Derek Vice

Partner
Insurance
Tel: +27 82 711 2519
Email: derek.vice@kpmg.co.za

DEMYSTIFYING THE NEW INSURANCE ACT

Consider the following. For the year ended March 2011, the MSCI World (global stock funds) Index dropped by 52%. The worst ever performance of the Johannesburg Stock Exchange (JSE) was for the twelve months ended 31 May 1970. Over this period, the JSE index dropped by 49.5%. Over the twelve months to February 2009, the JSE dropped by 39.8% and for the period to 31 August 1980 it dropped by 36.2%[1].

Shall we talk natural catastrophes? The damage from the Gauteng hail storms in 2012 amounted to more than R1 billion[2]. It is estimated that over the following four years, weather-related insured losses amounted to R2.5 billion[3]. Add to this the Knysna fires (total property damage of around R4 billion[4] with insured losses close to R3 billion[5]) and the St Francis fires (with property damage estimated at R300 million[6]).

Or how about pandemics? By June 2018, there were 1,053 reported cases of listeriosis in South Africa, with 212 deaths[7]. In West Africa in March 2016, Ebola infected 28,616 people resulting in 11,310 deaths[8]. Unlike property damage, many of these pandemics affect the poorer and uninsured portions of the market[9]. Although this is usually the case, it is not always so. The Spanish flu of 1918-1920 killed approximately 75 million people. Many of the people killed by this pandemic were "previously healthy adults". During the first year of this pandemic, life expectancy in the United States dropped by about 12 years.[10] Quantifying the impact of these and the impact directly on mortality claims against life insurers is difficult. In 2010, 66% of all worldwide HIV/ AIDS related deaths occurred in sub-Saharan Africa (approximately 1.2 million deaths per annum). Which of the 1.2 million individuals had life insurance is hard to tell. Either way, HIV/AIDS had a significant impact on the mortality rates of life insurers.

[1] Position Paper 47 – Equity Risk
[2] https://www.fanews.co.za/article/short-term-insurance/15/general/1217/hail-storms-batter-gauteng-suburbs-while-consumers-and-insurers-count-the-cost-of-damage/14860
[3] https://www.fin24.com/Money/Insurance/impact-of-east-rand-declared-catastrophe-zone-by-insurers-20161111
[4] https://www.iol.co.za/personal-finance/insurance-lessons-from-knysna-devastation-11430535
[5] https://businesstech.co.za/news/finance/195666/the-most-catastrophic-event-in-south-african-insurance-history/
[6] https://www.fanews.co.za/article/short-term-insurance/15/general/1217/an-expensive-lesson-in-underwriting-residential-fire-risk/12861
[7] https://www.foodstuffsa.co.za/sas-listeria-outbreak-need-know/
[8] http://apps.who.int/iris/bitstream/handle/10665/208883/ebolasitrep_10Jun2016_eng.pdf;jsessionid=A5609269A0EA627CC04A4FA20147CE5D?sequence=1
[9] https://www.reuters.com/article/us-global-pandemic-insurance/world-bank-launches-pandemic-bond-to-tackle-major-outbreaks-idUSKBN19J2JJ
[10] https://en.wikipedia.org/wiki/Spanish_flu

What does all this have to do with the Insurance Act? The introduction of the Insurance Act, no. 18 of 2017 (the Act) sees the final step in the long journey toward a **risk-based prudential regime**. The Act is law makers' way of trying to ensure that insurance companies are adequately prepared to deal with these shocks. It deals with ensuring these companies have both enough money and adequate processes to survive these stresses. Technically these are referred to as having adequate capital and a risk management system, respectively.

Many insurers might look back fondly on the days of simple calculations such as holding 10% of approved net written premium as capital and for non-life insurers, an easy 7% IBNR. However harking back to those days is akin to wishing for unwashed scalpels in surgery rooms and leeches to balance the humours. Times have moved on and our understanding of corporate failures has too. Core to this understanding is embracing the uncertainties of global markets and human and natural catastrophes and attempting to quantify and manage them.

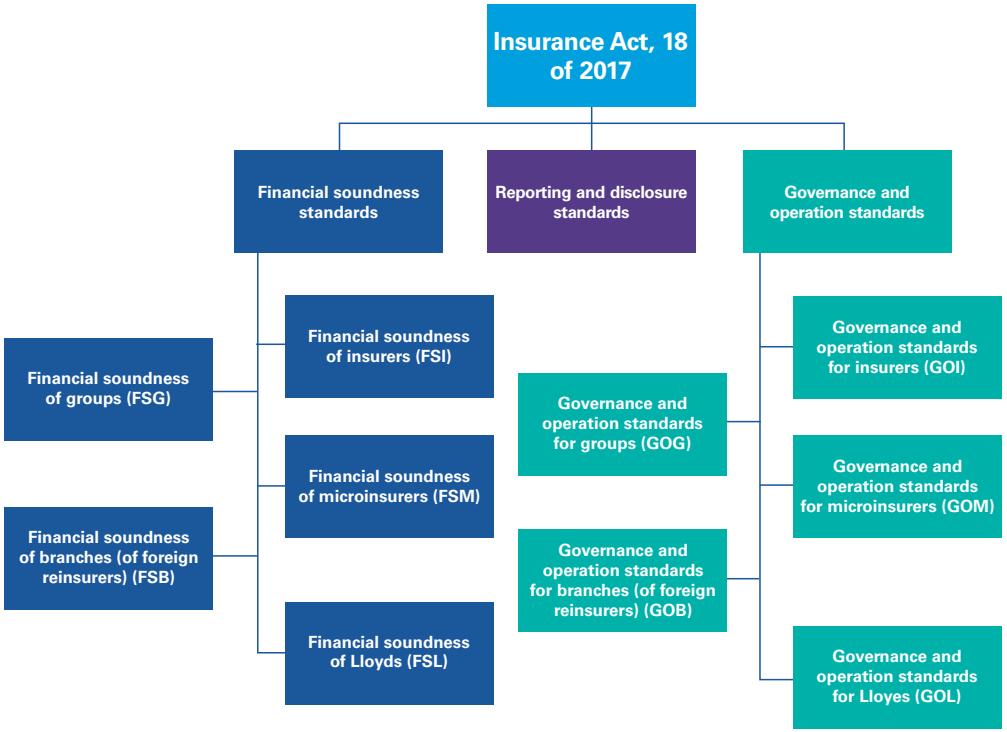
In this article we hope to arm, not the educated, but the uninformed user with the basics of the new Insurance Act. We will explore the key objectives of the Act and provide some context to the regulations and the significantly more complicated governance and measurement regimes that have come in to force with it.

We will explore the core constituents of the Act in the context of its objective which can be paraphrased as:

- To provide for a legal framework for the prudential regulation and supervision of insurance business in the Republic;
- Promote the maintenance of a fair, safe and stable insurance market;
- To introduce a legal framework for microinsurance to promote financial inclusion; and
- To replace certain parts of the Long-term Insurance Act, 1998, and the Short-term Insurance Act, 1998 (the Acts).

A Legal Framework

It is important to note that the Act is a framework piece of legislation which is supported by various underlying documents known as the Prudential Standards (the Standards). The Standards deal variously with: financial soundness; governance and risk management; and reporting – broadly the three pillars of the prudential framework. The Act allows for various legal forms of insurance entities namely, solo insurers (insurers), insurance groups (groups), microinsurers, branches of foreign reinsurers and the Lloyd's representative office in South Africa. Detailed regulations have been established for each of these entities, as illustrated below.



"What a year 2017 was, with the largest insured losses the country has ever recorded in a single year. The industry demonstrated its resilience and maturity that is so vital to the country's badly needed economic recovery and sustainable growth by meeting all arising obligations without fail. Kudos to the industry!"

Ibrahim Ibisomi, CFO, African Reinsurance Corporation

Prudential Supervision

One of the most significant developments brought about through this process is the establishment of the **Prudential Authority** (PA). Before the Financial Sector Regulation Act (the FSR Act), the Financial Services Board (FSB) acted as the prudential regulator for insurers and the South African Reserve Bank (SARB) acted as the prudential regulator for banks. This created the unwieldy situation where a company could have one regulator, its parent another and its ultimate parent could be regulated by either of them. Clearly in a post credit crisis world, financial conglomerate and group supervision is essential and this important step has taken South Africa one step closer to this objective.

A Prudential Framework that Promotes a Safe and Stable Insurance Market

The new Act introduces a **risk-based framework**. Simplistically speaking, this means that the more uncertain a balance sheet position is over a time horizon (in this case one year), the more capital is required to support that balance sheet.

Let's consider an insurer that backs its insurance obligations with shares. Based at what happened at the JSE in 2009, it is entirely plausible that the shares backing those obligations could drop by 39% in twelve months. Both the MSCI world index and the JSE have dropped by significant amounts like this – more than once. Consequently, a balance sheet where shares back insurance obligations is riskier compared to one backed only by cash or government bonds. As a result of this, an insurer that holds significant amounts of shares should hold greater amounts of capital to support this uncertainty. This is generally referred to as **"stressing"** the balance sheet or applying **"shocks"** to the balance sheet - moving from a starting position and seeing how different that position could be if specific variables change.

However, before we get to shocking, we need to deal with some of the anomalies that the accounting standards introduce. Consider that a company could hold the above shares at their cost or their fair value. If the cost is significantly lower than the fair value, the starting point of any shock would be unreasonable. For this reason, the risk based regime requires insurers to **prepare an economic balance sheet** view of the company. Shocking the cost price of a share carried at R10 by 39% would lead to a capital requirement of R3.90 (alternatively, we could view this as the assets being worth only R6.10). Against insurance obligations of R10 we might conclude that the company is not sufficiently capitalised. However, this conclusion is meaningless if the current fair value of these shares is R100. Although the capital requirements would increase to R39 (39% of R100), the excess assets would be R61, which are clearly sufficient to meet the insurance obligations of R10.

The notion of an economic balance sheet (sometimes referred to as a market-consistent valuation) is particularly important when we consider the various ways in which insurers currently value their liabilities (i.e. the obligations arising under their insurance contracts). It is a common practice for non-life insurers to include prudence in the accounting for their insurance contract liabilities. This is understandable, but results in a misleading balance sheet when used as a starting point for calculating capital. If we accept that insurance provisions contain uncertainty (i.e. risk) then we should shock these amounts. Such shocks would be overstated if applied to a prudent carrying value of the liabilities.

It is even more complicated for life insurers. Many life insurers choose not to carry the embedded value of their insurance book on their balance sheet. In many instances the present value of a profitable book is not recognised at all or only recognised for those policies that are potentially loss making. Not only would this distort the shocks which are applied to life business, it might also hide entirely the true sources of uncertainty for a life insurer.

Company A expects to make R10 billion over the life of a particular book of business. A portion of this business is expected to make a loss of R1 billion. An increase in **mortality or morbidity rates** would generally increase the liabilities. In contrast an increase in lapse rates would generally reduce the assets. Only recognising the R1 billion liability could lead us to conclude that the most significant risk for this company is that mortality or morbidity rates (i.e. the rates at which people die or are injured) increase. A 10% increase in these rates might increase the R1 billion liability by R100 million[11]. However if the R10 billion asset was recognised, it

[11] We have made a simplifying assumption that mortality and lapse rates have a linear relationship with the liability value.

would be clear that the company has sufficient assets to meet this shock. More importantly, it might also become more apparent that a 10% increase in lapse rates is significantly more detrimental to the company. When a policy lapses, the expected future profits will not realise.

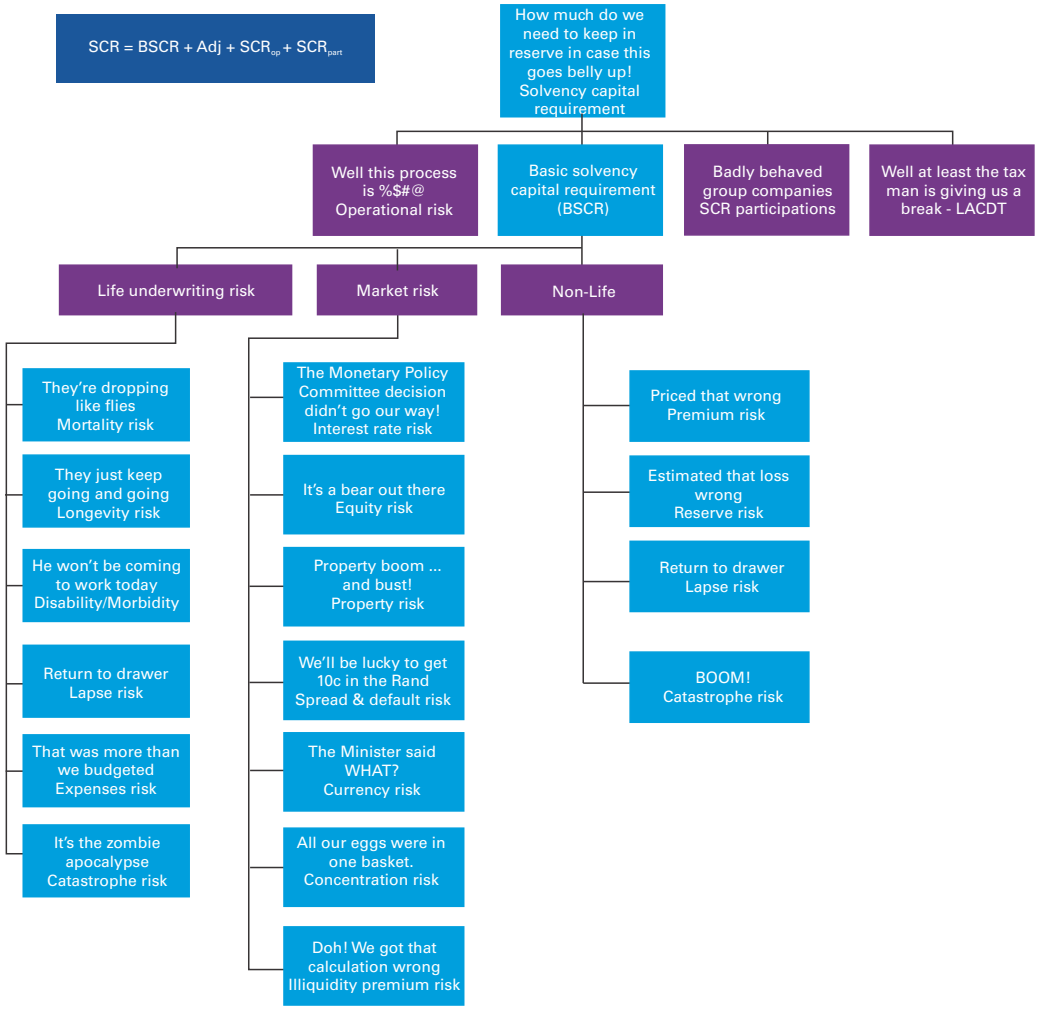
Lapse risk is the most significant contributor to life insurance underwriting risk. In an impact study conducted as part of the development of the new insurance act, lapse risk was identified as the most significant contributor to the capital requirement for life insurers[12].

Broadly speaking then

— the quantitative approach to prudential regulation takes;
— an economic, market-consistent view of an insurers' balance sheet then;
— stresses this balance sheet for known areas of uncertainty to;
— establish how much the economic position could change over a year.

Technically this is what is referred to as the **Value-at-Risk** (VaR). The VaR is calculated considering a one year time horizon. The VaR is also set to consider worst- case scenarios, i.e. one-in-two hundred year variations (1/200). The 1/200 requirement is also referred to as a **99.5% confidence level**, which is to say that it should be right 199 out of 200 times – or 99.5% of the time.

The VaR considers various areas of uncertainty in building up a view of the extent to which an insurer's balance sheet can change over a one year horizon. These areas are the modules and sub-modules which make up the **Solvency Capital Requirement** (SCR). The SCR is the amount of capital (excess regulatory assets) that an insurer must hold to cover the VaR at a 99.5% confidence level. The table alongside summarises "where things can go wrong" (i.e. the modules and sub-modules of SCR) and "how much insurers need to keep in reserve in case things go belly up!" (i.e. SCR).



[12] Quantitative Impact Study 3 conducted by the Financial Services Board

Governance and Risk Management

It is often said that companies do not fail because of a lack of capital but because of poor decisions and risk management. By the time a company is insolvent (on most bases of measuring insolvency) the company is often far down a path of no return.

- Over-committed on property exposures,
- Locked into debt spirals,
- Balancing on circular inter-company loans,
- Exposed to open derivative positions, encumbered assets,
- Inaccessible investments,
- Down-side risk

These are all examples (mostly South African) of insurance and financial services failures.

It is in this context that the Act includes various structural requirements for insurance companies. Many of these have been drip fed into the industry over the last few years. Key reforms and structural requirements not in place ten years ago include requirements for:

- A risk committee, to identify, monitor and manage the key risks facing the entity;
- A remuneration committee, to ensure that practices promote the interest of not only the shareholder, but other stakeholders – notably the policyholders;
- Mandatory control functions (internal audit, risk, compliance and actuarial) and accountable individuals for these functions (called the Head of the Control function);
- An annual consideration of how the business strategy impacts the future capital of the company;
- Rules around outsourcing and contracting with third parties; and
- Fit and proper requirements for the leadership of the entity.

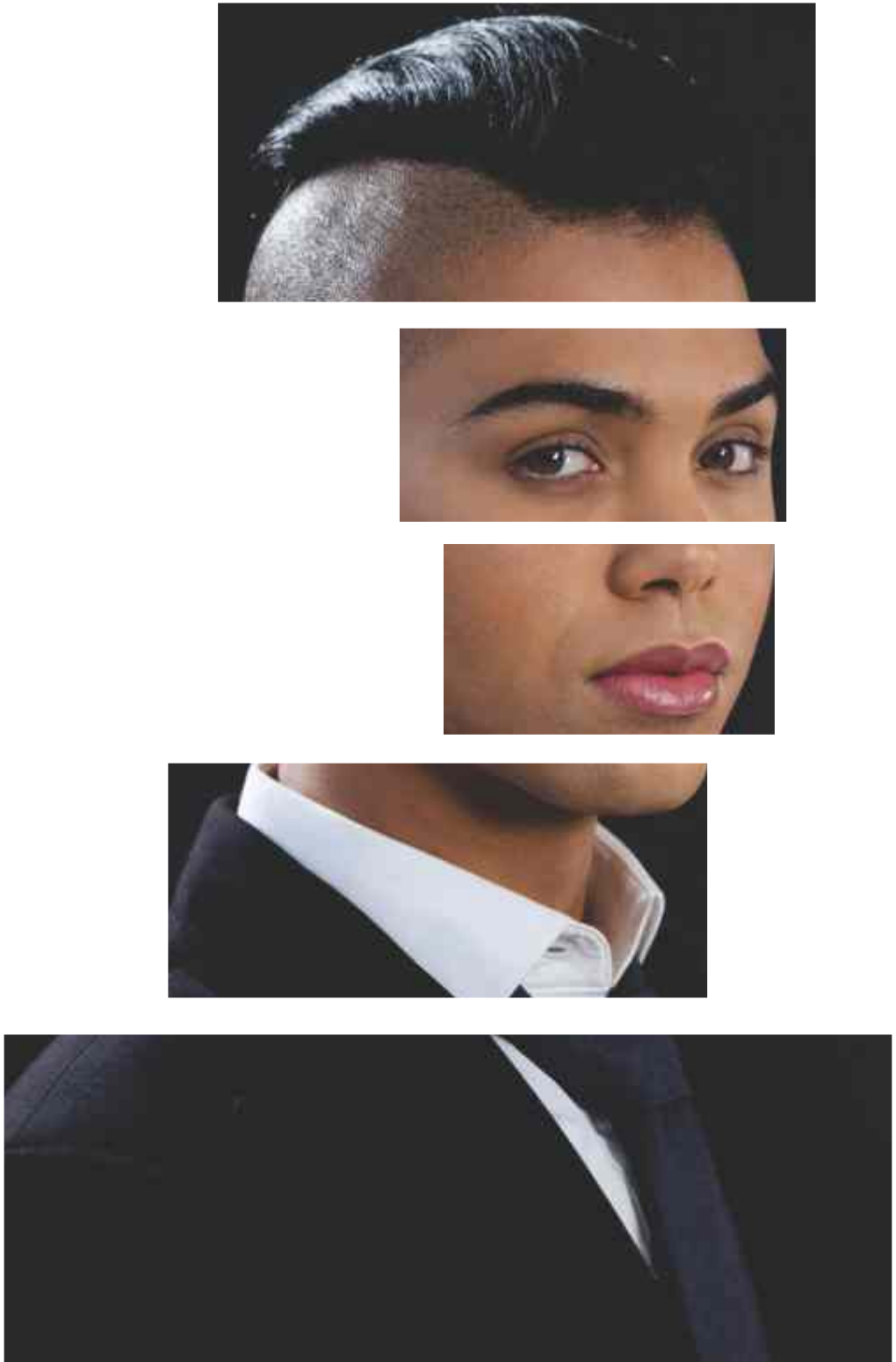
Another significant development is the requirement for insurers to perform an Own Risk and Solvency Assessment, requiring insurers to consider the entirety of their risks and controls, how their strategies impact future solvency requirements and risks not specifically covered in the modules and sub-modules.

Fairness

It is interesting to note that the objectives of the Act include "fairness". It should be noted that this is a reference to a fair legislative framework rather than fairness to customers as referred to in the Treating Customers Fairly requirements. Conduct aspects are not generally incorporated into the Act or the subordinate legislation. Market conduct and fair customer outcomes are the ambit of the Financial Sector Conduct Authority and beyond the scope of this article.

Conclusion

The Act is a significant step forward for South Africa… it should help protect customers' interests when things go belly up! Furthermore, it puts us on a level playing field with the international community and embeds international best practice. Although we have simplified things somewhat, follow us @KPMG for a more advanced understanding of the new Insurance Act - available soon.



"In the fast changing world of insurance - with the introduction of IFRS 17, new technologies and changing regulations – it is more important than ever to be able to simplify the complexity for all stakeholders and to listen carefully to what customers really want. "

Hennie Nel, Group CFO, Santam