, and how it may impact their solvency positions.

### CREDIT QUALITY STEPS

The prudential standards make reference to credit quality steps – that can be approximately mapped to “...international scale local currency credit ratings.” This approach has been used by many insurers.

Some insurers have taken aggressive approaches to determining the credit quality steps:

- Many insurers have mapped national scale ratings incorrectly
- Some insurers are using the credit quality (credit rating) of a parent company
- There are different approaches as to how *parental guarantee* and similar contracts are treated

In other instances, opportunities may have been missed to assign credit quality steps to unrated entities through existing credit evaluation processes, resulting in unnecessarily high credit risk and concentration risk capital charges.

## Market risk calculations

### THE ROLE OF THE BANK IN ASSET-BACKED SECURITIES

Many insurance companies (often unknowingly) have exposure to asset-backed securities. In calculating the market risk (particularly the credit risk), insurers need to carefully distinguish between the issuer, originator, and arranger of these debt instruments.

In many instances, with asset-backed securities, banks are involved as the originator or arranger of the debt instrument. However, they are not the issuer of the instrument. In fact, the debt instrument has been issued by a special purpose vehicle to reduce the risk on the bank’s balance sheet. As such, the issuer (and the counterparty to which the insurer is exposed) is not the bank but rather a completely separate entity.

### TYPE 1 VS TYPE 2 EXPOSURES

The separation between Type 1 and Type 2 exposures is not always clear; and is often incorrectly applied by insurers. Many of these exposures are unrated and the incorrect classification of these exposures may have significant capital implications.

As per FSI 4.1, exposures should only be classed as Type 2 if there are 15 (or more) independent counterparties.

### CLASSIFICATION OF TYPE 1 EXPOSURES

Errors can also arise in the classification of Type 1 exposures for the purposes of calculating the Loss Given Default (LGD). In particular, it should be noted that the classification “Fully cash covered with regular marking to market of collateral” does not apply to deposits. Rather it only applies in the situation where cash is held by one of the parties.

### TYPE 3 EXPOSURE AND CONCENTRATION LIMIT

The Type 3 credit risk is only meant to be applied to deposits at a bank—and not all of the bank’s debt instruments. Often an insurer will have more exposure to the different bond instruments issued by banks.

This can further impact the concentration risk calculation as:

- The higher concentration limit should only be applied to deposits at the banks
- The exposure for banks needs to be separated between deposits and other assets

### CREDIT QUALITY: CONCENTRATION RISK

The credit quality step should be the average credit quality step of the group exposure; and not that of the ultimate parent. Insurers have used the credit quality step of an international parent, although the vast majority of their exposure is to a local (lower-rated) entity.

## Loss-absorbing capacity of deferred taxes (lacdt)

The technical specification makes allowance for LACDT. Furthermore, in calculating the LACDT one can raise a deferred tax asset equal to a maximum of the amount, which “... can be recovered from the ensuing (i.e. after the stressed event) three years’ profit.”

There are many approaches used by insurers to calculate the three years’ profit, and a number of insurers use unreasonably aggressive assumptions about the level of profit. In particular, after a mass lapse shock it cannot be assumed that the business will immediately return to normal profitability.

## Technical provisions

### DEFAULT IMPAIRMENT FOR REINSURERS

In certain cases, insurers are applying a credit risk calculation in calculating the default of reinsurance recoverable. However, this is not appropriate. The reinsurance asset should be impaired with a best estimate default allowance.



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