SAIA

Publication of the South African Insurance Association

SAM NEWS

SAIA – (011) 726 5381 Issue 10 / 2011

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Silence is not golden

Introduction

How does the South African Short-term Insurance Industry ensure that a solid new solvency regime is constructed in a fair and equitable manner, with due consideration given to the divergent views and issues that are prevalent within our market? In short, by ensuring that our voice as a collective whole is heard by the FSB and that we do not remain silent regarding the changes that SAM will require!

Time is running out and the work required to be completed by the SAM structures continues to mount. Resources at insurers are stretched to the limit and for this very reason insurers have opted to choosing their SAM battles carefully, as opposed to fighting every fight, as a manner of speaking!

The SAIA SAM Project Support Office (PSO) is well aware of the numerous challenges our members are facing -. We have therefore established a number of communication channels to assist our members in ensuring that their voices do not fall along the wayside regarding the development of the new proposed SAM regime.

The SSNI Forum

Our Smaller Specialised Niche Insurers Forum (SSNI Forum) was established in November 2010, with the objective of providing a platform whereby insurers are able to raise concerns and engage with each other regarding the challenges posed by SAM. A number of industry experts have addressed the SSNI Forum and provided valuable insight pertaining to specific important topics regarding SAM.

These Forums have been well supported by our members since inception and have also produced numerous issues regarding the SAM project that we have taken up with the FSB requesting further clarification.

We will continue with this successful Forum during 2012 and heighten our objective of scrutinising and gathering comments pertinent - to Discussion Documents and Position Papers. In this manner we are able to influence the design of the Secondary Legislation at each crucial stage within its evolutionary journey to completion.

While it is important for insurers to continue to develop and contribute towards Pillar I activity, we as the Project Support Office, will be adjusting our spotlight slightly in order to highlight and address the important requirements stemming from Pillar II and III.

We will be approaching various industry experts as well as the Pillar II and Pillar III Task Group Chairpersons, requesting them to share their views in respect of these rather onerous imminent requirements expected from these Pillars with our SSNI Forum members throughout 2012.

Please feel free to contact our office should you wish to be part of this dynamic Forum.

SAIA SAM Workshops

The SAIA SAM PSO recently held a workshop to discuss and debate the new Draft Insurance Laws Amendment Bill as well as the ORSA and USE Test Discussion Documents. The overriding objective of this workshop was to scrutinise the abovementioned documents to ensure that the short term insurance industry's comments and concerns are noted by the FSB.

The comments generated by the workshop were submitted to FSB and filtered back to the various task groups in the structure for consideration. We are pleased to report that the comments produced by the ORSA and Use Test workshop members were able to influence the design of the two Discussion Documents in a positive manner. The comments have resulted in these particular Discussion Documents being updated thereby enhancing the content of the document. It is important to reiterate that all Discussion Documents will be considered and incorporated by the FSB in drafting the Secondary Legislation.

The active involvement by our members of these ad-hoc SAIA SAM Workshops will assist in contributing towards the design of a SAM regime that will best favour the industry. We intend to host further workshops similar to these and continue with our objective to influence the design of this new proposed regime.

Requesting Comments on Discussion Documents and Position Papers

The SAIA SAM Project Support Office continues to solicit comments from our members specific to various Discussion Documents and Position Papers that have been approved by the FSB's SAM Steering Committee for public comment.

We have had numerous comments from our members pertaining to various Discussion Documents and Position Papers which we have passed on to the FSB. These consolidated SAIA member comments play an important part in stimulating further debate and thought around the content and scope of these particular documents. In doing so The SAIA and its members are actively contributing to a more complete consultation process which ultimately results in more comprehensive technical papers being generated.

We will actively pursue our objective of gathering comments from our members as and when Discussion Documents and Position Papers are released by the FSB for public comment.

The SAIA SAM Online Discussion Forum

This online discussion forum has been established to encourage members to engage with each other through informal discussion regarding various aspects relevant to the SAM project, from challenges faced and concerns identified to general opinions and views in respect of specific topics within the SAM structures.

The SAIA SAM Online Discussion Forum is hosted on the LinkedIn website which can be accessed by visiting the following address***: www.linkedin.com***.

Participation in the online forum is free of charge and registration is quick and convenient.

Regular Strategic FSB Meetings

The SAIA SAM PSO has had a number of strategic meetings with the management of the FSB's SAM Unit throughout 2011. At these meetings we discussed and debated the various concerns, challenges and uncertainties that our members face regarding the SAM project.

These strategic meetings are conducted with the objective of ensuring mutual understanding for the challenges and concerns that the regulator and the insurance industry face regarding SAM.

We will continue with these strategic FSB meetings in order to debate the various challenges that the SAM project poses to our members. However the future success of these meetings will rely heavily on the input that we receive from our members. The FSB have made their intention clear by indicating their desire to engage with the insurance industry in designing the new proposed SAM regime.

We continue to encourage our SAIA members to raise any concerns that they might encounter or have encountered specific to SAM with us in order for us to address these with the FSB directly.

Issues logs

At our SAIA SAM Internal Steering Committee meetings as well as at our SSNI Forum meetings members are given an opportunity to raise any concerns or issues that they might have with the SAM process. These issues are then recorded in our issues log. The issues logged are brought to the attention of the FSB in an effort to obtain guidance and further clarification from them.

We remain committed to persuading our members to add their concerns to our issues log in order for us to debate these with the FSB as part of our regular strategic FSB meetings.

Conclusion

We appeal to our members to make use of the various communication channels that we have put in place to ensure that the FSB receives as many SAM specific comments and concerns as possible for their consideration.

Our channels of communication have already produced a number of favourable results and have successfully succeeded in influencing and contributing towards the effective design of SAM thus far.

Throughout the course of 2012 we as the SAIA SAM PSO will continue to develop and refine our various channels for the effective communication of SAM related matters to the FSB.

The support and contributions received by our members, no matter how seemingly insignificant, will ensure that the short term insurance industry is adequately prepared for the new regime.

For further information regarding this article please contact Gareth van Deventer at gareth@saia.co.za

SAM Snippets

- SA QIS 1
  - The FSB are hard at work reviewing the results of the recently completed SA QIS1 exercise. It is expected that a high level overview of the report compiled by the FSB will be presented at the FSB SAM Steering Committee meeting on the 5th December 2011
  - According to high-level information at our disposal and still subject to change:
    - 55 submissions were received by short term insurers
    - 2 non-life insurers fall short of the MCR requirement
    - 10 non-life insurers fall short of the SCR requirement
- The SA QIS2 exercise will take place in 2012 and early indications are that it is expected to follow similar timelines and deadlines as were applicable to the SA QIS1. At this stage the FSB are still considering whether participation in the SA QIS2 exercise will be compulsory for all insurers

- It is expected that the FSB will issue a second draft of the Primary Legislation by the 15th December 2011. The first draft of the much anticipated Secondary Legislation can be expected for release sometime in April 2012

- The Insurance Laws Amendment Bill is scheduled for presentation at Parliament in the second quarter of 2012. It is expected to be enforced towards the end of 2012. This Bill addresses the interim measures specific to ***Governance, Internal Controls and Risk Management***

  NB - Members are reminded that ***Board Notice 169 of 2011*** pertaining to ***Prescribed requirements for the calculation of the value of the assets, liabilities and capital adequacy requirement of short term insurers***, will become effective and enforceable as from ***1st January 2012*** and as such the FSB will require full compliance with these new capital requirements from day one

- The following Discussion Documents have been released by the FSB's SAM Steering Committee for public comment:

  - Discussion Document 39 (v3) entitled: Assets and Liabilities other than technical provisions
  - Discussion Document 47 (v2) entitled: Equity Risk

  The FSB has requested that comments pertaining to the above Discussion Documents be submitted to them by the ***17th January 2012*** for consideration

- The Economic Impact Study Task Group have drafted their terms of reference *(T.O.R)* document and begun discussions regarding the economic impact study. It is expected that the results of the SA QIS2 exercise will form the basis for this study

- The South African Reserve Bank (SARB) has been included as a new stakeholder participating in the SAM forum structures

- Internal Model Approval Process (IMAP)

  - The first window for the submission of the Pre-Application Qualifying Criteria template (PAQC) as part of the Internal Model Approval Process (IMAP) closed on the 30th November 2011. According to our information approximately 10 insurers (including life and non-life) submitted their PAQC's in this window

  - The FSB have indicated that they will scrutinise these PAQC's and revert back to insurers by the 15th December 2011, to inform those who were successful with their application for the review of their models as part of the next step (pre-application phase)

- A ***Board Notice (188 of 2011)*** was issued on the 25th November 2011 setting out the fees that will be applicable to insurers who are seeking approval of their internal models as part of the IMAP process. These fees will be applicable to insurers who will be participating in the pre-application phase once they have been granted approval by the FSB, after reviewing their Pre-application Qualifying Criteria templates

  The Board notice sets out the fees applicable as per the various categories of review required by the FSB, as well as the payment terms and conditions regarding the fees

  A copy of this Board Notice can be found on the SAIA SAM Webpage. Please contact us directly should you require any further assistance or information pertaining to these fees

- The Role of the Statutory Actuary is currently being addressed within the internal structures of the FSB and feedback regarding the work done is expected to be communicated early in 2012

- The number of Discussion Documents being generated by the SAM Governance Structure continues to climb and now stands at 89

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

SAM SA QIS1 – Where to from here?

In July 2011 the FSB released the first quantitative impact study (QIS1) in preparation for Solvency Assessment and Management (SAM), which is expected to be implemented from 1 January 2014. QIS1 was based on QIS5 for Solvency II, although it did have some South African specific adjustments. The QIS aims to highlight the quantitative impact of SAM on the required solvency for the insurers, and provide insights for future refinements to the standard formula before 2014. First indications are that 55 short-term insurers and 39 life insurers took part in QIS1.

A second QIS is expected in either the second or third quarter of 2012. The various SAM task groups and working groups are currently investigating possible refinements to the standard formula, based on the feedback and data gathered through SA QIS1, as well as the latest developments in other similar regulatory frameworks around the world.

Key findings from SA QIS 1

The FSB requested insurers to complete QIS1 on a 'best efforts basis', which means it is difficult to gauge how many insurers managed to comply with the technical requirements of the standard formula calculation. However, based on the large number of insurers that did take part, the following general observations can be made in respect of the short-term insurance market:

- The capital requirements for short-term insurers from the QIS were found to be reasonable in the main, although they were on average higher than the current capital requirement of 25%.
- However, the standard formula places a big emphasis on diversification and is particularly penal for certain mono-line insurers – especially so for credit insurers. As an example, the premium risk parameter for credit insurance is 21.5% compared to 7% for personal motor (non-liability) business. Comparing two companies where each writes R100 of premium in their respective class, ignoring all other elements of the balance sheet, the credit insurer will have a capital requirement of R75.2, compared to the motor insurer's of R25.3 – roughly one third of the former.
- The catastrophe scenarios for natural and man-made risks need refinement and the man-made risks need to be made South Africa specific. The relative weight between perils for catastrophes also requires further refinement, as some insurers observed high capital requirements for perils to which there is not significant exposure in practice.

Common challenges among short-term insurers

1. Calculating the technical provisions

The technical specifications require that the best estimate technical provisions be calculated as the discounted probability weighted cash flows that are expected to occur from the business that the insurer currently has on its books. This has proven challenging for insurers to get right, especially considering the onerous historical data requirements for performing this calculation, compared to the current simple percentage based methods of 7% of net written premiums for IBNR or the 365th method for UPRs.

2. Look through approach for market risk

Insurers found it difficult to get sufficiently detailed information from their asset managers, including on their collective investments, such as unit trusts. This made it challenging to determine the market risk, which requires detailed credit ratings, durations, valuation bases and other information on each individual asset.

3. Shocking the whole balance sheet at once

The requirement that the shocks be applied to the entire balance sheet posed unique challenges to insurers. As an example, it requires that technical provisions and bonds be re-valued simultaneously under various different interest rate scenarios. It is important that insurers consider all relevant items on both sides of the balance sheet, and their interaction, when assessing the prescribed standard formula shock scenarios.

4. Significant contribution of default risk

The risk of default considers all current and potential future counterparties, to assess how much capital to maintain in case of any of these failing. This includes the risk of default on all future reinsurance recoveries that are expected to be made on future claims. This is particularly onerous for companies that purchase high levels of catastrophe cover. Insurers also found it difficult to get the details on all the counterparties, adding to the challenge of valuing the default risk from these counterparties.

5. Definition of contract boundaries

There was some debate over the contract boundaries for short-term insurers. The Errata & Clarifications document issued by the FSB defines the contract boundary as the next date that the contract rates can be reviewed. Most insurers who write monthly renewable business only review the rates once a year. This creates a grey area on what the contract boundary actually is. Generally most short-term insurers considered their business as having a contract boundary of one month.

This one month assumption for contract boundaries has the further implication that these insurers did not incur any capital charge for the lapse risk shock, due to the one month contract boundary assumption. In practice, contractually, there are classes of short-term insurance which are generally written as annual contracts, and as such, should be subject to lapse risk (or mid-term cancellation risk).

6. Deferred tax adjustment

There was no clear guidance on the deferred tax adjustment; especially the consideration of how to assess whether "realisation of that deferred tax asset is probable within a reasonable timeframe" – effectively asking whether the insurer will continue operations if the 1 in 200 year event hits, in order to start making profit again. This lead to inconsistency in how the deferred tax asset was calculated between the different insurers making a comparison of the absolute capital levels challenging.

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What are short-term insurers doing to get ready for SAM?

With SAM preparation firmly underway and SA QIS 1 highlighting some areas that insurers need to focus on, what are the common actions being taken in the industry to ensure readiness for 2014?

1. For the moment, the focus certainly has shifted away from internal models. The internal model approval process is extremely onerous (and costly), especially given the timelines associated with the first window. It is expected that not more than 10 insurers (life and short-term) will aim to get approval during this first phase. If the internal models are approved in the first wave, it will still be required that insurers calculate and hold capital based on the standard formula for at least a year with a further 12 months phase in after that. Most insurers have decided to take more of a wait and see approach on internal models, due to the uncertainty around the standards and the approval process, and have opted for deepening the embedding of their existing models in the risk management and ORSA processes.

2. Short-term insurers have narrowed their focus on the gathering of data and improving their data systems for calculating technical provisions. As stated earlier, SAM compliant technical provisions require a comprehensive reserving exercise to be performed. This extends to elements such as detailed expense analyses, to ensure that the best estimate claims provision includes sufficient allowance for direct and indirect (overhead) expenses.

SAM can easily be seen as just a massive compliance burden, and with all the work required, this is not an untrue observation. However SAM is not all about the numbers, but also about improving risk management and disclosure within the industry. One of the key challenges for the short-term industry is the formalisation of their existing risk management processes and structures. So most insurers have set up formal SAM programmes and are in the process of performing high level GAP analyses across all three pillars to determine the key areas that they need to focus on to ensure SAM compliance.

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Season's Greetings

The SAIA SAM Project Support Office would like to express our sincere thanks and appreciation to all our SAIA members for the tremendous support that we have received throughout 2011.

It has been a tough year but a significant one as the new SAM regime continues to take shape. One of the most noteworthy achievements of 2011 was the successful participation and completion of the SA QIS1 exercise by insurers. This landmark achievement provided valuable information to the FSB for consideration in building the new regime.

To those that will be travelling over this festive season we wish you safe travel mercies and to those that will be spending their time at home may your days be filled with peace and rest.

We look forward to your rejuvenated spirit in 2012 as together we tackle and overcome the challenges that await us, while continuing to favourably influence the design of the new proposed SAM regime.

We wish you all a very prosperous 2012!