SAIA
Publication of the South African Insurance Association
SAM NEWS

SAIA – (011) 726 5381 ***Issue 6 / 2011***

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Introduction

As the SAM project has evolved so too has the structure and focus of our monthly SAM Newsletter. Our new revamped ***SAM NEWS*** will change direction slightly by covering topics relevant to SAM and the SAM project only as opposed to the previous editions that included Solvency II content.

From time to time we will be approaching industry experts inviting them to contribute to our newsletter by sharing with us their thoughts and insight regarding specific topics relevant to SAM.

A new ***SAM Snippets*** section will endeavour to provide our readers with a regular update of current SAM activity as well as important areas that insurers should be cognisant of. Suggestions regarding specific SAM content and material to be included in our newsletter will be welcomed. Please e-mail Seema Maharaj seema@saia.co.za should you have any suggestions for potential articles.

The new proposed SAM regime will be unique to the South African environment and as such we hope to provide our readers with as much relevant communication regarding SAM as possible.

We sincerely trust that you will enjoy the read and find the content useful and relevant.

SAM – the next phase

The SAIA SAM Project Support Office believes that we have reached an important crossroad on the journey to SAM implementation in January 2014 with the advent of the Discussion Document process. It is at this crossroad where vital decisions made could have a fundamental impact on the outcome of the fate of insurers when the new SAM regime is implemented.

We have objectively reviewed the SAM project structure and have categorised the project into four phases, as ***we see the process*** evolving, as follows:

Phase One – Inception, Research and Design [Completed]

Phase Two – Technical and Review [Started]

Phase Three – Lobbying and Communication [To commence]

Phase Four – Monitoring and Closure [To commence]

In Phase One Insurers, the Financial Services Board, National Treasury and various other stakeholders were coming to terms with what the objective and expectations of SAM would be. We believe that Phase One has been achieved and that we have now moved into Phase Two.

Phase Two requires technical knowledge, skill and expertise to be applied to the SAM project as it is at this point that industry has the opportunity to influence the construction and design of the legislation that will govern all insurers. This is achieved by providing input and comments for inclusion in the various Discussion Documents.

The deadline for submission of all comments regarding Discussion Documents has been set for the end of August 2011 after which the drafting of version one of Secondary Legislation will commence.

Our ultimate objective in this phase, through the active participation by all our SAIA members, is to ensure that the new proposed SAM regime will be sustainable, fair and proportional within the context of the South African environment.

The future of tax on insurers

The members of the newly constituted Tax Task Group operating under Pillar IV of the SAM Governance structure have a number of challenges ahead.

The mandate of the Tax Task Group is to consider the impact of the implementation of SAM on the taxation of insurers in South Africa. The task group will also consider the impact of the implementation of the Solvency II Directive principles on the taxation of insurers by jurisdictions comparable to South Africa. This will then ultimately lead to proposals from the Task Group on amendments to Section 28 (short-term insurers) and Section 29A (long-term insurers) of the Income Tax Act (Act No 58 of 1962 as amended), including proposals on indirect taxes, if any.

In many European countries the tax calculation is driven by Solvency I regulation. Solvency II however will not necessarily create a viable alternative source of taxable profit and as such, many European countries are considering a shift towards an International Financial Reporting Standard (IFRS) based profit as the starting point for tax purposes. This too shall be applicable to South African Insurers and Reinsurers, and will therefore need to be considered by the Tax Task Group.

The deadline for finalisation of the various proposals will be challenging. Annual tax proposals are announced in February each year as part of the National Budget and the related tax legislation is then drafted by May in the same year. The process to consider tax

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proposals starts approximately six months before the Minister of Finance delivers his Budget speech. Therefore, in order for National Treasury to consider the SAM proposals for approval by Parliament and implementation in January 2014, the Task Group would need to finalise proposals by September 2012.

As both National Treasury and the South African Revenue Services (SARS) have representatives on the Task Group it creates a unique opportunity for the industry to raise concerns and to discuss proposals addressing all tax-related issues. We therefore encourage active participation by insurers in this Task Group as it can make a fundamental difference to the way insurers will be taxed when SAM is eventually implemented.

For more information on the Tax Task Group please contact Nico Esterhuizen at nico@saia.co.za.

SAM Snippets

- 13 Discussion Documents have been made available for public comment. The comments are due for the end of July. There are approximately 70 Discussion Documents that have been produced thus far which are being considered by the various levels within the SAM Governance Structure.
- The Tax Task Group is in its infinite stage still requiring further volunteers to join this task group. Section 28 and 29A of the Income Tax Act are important focus areas for this task group.
- Insurers can expect further guidance and documentation to be published within the next few months concerning the Internal Model Approval Process.
- The SA QIS 1 deadline is the 16 September 2011 and will not be delayed or extended.
- The Drafting of Primary Legislation is a high priority on the FSB's agenda at the moment.
- The implementation date for Solvency II may have been postponed to 1 January 2014 but SAM is still on track to go live from 1 January 2014. However developments in the European Union regarding Solvency II will be closely monitored by the FSB.
- Short-term Insurance Board Notice: *Prescribed requirements for the calculation of the value of the assets, liabilities and capital adequacy requirement of short term insurers*, was sent out on 19 July 2011 to all short term insurance companies Public Officers. This Board Notice is based on Position Paper 6: *Interim Measures relating to Technical Provisions and Capital Requirements for short term insurers*. Members are requested to provide their comments regarding this Board Notice by the 16 September 2011. This Board Notice forms part of the Interim Measures intended for implementation in 2012.
- In light of the ever changing legislative landscape, the FSB will be restructuring their insurance department, as from the 1st October 2011. The Insurance department will be divided into the following five departments:

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- The current Prudential department will be split into two divisions namely **Insurance Groups** (Head - Suzette Vogelsang) and **Prudential** (Head – to be advertised)
- **Micro Insurance** department (Head – Jacky Huma)
- **Regulatory** department (Head – Jo-ann Ferreira)
- **Market Conduct** / **Compliance** department (Head - Lesedi Letwaba)
- **SAM Unit** (Head - Ian Marshall)

For more information on these SAM Snippets please contact Gareth van Deventer at gareth@saia.co.za

Guest article

Stress Testing by Hugo Louw (KPMG)

What is stress testing all about?

The advent of SAM has brought with it many new terms and buzz words that are often used widely, but not always practically understood. One of these is stress testing. This article will attempt to shed some practical light on the world of stress testing; where it fits in and some of the forms of stress testing the industry will come across.

There are a number of definitions out there on what exactly stress testing is. The following definition from Investopedia is a good one:

"A simulation technique used on asset and liability portfolios to determine their reactions to different financial situations. Stress tests are also used to gauge how certain stressors will affect a company or industry. They are usually computer-generated simulation models that test hypothetical scenarios."

Objectives of stress testing

Before covering some of the more common forms of stress testing, it is important to understand the objective of stress testing. Broadly most stakeholders will use stress testing for one or more of validation, decision making or external communication. In the insurance world one of the key focus areas is on the capital needed in the business (i.e. the decision on capital buffers under Pillar II).

The **validation** objective of stress testing is almost exclusively used by internal management within a firm. Stress testing in this context is used to test the validity of models. In practise the stress testing validation process around models will be very involved and include a number of detailed tests to confirm the robustness of models. However, simplistically there are two main questions to be answered:

- If the input parameters are changed (i.e. stressed) does the model results move in an intuitive manner? This will include the testing of extreme movements in parameters.
- If input parameters are set to reflect specific historic events, does the output of the model mirror reasonably well what actually happened in practise?

The **decision making** objective is arguably the most important objective of stress testing. Depending on the particular stakeholder, the results of stress testing will be used for different decisions. For example the management of an insurance firm should incorporate the results of stress testing in its capital assessment and capital budgeting decisions and in business planning. On the other hand, the regulator (the FSB in this case) will use stress testing results as an input to the regulatory dialogue with insurers as part of indentifying the specific resilience of individual insurers. In addition, the regulator will use the results of industry wide stress tests to assess the resilience of the industry as a whole.

The final objective is in respect of **external communication**. This involves, amongst other items, the publication of an insurer's results under certain stressed scenarios. Analysts and shareholders will often use these results to better understand the impact of certain risks faced by the insurer over time. This will in turn inform their view of the inherent value of the insurer.

Forms of stress testing

Depending on the objective of stress testing, there are broadly three types of stress testing. These are, in increasing level of complexity:

- Single risks/parameter sensitivity tests;
- Scenario analysis; and,
- Reverse stress testing.

Single risks/parameter sensitivity tests

This involves the change in selected input parameters in isolation. Generally this form of stress testing is relatively simple and can generate results quickly. It gives an initial assessment of portfolio sensitivity to given risk factors and allows identification of risk concentrations. Within the SAM environment, these types of tests are usually performed in a Pillar I environment. It assists management to better understand the individual risks, the capital impact of these risks realising (e.g. underwriting risk, market risk, etc), identifying model risk and the effectiveness of management actions.

Scenario analysis

Scenario analysis performed by the management of an insurer involves multiple risks and has a much broader business focus. Scenarios will be chosen to understand the business and capital impact of a combination of risk factors. These would involve making allowance for the correlation that exists between certain risk events. For example in an economic downturn scenario, a life insurer will expect higher withdrawal rates on certain business classes. Due to the wider business view of risk, scenario analysis provides a more realistic basis to assist with capital and business planning. It should form an integral part of a company's Own Risk and Solvency Assessment (ORSA) process.

The regulator would also be interested in scenario analysis. In the SAM pillar structure, the scenario analysis results of a company would form a key input into the Pillar II process of the regulator's decision on whether a firm is holding sufficient capital. The regulator would also obtain valuable information on the weaknesses of the individual company.

A further use of scenario analysis by the regulator is at an industry level. By performing stress testing (scenario analysis) for the industry as a whole, the regulator is able to assess the vulnerability of the industry and inform its regulatory focus. It also provides a valuable benchmark for comparing individual companies operating in the insurance industry.

Reverse stress testing

Reverse stress testing is a relatively new concept that developed over the last number years. It involves determining scenarios that would deplete the existing capital of a company. In other words, what has to happen for the company to become insolvent? By considering the likelihood of these scenarios materialising over time, it provides management with valuable risk information and provides useful input into designing key risk indicators for the business and management actions than can be used to intervene, contain and avoid risk.

Importance of stress testing

Despite the fact that the new SAM framework and related guidance is expected to cover stress testing in some detail, stress testing should form a critical and integral part of overall governance and risk management for any well run insurance entity. The selected stresses should reflect the particular circumstance of a company and the results should be used in, and influence decision making throughout the company. Understanding and buy-in from board level down in the stress testing process is essential for the success of the company. Stress testing should not be a once off or even annual exercise to comply with regulatory requirements. To extract the greatest value from the stress testing process there should be a continuous update of the stress testing framework as the environment changes and new risks come to light or views on existing risks change.

This article was compiled by the Stress Testing Task Group chairperson Hugo Louw, an Associate Director at KPMG South Africa. Hugo can be contacted on: hugo.louw@kpmg.co.za