South Africa: Insurance Industry Update

Milliman

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Premium caps impact on Credit Life profitability

The final Credit Life insurance legislation prescribes a maximum premium of R4.50 per R1 000 Sum Assured. Insurers are forced to reconsider the profitability of such products. One area within their control is the level of expenses allocated to these products. There are a number of considerations in this regard.

- Subjective expense allocation could have a material impact on the measured performance of such policies. This relates to both expenses within an insurance entity, and expenses across a group of entities.
- Where fixed expenses form a material portion of the overall expense base, policy volumes rather than expense allocation will impact profitability. This is likely to be the case for insurers writing predominantly credit life business, along with smaller insurers.

We expect that the premium caps will make a portion of the current market non-viable, leading to reconsideration of lending criteria, business models and possibly market consolidation.

IFRS 17 survey readiness results

Milliman published the results of our global IFRS 17 survey in July. The survey focused on understanding insurers' general preparedness, the ability to use existing platforms and processes and the implications on business of the accounting standard. A total of 92 insurers participated in the survey, with 12 South African respondents.

Most insurers are already evaluating the impact IFRS 17 will have on their business. Many insurers' immediate next steps include creating simplified balance sheet and income statement models for key products, and establishing key objectives of the IFRS 17 project.

While the considerations are generally smaller for short-term insurers, there are several hidden complexities that will benefit from early planning.

Insurers also expect pricing, risk management and hedging to be affected by IFRS17.

The impact of the new standard on insurers' balance sheets and future earnings varied markedly, pointing to the different accounting policies currently in place.

Insurers will have to make an investment in either new platforms, or an upgrading of existing platforms, to ensure that suitable results can be produced.

A summary of our IFRS 17 survey findings are now available on request.

Progress with financial sector regulation

The Financial Sector Regulation Act 2017 (also referred to as the Twin Peaks Bill) was signed into law by the President in August 2017.

The Twin Peaks model dictates that the financial services sector will have two primary regulators, being the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA). The PA is expected to come into existence in the first half of 2018, and the FSCA earliest in the second half of 2018.

The passing of the Twin Peaks Bill paves the way not only for the legislation of the current SAM requirements (ultimately through the Insurance Act), but also the Conduct of Financial Institutions Bill (COFI Bill) which will embed the supervisory responsibilities of the FSCA. A number of transitional arrangements are expected to facilitate the conversion to the new supervisory framework.

Current indications are that SAM will go live on 1 July 2018, either through the passing of the Insurance Act, or the release of Board Notices, with the Conduct of Financial Institutions Bill to be passed earliest in 2019. As before, there remain risks that this timeline may be extended.

Revised Prudential Standards

The Financial Services Board published revised Financial Soundness Standards (FS) and Governance and Operational Standards (GOI), along with a first draft of Public Disclosure Statement (PDI1).

FINANCIAL SOUNDNESS STANDARDS

The bulk of material changes pertain to the Financial Soundness Standards for Insurers (FSI), the FS standards relating specifically to licenced insurers. Refinements made to the standard formula include allowance for some participation in banks and other credit institutions without a capital charge, a requirement to include participations in your risk margin calculation, clearer guidance on the allowance for linked insurance business in operational risk calculations and a recalibration of the life catastrophe module, amongst others.

Insurance groups may now also apply for alternative methods to calculate the own funds and capital requirements of non-regulated entities in their group.

GOVERNANCE AND OPERATIONAL STANDARDS

The GOIs will replace Board Notice 158 of 2014, and set out the governance and risk management requirements for insurers. The scope of the GOIs are greater than the current Board Notice, and include requirements in terms of an insurer's Own Risk and Solvency Assessment (ORSA) and fit and proper criteria explicitly.

Notable changes in the second draft include the need for annual assessment of CEO, senior management and control functions against their performance goals, clarification on the responsibilities of control functions and requirements in terms of the sign-off of the ORSA process and associated report.

GOI 7 was also published, dealing with miscellaneous requirements, aimed at covering elements not included elsewhere in the GOI standards.

PUBLIC DISCLOSURE STATEMENT

The first draft of PDI1 sets out the requirement for insurers to establish a public disclosure policy outlining the required controls to ensure that the information disclosed is timely, comprehensive, meaningful, reliable, comparable to other insurers in the same market, and consistent over time.

Crucially, it highlights which of the annual Quantitative Reporting Template and Qualitative Regulatory Return statements will be available to the public. Collectively the publically available statements will provide insight into an insurer's business profile, financial performance, financial soundness position, risk exposures and management and governance structure.

More clarity on the Head of Actuarial Control

The FSI and GOI standards collectively lay out the requirements for the Actuarial function lead by the Head of Actuarial Control (HAC), which will act as an oversight and control function under SAM. Both long- and short-term insurers will be required to appoint a HAC.

This will prove challenging for many short-term insurers for whom this will be a new requirement.

The responsibilities of the HAC will span the financial soundness, risk management system and product development and management of an insurer. The specific requirements are broader than those of the current regime statutory actuary, particularly as they pertain to the risk management framework, the ORSA and the evaluation of risk mitigation.

The revised GOIs state that the Actuarial Society of South Africa's Practice Certificate Framework may inform the appropriate practical experience required to fulfil the HAC role.

A Milliman summary of the role of the HAC is available on request.

Progress on market conduct regulation

Conduct risk is becoming a more prevalent regulatory focus point globally, with the United Kingdom in particular dealing harshly with firms that miss-sell products and take unfair advantage of policyholders.

Locally, efforts have also been introduced to regulate and monitor market conduct.

As a preamble to the Conduct of Financial Institutions Bill, a set of Policyholder Protection Rules (PPRs) have been published. These are intended to give effect to a number of conduct of business reforms, and extend on requirements previously introduced through the Treating Customers Fairly (TCF) principles. Coverage is also extended to include the Retail Distribution Review, the Complaints Management Thematic Review, Binder regulations and the Technical Report on the Consumer Credit Market in South Africa, amongst others.

The PPRs set out requirements in terms of:

- Product design
- Promotion, marketing and disclosure
- Intermediation and distribution
- Product performance
- Post-sale barriers
- Administration

CONDUCT MEASUREMENT

The Conduct of Business Returns (CBRs) are a new set of returns that need to be completed by all life and non-life insurers, excluding reinsurers and captive insurers. They will feed into the overall market conduct risk-based supervision framework, which contemplates the development of conduct risk profiles for individual insurers and groups. Returns should be completed on a best effort basis. Currently submission are done retrospectively, with the second return covering July to December 2016 to be submitted by 31 October 2017 based on communication received from the regulator.

The CBRs require a detailed breakdown of trends in sales efforts (successful and not), distribution costs, complaints and claims. The granularity of the data required makes submissions more challenging. The information required for the returns will be useful for business purposes, and should be utilized appropriately to inform decisions. Initial feedback from the regulator indicates that the quality of returns vary greatly across industry, and that significant effort it still required to get the reporting at an appropriate level.

Observable impact of natural catastrophes

A number of natural catastrophes have occurred over the last few months. Locally, fires that stretched between Great Brak and Plettenberg Bay caused significant damage, most notably in Knysna, where just short of 900 houses were destroyed. The insurance losses as a result are estimated to be around R4 billion. A survey conducted by the local council however indicated that more than 50 percent of houses were not insured, or underinsured. Various home owners have initiated legal action against brokers as a result.

The entire Western Cape province has been declared a disaster area, as a result of severe drought. The University of Cape Town estimates the severity of limited rainfall over the last two years to be a 1-in-1 150 year event.

The Gulf of Mexico has also seen severe climatic conditions, with hurricane Harvey causing devastation as it moved through the Gulf of Mexico. The impact on the coastal town of Houston is the most costly natural disaster to hit the United States. The estimated impact on the economy is between $180 and $190 billion. The insured losses are estimated to be $3 billion, with only approximately 20 percent of houses insured in the areas
hardest hit.

Hurricanes Irma and Maria have also caused great damage across the Gulf and Caribbean Islands. Irma was classified as a category 5 hurricane (with wind speeds in excess of 252 km/h) as it moved over the Caribbean islands. At the time of writing, the financial and insured losses of these events have not been fully quantified.

Climate change will affect future catastrophe claims and risk mitigation needs, but also the demand for insurance. Capital and reinsurance optimisation models will require recalibration.

Cyber risk and operational loss data

Cyber Risk is a top emerging risk, regardless of industry. The recent extensive ransomware attacks have prompted many companies to revise risk mitigation strategies for cyber risks. Experts estimate that the number of ransomware attacks increased by 250 percent during 2017.

The Data Protection Directive, enforceable from 25 May 2018 in the European Union, can fine organisations up to 2 percent of global annual turn-over. Industry experts have indicated that the average ransom hackers will demand is likely to increase significantly, from the $300 per attack associated with the WannaCry ransomware attack earlier this year, as a result. Locally the maximum fine for breaching the Protection of Personal Information (PoPI) Act will be R10 million.

The monitoring of operational risk losses, and the suitable modelling thereof, is becoming a more prevalent discussion point for insurers. The need for an industry wide, centralised operational loss database to assist with benchmarking and modelling of risks has become critical.

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