SAIA

Publication of the South African Insurance Association

SAM NEWS

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Ensuring sufficient eligible Capital Resources

One of the first Discussion Documents approved for industry comments is Discussion Document 26 (version 5); “the classification and eligibility of capital resources”. Capital resources consist out of basic own funds, which consist of the excess of assets over liabilities and subordinated liabilities and ancillary own funds, which consist of items other than basic own funds which can be called up to absorb losses such as unpaid share capital or initial funds that have not been called up; letters of credit and guarantees and other legally binding commitments received by insurance and reinsurance companies.

The primary purpose of capital resources from a regulatory perspective is to act as a shock absorber against adverse losses and to ensure that the insurer and reinsurer are able to meet its obligations to policyholders when they are due. From a macro-economic perspective, requiring the insurer and reinsurer to maintain adequate capital in terms of both quantity and quality enhances the safety and soundness of the insurance sector and the financial system as a whole.

The document does not focus on issues relating to matters of valuation, rather it outlines the methodology whereby capital resources are classified in order to determine eligible own funds, which are as follow:

- An assessment of the *quality (characteristics)* of the capital instruments comprising the total amount of capital resources
- *Creating a list* of capital elements that comply with the requirements.
- On the basis of the assessment, a determination of the capital resources *eligible* to meet regulatory capital requirements.
- Recommending *approval guidelines* for capital elements not listed in this Discussion Document.

The Discussion Document recommends that the capital resources are classified into three tiers, based on whether they are basic or ancillary own fund items and to the extent to which they possess the proposed characteristics, which are:

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Characteristics	Guide
a. Loss absorbency	The item is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding-up.
b. Subordination	In the case of winding-up, the total amount of the item is available to absorb losses and the repayment of the item is refused to its holder until all other obligations, including insurance and reinsurance obligations towards policyholders and beneficiaries of insurance and reinsurance have been met.
c. Sufficient duration	When assessing the extent to which own-fund items possess the characteristics of permanent availability and subordination currently and in the future, due consideration shall be given to the duration of the item, in particular whether the item is dated or not. Where an own-fund is dated, the relative duration of the items as compared to the duration of the insurance and reinsurance obligations shall be considered.
d. Free from requirements and incentives to redeem	Whether the item is free from requirements or incentives to redeem the nominal sum.
e. Free from mandatory costs	Whether the item is free from mandatory fixed charges.
f. Absence of encumbrances	Whether the item is clear of encumbrances.

Divided into three tiers and between basic own funds and ancillary own funds the results are as follow:

	Basic Own Funds	Ancillary Own Funds
Tier 1	Substantially possess characteristics of (a) and (b), taking inconsideration (c), (d), (e) and (f).	Not allowed
Tier 2	Substantially possess characteristics of (b), taking inconsideration (c), (d), (e) and (f).	Substantially possess characteristics of (a) and (b), taking inconsideration (c), (d), (e) and (f).
Tier 3	If not Tier 1 or Tier 2	If not Tier 2

It is recommended that the division of the Tiers follow the advice coming from the EU as illustrated below:

	Recommended Tiers
SCR	• Tier 1 > Tier 2 > Tier 3 • Tier 1 > 50% of total Eligible own funds • Tier 3 < 15% of total Eligible own funds
MCR	• Tier 1 > Basic own funds Tier 2 • Tier 1 > 80% of total Eligible basic own funds • No Tier 3

Tier 1 should contain the highest quality of capital resources which fully absorb losses and enable an insurer and reinsurer to continue as a going concern. To be classified as Tier 1, capital instruments must be fully paid in. For inclusion in own funds, there should be certain minimum qualitative requirements. In particular, Tier 3 basic own funds should contribute toward avoiding insolvency as well as toward avoiding the acceleration towards insolvency.

Based on the assessment guides above capital instruments can be grouped as such:

Basic Own Fund	Ancillary Own Funds

Tier 1 requirements
• Paid in ordinary share capital
• Paid in equivalent of ordinary share capital of mutual undertakings
• Other paid in capital instruments, including preference shares that absorb losses first or rank pari passu, in going concern, with capital instruments that absorb losses first.
    o Instruments that automatically covert to ordinary share capital, or to the equivalent of ordinary share capital of mutual undertakings, as and when the undertakings needs to absorb losses, and in any case when the undertaking breaches the SCR.
    o Instruments subject to write down as long as losses persist, as and when the undertaking needs to absorb losses, and in any case
	Tier 2 requirements
	• Ordinary share capital callable on demand.
	• Equivalent of ordinary share capital, callable on demand, of mutual undertakings.
	• Supplementary member calls of mutual undertakings, within the next twelve months, that can be made on demand, where the call generates Tier 1 own funds and is clear of encumbrances.
	• Letters of credit and guarantees which are held in trust for the benefit of insurance creditors.
	• Other capital instruments, callable on demand, that absorb losses first or rank pari passu, in going concern, with capital instruments that absorb losses first.
	    o Instruments that automatically convert to ordinary share capital, or to the equivalent of ordinary

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Basic Own Fund	Ancillary Own Funds
when the undertaking breaches its SCR. • Reserves, to the extent that they are available to absorb losses at any time arising from any segment of liabilities or from any risks, including: o retained earnings o surplus funds o revaluation reserves o other reserves • Paid in subordinated mutual member accounts	share capital of mutual undertakings, as and when the undertaking needs to absorb losses, and in any case when the undertaking breaches its SCR. o Instruments subject to write down as long as losses persist, as and when the undertaking needs to absorb losses, and in any case when the undertaking breaches its SCR.
Tier 2 requirements • Called up ordinary share capital • Other called up capital instruments that absorb losses first or rank pari passu, in going concern, with capital instruments that absorb losses first. • Other capital instruments, including preference shares that do not have the conversion features required for Tier 1 but that display the features below. • Other capital instruments, including preference shares, not subject to write down as long as losses persist, but that display the features below.	**Tier 3 requirements** • Callable preference shares classified in Tier 2 or Tier 3 • Other callable capital instruments classified in Tier 2 or Tier 3
Tier 3 requirements • Other capital instruments, including preference shares, that do not display the features required for Tier 1 or Tier 2. • Deferred tax assets, [if not excluded from own funds]	

A number of valid reasons exist for the Discussion Document to consider alignment with the banking industry to ensure an effective and sustainable financial services industry. Based on the above insurers and reinsurers should carefully consider their future capital plans.

For further information regarding our Capital Resources article please contact Nico Esterhuizen at nico@saia.co.za

SAIA SAM Online Discussion Group – www.linkedIn.com

In the last couple of months insurers have been faced with an information explosion as more details of the new proposed SAM regime begin to unfold. The SAIA SAM Project Support Office (PSO) have identified and pursued a number of initiatives to ensure that useful and relevant communication specific to the SAM project is provided to all our SAIA members.

In light of the recent increase in SAM activity and in keeping with our objective of encouraging a unified voice representative of our membership, we are excited to announce the launch of our SAIA SAM Online Discussion Group.

The discussion group will be created and hosted on the ***LinkedIn*** *website*. The discussion group will provide members with an opportunity to engage each other regarding all aspects of the SAM project, from challenges faced and concerns identified to general opinions and views regarding specific topics within the SAM project.

The discussion group will be created for the exclusive use by our members and as such membership will be limited to SAIA members only. The process is simple and quick as it only requires a brief registration on the LinkedIn website before being able to participate in the SAIA SAM Online Discussion Group.

Our project office has regular standing meetings with the FSB where we discuss industry concerns as identified and experienced by our members within the SAM project. The proposed SAIA SAM Online Discussion Group will assist us in identifying further issues, concerns and challenges that we will add to our agenda for discussion with the FSB at these regular standing meetings.

Further details regarding access to our discussion group will be communicated to all our members in due course.

The old adage “you are only as strong as your weakest link” holds true and as such we would like to strengthen and align our SAIA SAM chain by encouraging all our members to “Link in” and join the SAIA SAM Online Discussion Group.

For further information regarding our SAIA SAM Discussion Group please contact Seema Maharaj at seema@saia.co.za

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SAIA SA QIS1 Survey

The deadline for submission of the first ***South African Quantitative Impact Study*** or SA QIS1 is the ***16th September 2011***. The SAIA SAM Project Support Office is in the process of undertaking a short telephonic survey among our members to obtain feedback regarding their experience with regards to the completion of the QIS.

The main objective of our SAIA SA QIS1 Survey is to gather as much pertinent information as possible regarding the process of completion of the QIS in order to identify specific challenges, concerns and areas which require further scope for improvement.

The survey will be conducted telephonically and be limited to 15 minutes. All our members SAM Coordinators will be contacted in due course by our project administrator, Ms Seema Maharaj, to arrange a convenient time slot in which to conduct our survey.

The information obtained from our members who participate in the SAIA SA QIS1 Survey will be brought to the attention of the FSB for further discussion. It is the intention of the FSB to conduct a second QIS (SA QIS 2) in 2012. We intend to engage with the FSB regarding our findings to ensure that SA QIS 2 is conducted in an efficient manner and that the concerns and challenges as identified under SA QIS1 are not repeated in SA QIS2, but rather improved upon.

To those of our members who completed the SA QIS1 exercise, your valuable input in the process is of extreme importance to us and we would sincerely appreciate your participation in our brief SA QIS1 Survey.

For further information regarding our SA QIS1 Survey please contact Gareth van Deventer at gareth@saia.co.za

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SAM Snippets

- Mr ***Ian Marshall***, the newly appointed ***Head of SAM*** at the FSB, took up office on the 15th August 2011. Mr Marshall will be responsible for overseeing the entire SAM project.

- The FSB are currently in the process of appointing what they term subject matter experts (***SME's***) to assist with the review and advice relating to the technical aspects of SAM. Mr Donovan Hutchinson has recently been appointed in the role of an SME to assist Mr Ian Marshall with the SAM project.

- On the 16th August 2011 the FSB released two further important sets of documentation pertaining to the Internal Model Approval Process. ***The Contents of Application (CoA)*** and the ***IMAP Independent Review Guidelines*** documents provide further important pertinent information to insurers who intend to apply for the approval of their Internal Models.

- On the 26th August 2011 the FSB released the following documents to the insurance industry for comment:
    - Draft Insurance Laws Amendment Bill
    - Discussion Document 81 (v2) Interim Requirements: Governance, Risk Management & Internal Controls
    - Discussion Document 1(v8) Interim measures for Insurance Groups

  The deadline for submission of all comments pertaining to these documents to the FSB is the 30th September 2011.

- At the FSB SAM Steering Committee meeting held on the 19th August 2011 a number of Discussion Documents were approved to be released for public comment. A number of Discussion Documents that have been open for public comment for some time now were also approved by the FSB SAM Steering Committee for adoption as Position Papers. Further information regarding these documents can be obtained by contacting us directly.

- The number of Discussion Documents that have been generated within the SAM Governance Structure currently stands at a staggering 81.

- The next major milestone on the SAM timeline is the submission by insurers of the SA QIS1 information to the FSB by the 16th September 2011. Any submissions beyond this date will not be included as part of the analysis of the results.

- All the task groups were given a deadline of the end of July to submit their comments on the first draft of the Primary legislation. It is the intention of the FSB to release a second draft of the Primary legislation by the 16th September 2011.

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

Guest Article

Insurance Group Supervision

by Johan Heyneke (FSB Project Manager: Insurance Prudential)

What is insurance group supervision all about?

Currently the Financial Services Board ("FSB") performs prudential and market conduct supervision of registered insurance companies and other financial institutions on a solo basis only (i.e. supervising each licensed entity separately). While the major insurance groups voluntarily provide information at a group level, there is no formal requirement in legislation to do so, nor are there regulatory requirements that apply at a group level.

The FSB is in the process of developing a new risk-based solvency regime for South African short-term and long-term insurers, known as the Solvency Assessment and Management regime ("SAM"), to align the South African insurance industry with international standards.

SAM will be based on the Solvency II capital adequacy, risk governance, and risk disclosure regime being implemented for European insurers and reinsurers. SAM will share the same broad features as Solvency II, being a principles-based regulation based on an economic balance sheet, and utilising the same three pillar structure of capital adequacy (Pillar 1), systems of governance (Pillar 2), and reporting requirements (Pillar 3).

The effective supervision of insurance groups is an essential element of a 3rd country equivalence assessment under Solvency II, and hence a regulatory framework for insurance group supervision will form a critical part of SAM. Given the urgency around the issue of effective group supervision that was highlighted by the recent global financial crisis, interim measures for the supervision of insurance groups in South Africa will be introduced as early as 2012.

Why the FSB needs to implement a group-wide supervisory regime

It is important for the FSB to form a comprehensive view of the overall risk exposure of South African insurance groups, and financial conglomerates, especially the potential impact on the regulated entities operating within South Africa.

The International Monetary Fund ("IMF") and the World Bank regularly assesses South Africa's regulatory and supervisory regime in terms of a financial stability assessment programme ("FSAP").The FSAP benchmarks the South African regulatory and supervisory regime against international standards. In the case of insurance regulation and supervision, these international standards are contained in the International Association of Insurance Supervisors ("IAIS") Insurance Core Principals ("ICPs"). One of the major shortcomings of the current regulatory and supervisory regime for insurers, as noted in the 2010 FSAP, is the lack of a group-wide regulatory and supervisory regime.

The FSB is therefore committed to adopting a group-wide regulatory and supervisory regime so as to align South African insurance supervision with requirements of the IAIS and international best practice.

The Long-term and Short-term Insurance Acts will be amended to provide for the necessary regulatory powers and legal authority to carry out group-wide supervision; and the ability to cooperate and coordinate with other relevant supervisors on a cross-border and / or cross-sector basis, including information sharing.

Defining an insurance group

A group is considered to be an insurance group for the purpose of group-wide supervision if there are two or more entities of which at least one is an insurer and one has significant influence on the insurer.

Some insurance groups may also be financial conglomerates.

An insurance group is considered to be a financial conglomerate if it consists of a group of companies that conducts insurance activities plus financial activities either:

- In at least one of the other regulated financial sectors; or
- In at least one non-regulated financial sector to the extent that the financial activities in that sector are not subject to group wide/consolidated supervision by sectoral frameworks.

Group-wide regulatory framework

The regulatory and supervisory framework applied to insurance groups will, in accordance with the proportionality principle, differ depending on the type of insurance group. The supervisory approach to be followed will not replace solo supervision but will be an extension of solo supervision.

The group-wide regulatory framework addresses:

a. Transparent group structures - For effective group-wide supervision, it is important for the supervisor to understand the insurer's group structure appropriately. An insurance group should make and keep its group structure transparent in order not to impede effective group-wide supervision. Supervision will take into account the individual structure and character of each group;

b. Non-operating holding company ("NOHC") - Authorising a NOHC will achieve an easier application of fit and proper, internal control and risk management requirements if governance, strategic direction and senior management are concentrated at NOHC level. It will also enhance information access, supervisory review and supervisory enforcement. The intention of group supervision does not extend to the solo supervision of the NOHC but rather to holding the NOHC accountable for the financial position, governance and risk management of the group;

c. Group-wide solvency - A group-wide solvency assessment assesses whether management of risk and capital for the group is adequate, especially to the extent that the group conducts activities that may adversely impact on the financial / solvency position of insurance entities within the group. It covers other important issues such as investments in affiliated entities, intra-group transactions, risk exposures and double gearing of capital.

The insurance group solvency requirement is not intended to replace the solvency requirements of the solo entities; however, it does assist in evaluating whether the amount and quality of capital is appropriate given the level of risks present within the insurance group;

d. Group-wide governance - Ensuring that insurance groups have appropriate governance, risk management and internal controls suitable for their nature, size and complexity; and determining appropriate fit and proper requirements for the group's board of directors, shareholders and senior management will be addressed within the mandate of Pillar II of the SAM project and included in both the interim and the final SAM measures for governance;

e. Group-wide market conduct - Group-wide market conduct is concerned with how insurers within a group and/or the group as a whole conduct their business activities, especially as they involve the fair treatment of customers and appropriate disclosures to the public. Market conduct issues may relate to reputational and contagion risk. These issues will be addressed in the final SAM measures, incorporating recommendations arising from the Treating Customers Fairly ("TCF") process; and

f. Reporting requirements - Relevant, comprehensive and adequate information needs to be disclosed on a timely basis in order to give market participants a clear view of the business activities, performance and financial position of insurance groups. This will enhance market discipline and understanding of the risks to which an insurance group is exposed and the manner in which those risks are managed.

Information exchange, cooperation and coordination with other supervisors

An important component of a well structured group-wide supervision regime is the ability and authority to exchange key information between supervisors. With the implementation of the interim insurance group supervisory regime it will be necessary to cooperate and coordinate with other supervisors on either a cross-border or cross-sector basis. This will allow for the exchange of information, views and assessments among supervisors in order to allow for a more efficient and effective group and solo supervision and timely action.

Conclusion

It is important that insurers assess the full impact of the interim group supervisory requirements and determine the most appropriate response to them, in light of their specific objectives and preferences. The variety of group supervisory approaches means that there are regulatory considerations, for groups to consider, making it vital that groups understand the consequences for them and plan now for group supervision.

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