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FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2022

TECHNICAL NOTE ON INSURANCE SECTOR - REGULATION AND SUPERVISION

This technical note on Banking Regulation and Supervision was prepared by a staff team of the International Monetary Fund and World Bank in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP). It is based on the information available at the time it was completed in June 2021.

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FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2, 2022

TECHNICAL NOTE

INSURANCE SECTOR: REGULATION AND SUPERVISION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared in the context of the Financial Sector Assessment Program in South Africa during June 2021 mission led by Jennifer Elliott, IMF and Eva Gutierrez, World Bank and overseen by the Monetary and Capital Markets Department, International Monetary Fund, and the Finance, Competitiveness and Innovation Global Practice, World Bank. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary

AI	Artificial Intelligence
ALM	Asset Liability Management
CEO	Chief Executive Officer
CIS	Collective Investment Scheme
ERM	Enterprise Risk Management
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSB-SA	Financial Services Board of South Africa
FSCA	Financial Sector Conduct Authority
FSRA	Financial Sector Regulation Act
IAIS	International Association of Insurance Supervisors
IA	Insurance Act
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
LGD	Loss Given Default
ML	Machine Learning
MoU	Memorandum of Understanding
ORSA	Own Risk and Solvency Assessment
PA	Prudential Authority
PD	Probability of Default
SAM	Solvency Assessment and Management Framework
SARB	South African Reserve Bank
TCF	Treating Customers Fairly
ZAR	South African Rand

EXECUTIVE SUMMARY[1]

The South African insurance sector is large, complex, internationally active, and competitive. Supported by high penetration and density of insurance products, the insurance sector has grown to account for 18 percent of the financial sector in South Africa. The industry hosts an unusually diverse range of business models, including traditional participation focused models, bank-led conglomerates, asset management focused groups, and technology driven new entrants. Even among large insurers, risk profiles vary significantly, which is unique relative to other major insurance markets. Most large insurance groups are actively expanding their business both regionally and globally.

The adoption of twin peaks has allowed both the conduct regulator and the prudential regulator to deepen their expertise, thereby strengthening supervision of the insurance sector. The Financial Sector Regulation Act (FSRA) was promulgated in August 2017 to establish the Twin Peak Model. In April, the Prudential Authority (PA) was established operating within the administration of the South African Reserve Bank (SARB), and the Financial Sector Conduct Authority (FSCA) was established as the legal successor of the former insurance supervisor (Financial Services Board or FSB-SA). The SARB remains responsible for maintaining financial stability. The institutional changes have allowed greater specialization of focus but additional coordination between the two bodies is called for.

The authorities have made number of substantial regulatory reforms since the last FSAP, in line with the international standards. The PA has implemented a new risk sensitive Solvency Assessment and Management Framework (SAM) for solo insurers in January 2018 and established group wide supervision (so called "level 2") and in the process of designation[2] of large insurance groups. The new Insurance Act (IA) has established comprehensive Governance requirements. SAM implementation also substantially improved the reporting framework. The FSCA is actively using its powers to improve the conduct, including thematic reviews, mystery shopping, and number of enforcement actions and has implemented number of important regulatory reforms proposed by the Retail Distribution Review (RDR) in 2014, including the Treating Customers Fairly (TCF) initiative. Additional reforms are underway to prepare for the future Conduct of Financial Institutions (CoFI) Act.

While the impact of COVID-19 on the insurance sector has been relatively muted, potential challenges to solvency and liquidity call for further enhancement of prudential supervision. Many life insurers remain highly exposed to equities, and experience very high lapse and surrender rates, with attendant liquidity risks. The inclusion of substantial future profits from existing policies into Tier 1 capital, combined with high lapse and surrender scenario, could also have an impact on capital resources. Further, while solvency ratios remain high (182 percent for life and 173 percent for non-life at the end of 2020) and stable even during COVID-19 crisis, stability of solvency ratio was partially achieved by an underestimation of sovereign credit risk, where recent downgrades of South African government bonds increased the discount rates used in insurance liabilities valuation for solvency calculation and thus reduce the value of insurance liabilities. Adoption of the International Financial

[1] This technical note was prepared by Nobuyasu Sugimoto, Senior Financial Sector Expert in the IMF's Monetary and Capital Markets Department.

[2] Three insurance entities were designated as part of an insurance group as of June 2021, when PA's annual report 2021/21 was published.

Reporting Standards (IFRS) 9 and 17 may have an impact on accounting profit and the capital of the insurers, as credit risks of the sovereign bonds would be incorporated into both assets and liabilities valuations. Consolidating gains made with implementation of SAM through enhanced monitoring and industry wide stress-testing is highly recommended. The PA should also consider focusing supervisory efforts on those firms or groups with a high reliance on future profit. Introducing recovery planning for insurers would be a welcome addition, especially for more complex firms.

Robust scrutiny of the key assumptions that insurers are using in their valuation and capital calculation will enhance the effectiveness of SAM. By design, SAM relies on a significant number of internal models and a firm's own estimations, both in the valuation of assets and liabilities, and capital requirements calculation. Without thorough monitoring by the competent authorities, there is a significant risk of manipulation and delay of regulatory actions, including in the modelling of valuations for illiquid assets. The PA should consider devoting additional resources to the validation of material key assumptions, such as probability of default (PD) calculation. The PA is encouraged to enhance coordination between insurance and banking teams to leverage expertise.

The effectiveness of conduct supervision has been improved by shifting to risk-based supervision—adopting a more forward-looking and better coordination between supervisors will further enhance these efforts. The FSCA is shifting to a risk-based supervisory framework, but supervisory activity still focuses on individual cases and remediation of materialized incidents. More attention to actions to mitigate future misconduct risk is warranted, such as imposing a robust governance and risk management framework. Further strengthening of PA-FSCA coordination to enhance compliance with governance requirements would also be important. Recent initiatives to enhance data sharing between the two authorities are a welcome step forward. Greater coordination on deep dives (e.g., on high lapse and surrender products) could help address conduct and liquidity risks of the industry more effectively.

Some insurers are actively using complex customer behavioral models and are adopting Artificial Intelligence (AI) and Machine Learning (ML). The authorities are carefully monitoring the development of insurtech development by establishing an innovation hub. A regulatory sandbox will be launched in 2020, managed not only by financial authorities but number of government agencies. Some advanced insurers are considering introducing AI and ML for their core insurance business decision-making (such as underwriting and premium setting). It is recommended that the authorities enhance the monitoring of the development even further and prepare for appropriate regulatory actions.[3]

Further efforts to increase resource and enhance skillsets in key technical areas will be key to the authorities' ability to realize full effectiveness of recently adopted and planned reforms. Regulatory reforms would require robust and continuous monitoring and scrutiny by supervisors with requisite specialized skills. Areas of increasing risks, such as cyber, group, conduct, and cross-border, warrant an expansion of resources in certain key functions at PA and FSCA, such as in enforcement, and the supervision of IT and operational risks, as well as to support strengthened monitoring of foreign activities and cooperation with international regulators.

[3] Aspects pertaining to fintech and insurtech will be further explored during the second FSAP mission.

Table 1. South Africa: Recommendations on Insurance Regulation and Supervision		
Recommendations and Responsible Authorities	**Timing***	**Priority****
Conduct targeted inspections on estimations in insurers with high reliance on future profits in their capital resources with a view to potential revisions. (PA, ¶45)	ST	H
Conduct an impact study and industry wide stress test to address potential impact of IFRS 17 adoption. (PA, ¶46)	ST	H
Conduct deep analysis and/or joint inspections on high lapse and surrender products. (PA and FSCA, ¶80)	ST	H
Impose recovery planning to large groups which rely substantial amount of their Tier 1 on future profit from long term products (PA, ¶68)	MT	M
Expedite the changes to the legislative framework such that high legal priority is given to the protection of the rights and entitlements of policyholders (PA, ¶69)	MT	M
Build additional supervisory resources, with an emphasis on recruiting experienced staff and enhance resources with high demand skills (PA and FSCA, ¶33)	ST	H
Continuously improve IT systems with focusing on material and newly emerging risks, such lapse and surrender risks, operational and cyber risks (PA and FSCA, ¶33)	MT	M
Enhance data sharing between the authorities and analyze the risks of CIS investment by insurers. (PA and FSCA, ¶47)	MT	M
Ensure appropriate capital requirements by conducting thematic review on PD estimation with close cooperation with banking supervisors. (PA, ¶48)	MT	M
Encourage insurers to incorporate sovereign stress scenario in their capital and liquidity stress testing within the Own Risk and Solvency Assessment (ORSA) report and develop an optimal plan to supplement individual stress testing with supervisory stress testing. (PA, ¶57 and Box 2)	ST	M
Prepare for the more active use of big data, AI and ML by insurers. (PA and FSCA, ¶81)	MT	M
* C = continuous; I = Immediate (within one year); ST = Short Term (within 1-2 years); MT = Medium Term (within 3-5 years). ** H= High; M= Medium; L=Low.		

INTRODUCTION

A. Scope and Approach

1. **This technical note provides an update on the South African insurance sector and an analysis of certain key aspects of the regulatory and supervisory regime.** The note has been prepared as part of the 2020 FSAP) and draws on desk reviews of laws, regulations and pertinent data, as well as meetings conducted in South Africa from February 27 to March 16, 2020. Where applicable, the technical note references the Insurance Core Principles (ICPs) issued by the International Association of Insurance Supervisors (IAIS), as revised in November 2019. However, as the Covid-19 pandemic has had a significant impact on the insurance industry, and the situation remains fluid, supplemental analysis and discussion with the authorities has been conducted to describe COVID-19 impact on the insurance sector and regulatory measures taken by the authorities. The analysis and discussion are summarized in the Box 3, and relevant graphs are updated to indicate the impacts of COVID-19.

2. **The note analyzes practices of the South African authorities in relation to selected ICPs, in the context of a wider discussion of system-wide trends and developments in the insurance industry.** The note does not provide a detailed assessment of observance of the ICPs.[4] The most recent assessment, conducted on the basis of the 2011 version of the ICPs, was carried out in 2014. The main focus of this note is on recent developments in the regulation and supervision of the insurance sector, including major reforms of solvency requirements (Solvency Assessment Management). The note also reviews developments in some specific areas highlighted in the previous FSAP, such as group wide supervision.

3. **The note refers to laws, regulations and other supervisory requirements and practices in place at the time of the discussions in South Africa, as well as to ongoing and planned regulatory reforms.** In respect of the 11 ICPs[5] that served as a point of reference for this note, the authorities provided a self-assessment, supported by anonymized examples of actual supervisory practices and assessments. The institutional arrangements for financial sector regulation and supervision are outlined in the section of this note entitled *Institutional Setting*.

4. **ICPs selected as the focus for the analysis are broadly those with macro-financial relevance and those where there have been material regulatory changes.** They include the ICPs on solvency requirements (valuation, investment and capital adequacy), market conduct, group supervision. In addition, other important supervisory practices such as risk-based supervision, macroprudential surveillance and cross-border cooperation has been covered by a supplemental

[4] The IAIS ICPs apply to all insurers, whether private or government controlled. Specific principles apply to the supervision of intermediaries.

[5] The selected ICPs are: 1 (Objectives, Powers and Responsibilities), 2 (Supervisor), 7 (Corporate Governance), 12 (Winding-up and Exit from the Market), 14 (Valuation), 15 (Investment), 16 (ERM for Solvency Purposes), 17 (Capital Adequacy), 18 (Intermediaries), 19 (Conduct of Business), and 23 (Group-wide Supervisor).

questionnaire. As the exercise did not entail a detailed assessment of observance in line with the IAIS ICP methodology, no grading of the level of observance of the selected ICPs is given in this note.

5. **The author is grateful to the authorities and private sector participants for their excellent cooperation**. The author benefitted greatly from the inputs and views expressed in meetings with insurance regulators, supervisors, insurance companies, industry associations and professional organizations. The staff of the PA and FSCA, in particularly, were very open and accommodative to all information requests and engaged in discussions with the team, which was very much appreciated.

B. 2014 FSAP Recommendations and Implementation

6. **The 2014 FSAP conducted a full detailed assessment of the ICPs and made recommendations to improve compliance with the IAIS ICPs.** The full assessment found that the authorities had made good progress in aligning the supervisory and regulatory framework with international standards, while highlighting needed improvements in risk-based supervision, group-wide supervision, winding-up and risk management. In particular, the 2014 assessment found that:

- here are no explicit regulatory powers to conduct group-wide supervision and the authority relied on moral suasion or an informal framework for group supervision of insurance groups. It was also noted while they authority has added significant resources to its Insurance Division, additional skilled staff complement will be needed to effectively implement the regulatory reform agenda and supervise complex conglomerates;

- there were no explicit corporate governance requirements in the IA or regulations. The authority relied on registration requirements for insurers as the high-level legal basis to supervise insurers' governance practices. The relevant bill and Board Notice were in the process of implementation during the 2014 FSAP; and

- policyholders did not have priority of claims over unsecured creditors in the event of the winding-up of an insurer. The establishment of a policyholder protection scheme was under consideration during the 2014 FSAP.

7. **Insurance sector regulation and supervision has strengthened further since the 2014 FSAP.** A new risk-based solvency regime (modeled on the European Solvency II framework) has been adopted, with comprehensive governance and risk management requirements. In addition, a new IA, adopted in 2018, allows the PA to designate insurance groups and enables it to apply supervisory powers to the controlling companies, including group level capital requirements.

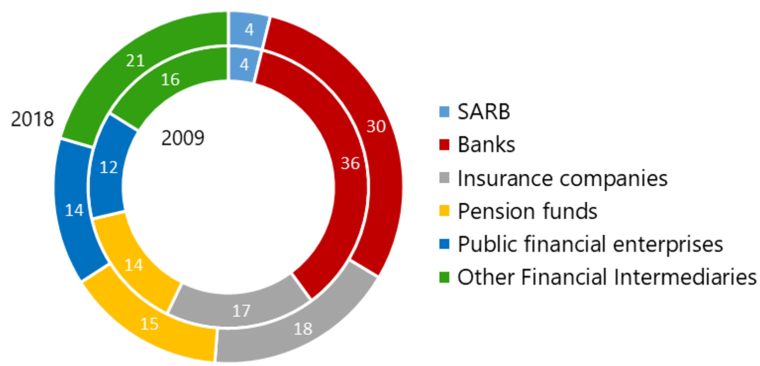
8. **However, there are areas where gaps remain.** Policyholders remain unprotected either by high priority over unsecured creditors or a policyholder protection scheme. Supervisory resources are under pressure, with a loss of skilled and senior staff in recent years, while the operationalization of the Twin Peaks structure, combined with the increasing sophistication and complexity of the regulatory framework and private insurance companies has increased the workload of supervisory staff.

C. Market Structure and Insurance Products

9. The insurance industry in South Africa is an important pillar of the financial sector. Insurance companies account for 18 percent of the entire sector (Figure 1), a share that has been relatively stable during the past decennium. There are 170 insures (67 life, 70 non-life, 9 reinsurers, 23 captives and 1 others). The industry is fairly concentrated especially in the life insurance sector, with the top five insurance companies accounting for 72 percent of the life sector and 48 percent of the non-life market.

Figure 1. South Africa: Size of Insurance Sector

The insurance sector is an important pillar of the financial system in South Africa.

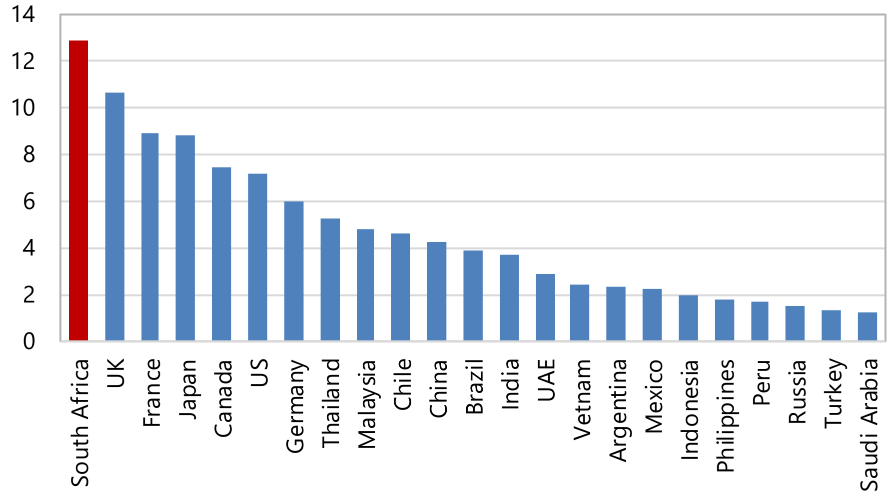


Sources: SARB.

10. Insurance penetration is among the highest in the world (Figure 2), mainly due to the popularity of life and investment focused insurance products. In particular, pension funds, pension preservation funds, and retirement annuities are actively sold and administrated by life insurers, which account for about 25 percent of the insurance total assets. Furthermore, accessing non-pension investments through a life product has advantages for both the investor and the sales force. The South African life insurance industry is significantly larger than non-life industry. As of the end 2018, the asset base of life insurers reached to South African Rand (ZAR) 3 trillion, while that of non-life insurers was around ZAR 136 billion. Given its dominance, the market and risk analysis below focus on the life sector, unless otherwise mentioned.

Figure 2. South Africa: Insurance Penetration: Premiums as Percent of GDP, 2018
(In percent)

Insurance penetration is one of the highest in the world.



Sources: Sigma SwissRe.

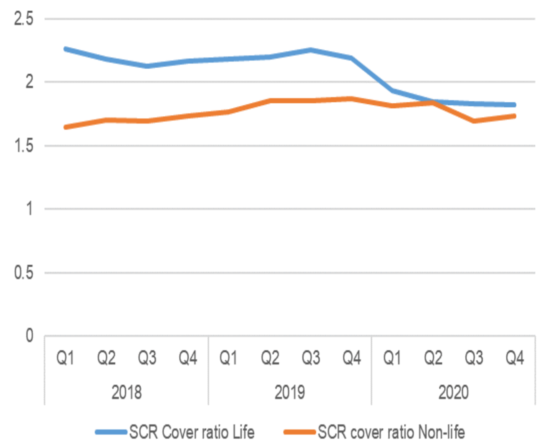
11. Most large insurers belong to financial and/or conglomerate groups, involving considerable intragroup transactions and business linkages. For example, among the largest five life insurers, Old Mutual (which is the largest by asset size) has minority share (20 percent) of Ned Bank (which is the fourth largest bank by total assets), Liberty group (which has the fourth largest life insurance entity) is owned by Standard Bank, and other three groups (Sanlam, MMI, and Alexander Forbes) have large asset management and other financial entities within each group.

12. Despite a challenging macroeconomic environment, solvency ratios remain high and stable. The Solvency Capital Requirement (SCR), the main regulatory requirement under the SAM framework, is risk sensitive as insurers must use market consist valuations for both assets and liabilities. While the macro-economic environment is weak, the average solvency ratios of both life and nonlife insurers remain stable and above the minimum level (100 percent) at the solo level (left chart of Figure 3). Although audited solvency ratios at the group level were not available at the time the mission, figures disclosed on a voluntarily basis by some large groups are also at a reasonable level against the minimum requirements (right chart of Figure 3).

Figure 3. South Africa: Trend of Solvency Ratio

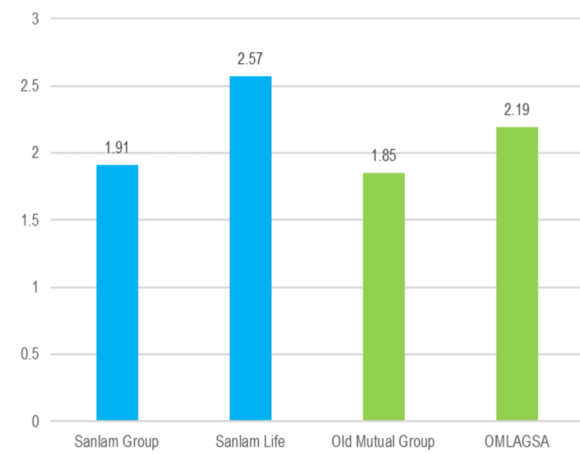
The insurance sector is highly profitable with good solvency coverage ratios, albeit with some recent negative pressure.

Insurers Solvency Coverage Ratio (Solo)



Sources: SARB.

Group Solvency Coverage Ratio (Voluntary Disclosure, December 2020)



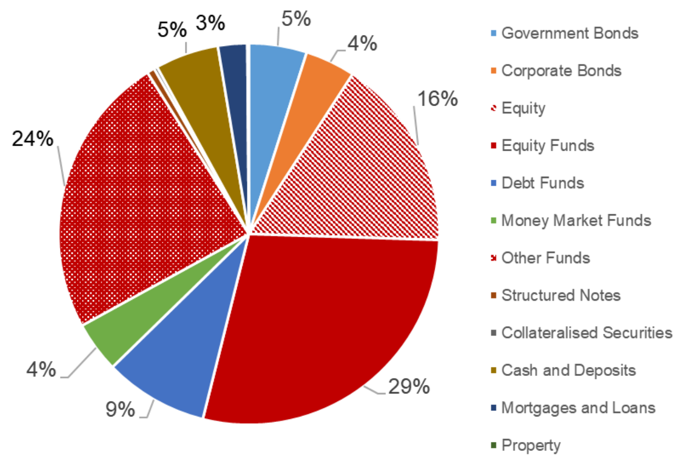
13. Life insurers' assets are evenly split between linked and non-linked products. Linked products, which benefits are linked to the performance of the underlying asset and thus protect the insurance companies against market risks, account for 48 percent of the total investment, while the non-linked products account for 52 percent. It should be noted however that, even among linked products, some residual market or investment risks may sit with insurers, namely if they have provided limited guarantees over those products. Investment risk in non-linked products is covered by insurance companies although traditional participation contracts allow some level of profit and loss sharing between insurers and policyholders.

D. Key Risks of the Industry

14. A large share of life insurers' holdings is comprised of equities and equity funds. Sixteen percent of assets in linked products are allocated to equities and 24 percent to equity funds, with this asset allocation driven by the policyholder risk preference (Figure 4). Non-linked products also allocate a high share of their assets to equity (15 percent) and equity funds (18 percent) (Figure 5). These exposures are subject to a high capital charge under SAM and thus discouraged since SAM implementation. The share of equities and equity funds in insurers' asset allocation is higher than in other countries. Industry representatives suggest that the allocation to equities is expected to decline in the long term due to higher cost of capital to support the equity investments, but material changes are not expected in the near future.

Figure 4. South Africa: Asset Allocation of Life Insurers (Linked Products)

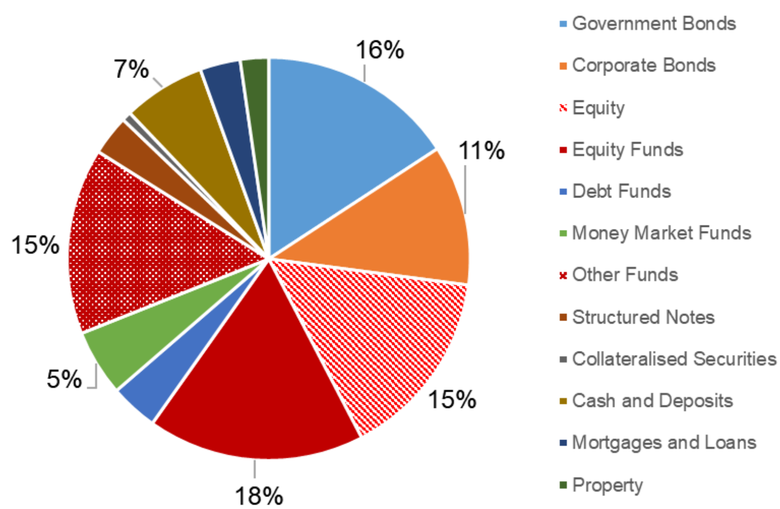
Life insurers have large exposure to equity and equity funds as of the December 2020, based on SAM valuation.



Sources: PA Other funds include Asset Allocation, Real Estate, Alternative, Private Equity and Infrastructure Funds.

Figure 5. South Africa: Asset Allocation of Life Insurers (Non-linked Products)

Life insurers have large exposures to equity and equity funds as of December 2020, based on SAM valuation.

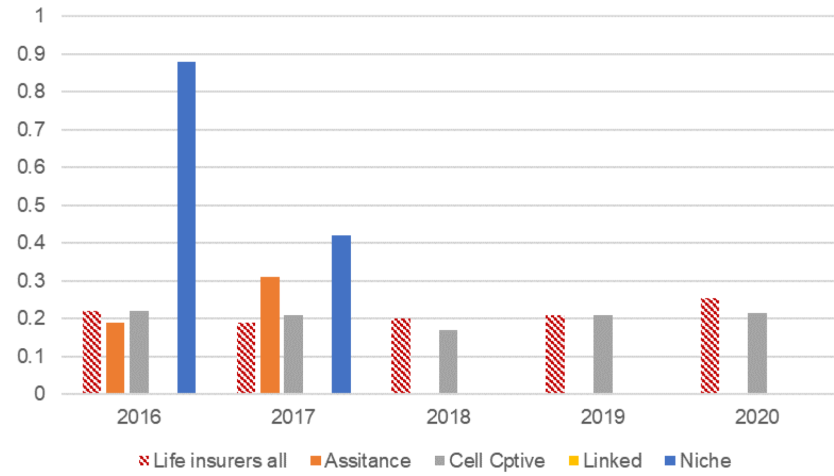


Sources: PA Other funds include Asset Allocation, Real Estate, Alternative, Private Equity and Infrastructure Funds.

15. Life insurers are suffering from high surrender and lapse rates. Insurance industry operates in a competitive environment with surrender penalties are low, and policyholders can easily take advantage of newer products that might offer better features. High lapse rates can also be explained by sales practices and policyholders' optimism, as policyholders faced difficulty to continue to pay premiums during economic downturn (Figure 6). Finally, high surrender rates may be explained by mis-selling of some products, as high rates are generally observed within the first 12 months of inception of the policy/product (Figure 7).

Figure 6. South Africa: Trend of Lapse Rates of Individual Products of Life Insurers

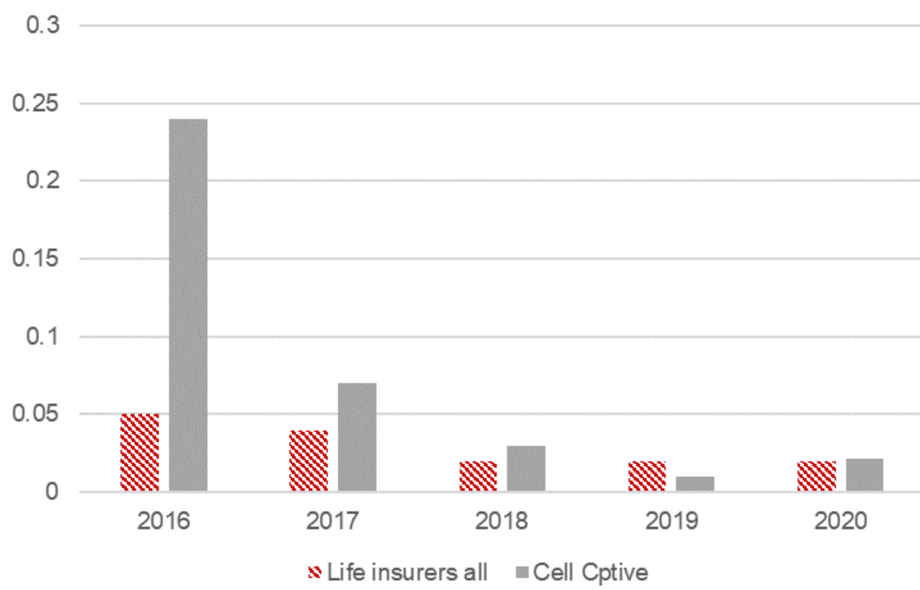
Life insurers are suffering from high lapse rates.



Sources: PA.

Figure 7. South Africa: Trend of Surrender Rates of Individual Products of Life Insurers

Life insurers are also suffering from high surrender rates, although they are lower than lapse rates.



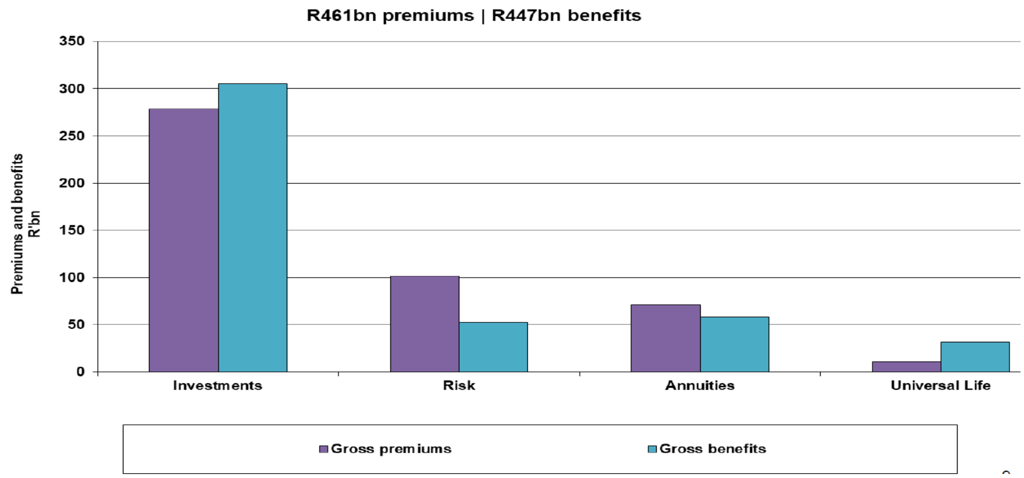
Sources: PA.

16. **While the impact of the low interest rate environment is not as acute as in advanced economies, some life insurers with traditional legacy policies may face challenges should current interest rate conditions persist.** South African life insurers rely heavily on investment type products (Figure 9), which must generate sufficient investment return to attract policyholders and compete with other products, including those of banks and asset managers. While there is no data available, insurers appear to actively market guaranteed investment products for which adequate investment returns are even more important. Managing asset liability management (ALM) risks would be difficult for insurers in a prolonged low interest environment since the duration of their liabilities is much longer than the

duration of assets available in annuity or whole life products. If insurers continue to underwrite those products amid a persistent low interest rate environment, they could be exposed to interest rate risks similar to life insurers in advanced economies.

Figure 8. South Africa: Premium Decomposition by Product Types

Most of the premiums are from investment and annuity products.



Sources: PA.

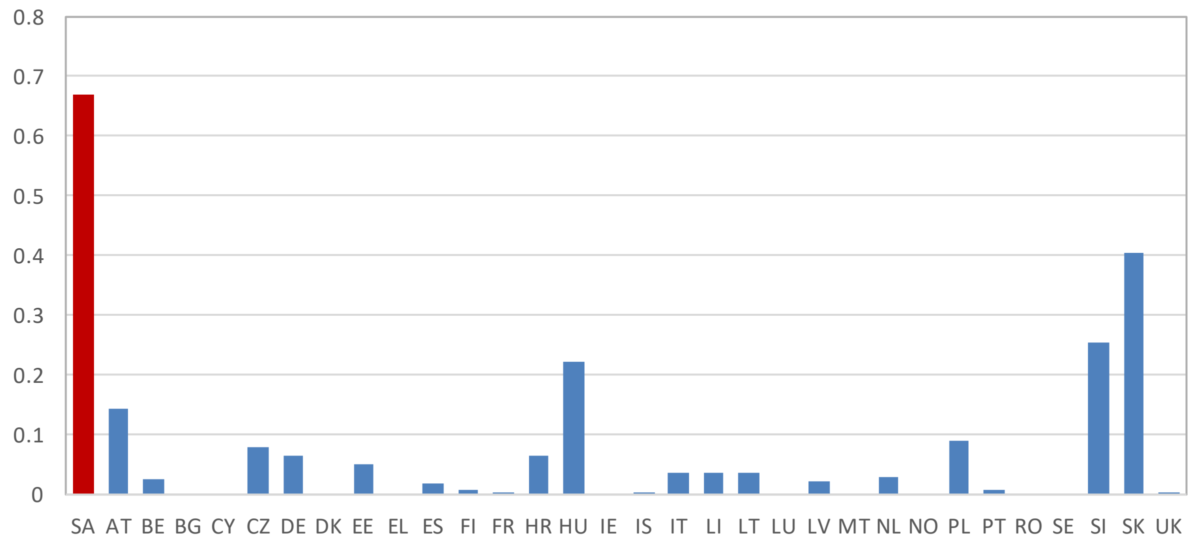
17. The variance in risk profiles in large insurers means that firms face different nominal and real interest rates risks. Nominal interest rate risk (especially those of assets and liabilities) is generally the most important risk that insurers face. In most advanced economies, the insurance industry has a common risk profile—with lower nominal interest rates over the long term having a negative impact. However, in South Africa, business models vary significantly among large insurance groups, meaning that some insurers are exposed to real, rather than nominal, interest rate risk. For these insurers, a higher nominal and real interest rate scenario would have a large negative impact. This is partly due to a large share of inflation linked products in some of those insurers and also significant amount of recognition of future profit from long-term products (described further below).

18. Life insurers rely substantially on future profits. Similar to European Solvency II and other economic based solvency regimes, SAM allows insurers to recognize the expected profit in future profits as part of their own funds (Tier 1), albeit with certain conditions and disclosure. In South Africa, however, the average share of future profit (described as Surrender Value Gap or SVG) account for about 70 percent of the total Tier 1, which is significantly higher when compared to any country in the EU (Figure 9).[6] Industry analysts and rating agencies are aware of the issue, and the insurance groups with high reliance on future profit are actively explaining the justification of the estimation of the future profit. But while such transparency is welcome, it does not fully alleviate the risk of capital ratios being overstated. While the potential impact of the forthcoming introduction of IFRS 17 on this practice has not yet been fully analyzed, South African insurance companies may also face a substantial increase in insurance liabilities (Box 1), as future profits would not be allowed to be recognized at the inception under IFRS 17.

[6] See Box 2.1. of EIOPA report (2018).

Figure 9. South Africa: Future Profit Over Capital Resources of Life Insurers

Life insurers in South Africa rely on future profit more than European insurers.



Sources: SARB and EIOPA.

Box 1. Recognition of Future Profit in Solvency Regimes in Other Jurisdictions and Upcoming IFRS 17

Economic based solvency regimes (including EU Solvency II and South African SAM) allow the calculation of negative reserves from insurance policies. The valuation of insurance policies is derived from the probability-weighted cash inflow and outflow of the existing policies, in addition to an appropriate level of risk margin. When the future possible cashflow is likely to be significantly higher than the future claims and other expenses, the result could become negative even after taking into account margin. In South Africa, risk margin account for 7 percent of the total liabilities. Before the implementation of SAM, insurers were required to set the value to zero for the policies of negative reserve calculation under Statutory Valuation Method (SVM).

International practice in treatment of future profits in capital calculations varies. EU Solvency II uses the term, Expected Profit in Future Premiums (EPIFP). The South African SAM defines Surrender Value Gap (SVG). Both regimes allow full recognition of those as part of Tier 1 capital. The Canada Life Insurance Capital Adequacy Test (LICAT) allows limited recognition, for example, with a 30 percent haircut to the negative reserves from private health and life products. Australia's prudential standard requires that future profits and recovery from Deferred Acquisition Cost (DAC) would be excluded from capital resources. The Japanese Solvency Margin Standard allows limited recognition of unamortized initial acquisition cost (which is expected to be covered by future premiums) into capital resources.

IFRS 17 (Insurance Contracts) was issued in May 2017, which requires a "Contractual Service Margin" as part of insurance liability recognition. IFRS 17 avoids a 'day 1' recognition of profit, any potential negative reserves are recognized as part of liabilities and margin is recognized gradually as profit over the coverage period. The relationship between the contractual service margin and SVG under SAM is not clear at this stage, however it is very likely that insurance liabilities under IFRS 17 could be much higher than those currently recognized substantial SVG under SAM—risking a cliff effect as companies would need to show substantial adjustments to their capital ratios.

Even in the current accounting standard (IFRS 4), some insurers have higher insurance liabilities than those in SAM, which is counterintuitive. Prudential requirements are historically more conservative than general purpose accounting and thus this reversal causes some challenges for the firms to explain the differences. Those firms are actively explaining to the market to justify the differences between the two figures, and so far, there does not seem material concerns among market participants.

IFRS 17 implementation is set for January 2021, although the IASB has proposed postponing implementation by one year to January 2022. South Africa has adopted IFRS and there will be no endorsement process. Once IFRS 17 is implemented, insurers also have to implement IFRS 9 (which is currently exempted by the time of IFRS 17 implementation), which is also likely to have additional pressures on the asset valuations. Therefore, once IASB decided the implementation date, listed insurers must comply IFRS 17 and 9 fully from the implementation date.

The PA should urgently conduct an impact assessment, with particular focus on firms with a high reliance on future profit in the SAM calculation. Even firms may not have a clear picture of potential quantitative impact, even while they are aware of the challenges from operational and compliance aspects. The PA should take the lead and work closely with the industry to conduct an impact study as part of the preparation for IFRS 17.

MAIN FINDINGS

A. Powers, Independence, and Resources

19. The FSRA established a 'twin peak' model for financial sector regulation. In April 2018, the FSCA and the PA were formally established. The FSCA is responsible for the conduct of insurers and insurance intermediaries, while PA is responsible for the prudential regulation of insurers. The SARB is responsible for protecting and enhancing financial stability.

20. Friendly societies have been excluded from licensing and other requirements under the IA. Friendly societies can provide both life and non-life insurance products with a maximum coverage of ZAR 15,000 per member, without being subject to licensing requirements. There were 196 friendly societies as of December 2017 and their total asset was ZAR 908 million, which is about 0.03 percent of the total assets of the both life and non-life industry. Friendly societies are exempted from both prudential and conduct regulations applicable to the rest of the insurance sector, but subject to different prudential and conduct regulations. Due to the size of the sector, their regulation and supervision are excluded from our analysis.

Prudential Authority

21. The PA is headed by a Chief Executive Officer (CEO) who is appointed by the Governor of the SARB with the agreement by the Minister of Finance. The FSR Act sets out clearly the requirements for the PA CEO, including qualifications, conflict of interests, and integrity issues. The person appointed as the CEO must be a SARB Deputy Governor who has appropriate expertise in the financial sector, other than the Deputy Governor responsible for financial stability. The CEO of the PA is appointed by the Governor with the concurrence of the MOF. When appointing the CEO, the Governor must agree, in writing, on the individual's performance assessment measures. These performance measures are not disclosed. A person appointed as the CEO holds office for a term no longer than five years with the possibility of re-appointment for one further term.

22. The governor of SARB, with the agreement by the Minister of Finance, may remove the CEO under limited and specified conditions. The PA CEO may be dismissed in two ways. The Governor can remove the CEO if the individual becomes a disqualified person. In such cases, the legislation does not require the reasons for the individual's dismissal to be disclosed publicly. Alternatively, the Governor may, with the concurrence of the MOF, remove the CEO from office if an independent inquiry has found issues which are stipulated in the FSR Act. In such cases, the MOF must submit the inquiry report to the National Assembly at which point the report becomes publicly available. These include material failure of the performance measures agreed in the appointment and other failures to discharge his or her responsibilities. If the CEO is removed from office, the Minister must, within 30 days, submit the report and findings of the independent inquiry to the National Assembly. The report is released to the public as well.

23. A Prudential Committee has been established and tasked with the responsibility to oversee the management of the PA. The members of the prudential committee are the governor, the CEO, and the other deputy governors. The CEO has also constituted several advisory and decision-making panels, such as PA management committee, policy panel, licensing panel, designation panel, restructuring and expansion panel, regulatory action panel, and risk and capital panel. The members of the panels are divisional heads, the heads of departments and the CEO. Managers and analysts are invited to the panel deliberations but don't have a voting right.

24. The PA has adopted a number of SupTech solutions for insurance supervision. Currently, the PA is using the information management solution to generate reports from submissions received from insurance companies. It also has plan for significant investment in SupTech, including: (i) a data management solution for data collection, validation, storage and analysis, (ii) a workflow management solution for work prioritization, tracking and workload management across the departments, and (iii) a supervised institution management system for better profile information and comprehensive view of an institution.

FSCA

25. The FSCA is headed by a commissioner who is appointed by the Minister of Finance. The Minister also must appoint at least two, but no more than four, persons who have appropriate expertise in the financial sector as deputy commissioners. The term of commissioner and deputies would be determined by the minister, which is not longer than five years, but are eligible for re-appointment for one further term.

26. Similar to the case of the PA, the Minister of Finance may remove the commissioner or deputy commissioners under limited and specified conditions. The minister of finance has to establish an independent inquiry to investigate that any removal would meet the conditions specified by FSRA. Those conditions include material failure of the performance measurers agreed in the appointment and other failures to discharge his or her responsibilities. If the Commissioner is removed from office, the minister must, within 30 days, submit the report and findings of the independent inquiry to the national assembly. The report is released to the public as well.

National Treasury and Parliament

27. The PA and FSCA are required to provide a copy of any draft regulations after the public consultation to the national treasury and parliament. As part of the approval process, the PA must submit prudential standards to Parliament through the National Treasury for a period of at least 30 days while Parliament is in session (in case of urgent prudential standards, the draft prudential standards should be submitted for a period of at least seven days.) Public consultation is conducted in a fully transparent manner, with all the comments and resolutions disclosed to the public. The process to share the outcome to the national treasury and parliament is aimed to enhance the accountability and no approval is required by either national treasury or parliament. Although Parliament cannot stop the issuance of secondary legislation, the FSR Act requires that any deliberations of Parliament should be considered by the PA. Authorities explained that Parliament involvement in this area is part of South Africa's broader democratic processes. There don't appear to have been any incidents requiring a change to a standard as a result of this process, although the process has caused some delay of the finalization of the standards from time to time.

Budget and Resources

28. Both the PA and FSCA are in the process of adopting a new funding regime promogulated under the Financial Sector Levies Act. Currently, PA is fully funded by SARB, while FSCA is funded fully by the industry levies. The new framework and process for the PA would be similar to the current process that FSCA has. The authorities propose draft levies for public consultation. Initial levies are subject to the consent of minister of finance, although any subsequent change of the levies would not require the minister's consent as long as the increase does not exceed the consumer price index plus 2.5 percent. The draft budget and proposed levies must be submitted to parliament for scrutiny for a one-month period. The public consultations have been conducted with fully transparent manners with all comments and resolutions disclosed to the public. According to FSCA staff, there have not been any interventions from the national treasury and parliament on the levies and budget processes. PA and FSCA also have enough flexibility to allocate their budget among sectors to address changing and emerging risks, and they are anticipating that the flexibility would remain after the shift to the new levies and budget framework.

29. PA and FSCA would need to enhance their resources to address both proper implementation of recently introduced regulatory reforms and new challenges. Around 50 staff are allocated to insurance prudential supervision (most have been transferred to the PA from the FSB-SA, the FSCA's predecessor) and around 40 staff to insurance conduct supervision. Due to the recent organizational change, historical data is not available. The PA sets its remuneration target at 85 percent of the remuneration average of the private financial sector, which is reasonable level compared with financial regulators in other jurisdictions. The PA remuneration package seems to be reasonably competitive to attract and retain good experts that are, in part, motivated by other factors than monetary considerations. However, anecdotal evidence suggests that experienced staffs have resigned from both the PA and FSCA, and some industry representatives indicated that high turnover of experienced staff in the transitional stage of the twin peaks reforms has adversely impacted the quality of insurance supervision, especially for the FSCA.

30. Both the PA and FSCA face significant increase in workload in view of recently adopted and upcoming reforms, especially from group and conglomerate supervision. Unlike insurance regulators in advanced jurisdictions, South African authorities have a limited ability to rely on host supervisors at the subsidiary level, as many host supervisors are also substantial (quantitative and qualitative) constraints. Hence, the authorities would need to conduct substantial (additional) work to ensure robust governance, risk management and solvency calculation in major subsidiaries abroad.

31. PA and FSCA IT systems are in the midst of a significant upgrade. Recent regulatory reforms are substantially improving data availability for both the PA and FSCA, but IT systems to process this information have not yet been fully upgraded accordingly—with especially FSCA staff relying on manual processing to handling their reporting data. New data based on the recent regulatory reforms and old data with long historical data has not yet been well integrated, which prevents staff from both agencies to conduct meaningful trend and peer analysis. Both institutions have medium term workplans in place to upgrade their own IT systems and achieve greater integration between PA and FSCA systems.

Coordination Mechanisms Between PA and FSCA

32. The FSRA requires that the PA, FSCA and SARB cooperate and collaborate when performing their functions. The FSRA sets out a number coordination requirements with the aim to improve supervisory effectiveness and minimize duplication, including on a consistent regulatory strategy, supervisory actions, the development and use of common or shared databases. Based on FSRA requirements, the authorities have established Memoranda of Understanding (MoU) for cooperation. The MoU describes which actions need the concurrence of the other authority, and which actions can be taken by an individual authority. The authorities recently agreed to establish an IT system to facilitate more active information exchanges between the organizations and are committed to enhance information-sharing even before the launch of this new IT system.

Recommendations

33. The PA and FSCA should be equipped with additional resources to ensure adequate supervisory coverage. Recent regulatory reforms (such as SAM at the solo level) still require high quality analysis and validation of industry practices to become fully effective. The workload of both PA and FSCA has increased significantly under these reforms and will continue to increase in the future as industry reliance on complex models is expected to increase. In addition, future regulatory reforms (such as group and conglomerate supervision) will have a material impact on the agencies' workload. To enable the PA and FSCA to properly implement those new reforms, additional resources are needed to support the recruitment and retention of staff with specialized expertise (such as in the areas of IT, cyber security, and advanced risk modeling). It is also important for both the PA and FSCA to invest in IT systems that can support the analysis of data that has become (or is expected to become) available as a result of the various regulatory reforms.

B. Solvency Requirements

Valuation of Assets and Liabilities

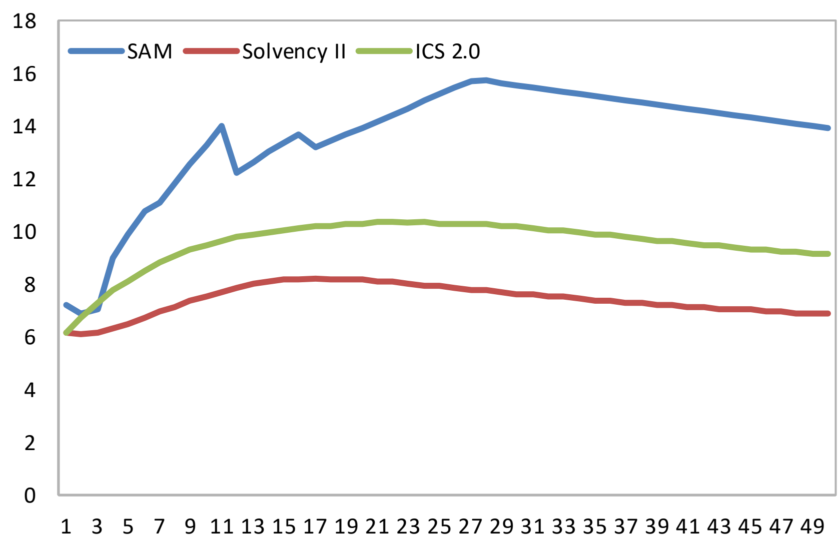
34. Insurers are required to adopt an economic, market-consistent approach to the valuations of assets and liabilities. Valuation of assets is derived from market observable values when available. Otherwise, the insurers may use either a mark-to-market or mark-to-model approach. Liabilities (including insurance liabilities) are valued at the amount for which they could be transferred, or settled, between knowledgeable and willing parities in an arm's length transaction. In many instances, assets and liabilities (other than insurance liabilities) valued in accordance with IFRS are deemed consistent with an economic valuation approach.

Insurance liabilities are valued by calculating the probability-weighted present value of future cash flows, with an additional risk margin to allow for the cost of capital associated with the uncertainty of these cash flow. The valuation of insurance liabilities must be comprised of a best estimate plus a risk margin. The risk margin is the portion of the liabilities calculation that ensures that the value of the liabilities is equivalent to the amount that another insurer would be expected to pay in assuming the liabilities in order to meet its insurance obligations. The margin is derived from a defined cost of capital, multiplied by the capital needed to cover underwriting risk with respect to the transferred business, as well as any unavoidable market risk and counterparty default risk with respect to eligible reinsurance contracts, etc. Large insurers use complex models to take policyholders' behaviors (especially lapse and surrender) into account in their best estimate calculations.

35. The discount rate yield curve for the present value of future cash flows is set by the PA and derived from South African sovereign bonds. The PA requires insurers to use the government bond curve published by the PA as the "risk-free" rate term structure to discount cash-flows for the purposes of valuing insurance liabilities, unless an insurer is approved to use its own estimation. In South Africa, there is no adjustment of default and credit risk implied in the market prices of the government bonds. International best practice, however, adjusts the credit risk implied in the market price of the government bonds to derive the "risk-free" rate (Figure 10). The South African yield curve is significantly higher in the longer term than that implied by international best practice. By implication, results using the current South African risk-free rate may imply a material underestimation of the best estimate of long-term insurance liabilities. Insurers can use alternative yield curve with PA approval and some large insurers are using yield curves derived from interbank offered rates, such as London Inter-bank Offered Rate (LIBOR) and Johannesburg Interbank Average Rate (JIBOR).

Figure 10. South Africa: Comparison of the "Risk-Free" Rates of ZAR (In percent)

"Risk-free" rates on ZAR derived by PA are substantially higher than other international best practices, especially between 20 to 40 years. ICS and Solvency II adjusted credit risk implied in the observed South African government bond yield



Sources: SARB, EIOPA, and IAIS.

Capital Requirements

36. SAM capital requirements at solo level[7] were implemented from July 2018 with higher confidence level and wide coverage of major quantifiable risks. SAM capital requirements are calibrated with 99.5 percent (1 in 200 years) confidence level, which has been increased from 95 percent (1 in 20 years) used in the previous capital regime (Statutory Valuation Method or SVM). The PA has

[7] Prudential requirements at the group level are described at the group supervision section.

smoothly implemented SAM without material transitional arrangement,[8] South African insurers are exposed to relatively high risk from (i) equity investment, (ii) high lapse and surrender, (iii) credit risk, and (iv) concentration risk. Those risks are incorporated in both standardized and internal model approaches used for the calculation of capital. In addition, SAM comprehensively covers other quantifiable risks, including interest rate, currency, property, concentration, liquidity premium, mortality, mobility, longevity, and catastrophe risks.

37. Credit risks (default and spread risks) used in capital calculations are based on insurers' own estimation of PD and Loss Given Default (LGD). The standardized approach provides standardized formulas to derive default and spread risks, but the current standardized approach allows insurers to estimate their own PD and LGD without supervisory approval, which is not in line with the international best practices. South African sovereign bonds are exempted from a credit risk capital charge.

38. Equity exposures are subject to high capital charges with moderate adjustment to accommodate short-term fluctuation of the market prices. Equity exposures are generally subject to high capital charges (33–49 percent depending on the sub-category of the equity). These capital charges can be adjusted by up to 10 percentage points depending on the last 3 years market trend (e.g., if the market has been booming in the last 3 years, capital charges are subject to a higher adjustment). In addition, derivatives, such as options and investment guarantees, are subject to an equity volatility capital charge.

39. Investments in CIS are subject to a 'look-through' approach wherever possible. The 'look-through' approach requires insurers to assess the risks of the assets underlying the investment vehicle and apply capital requirements for the relevant components of market risk to the underlying assets. This applies to passive funds, active funds and funds of funds. Where a CIS is not sufficiently transparent, insurers are required to use the investment mandate of the CIS to assess the market risk capital requirement—for example, if the CIS mandate specify the asset allocations, then market risk capital calculations should mirror the asset allocations. Insurers are required to assume an asset allocation which produces the maximum overall capital requirement when CIS' investment mandates prescribe ranges and provide managers with discretionary judgment. A fall-back option to treat the CIS as "other equity" which is subject to about 49 percent capital charge. While the last approach seems conservative for most funds, it still may not fully capture risks from highly leveraged CIS.

Capital Resources

40. Prudential standards allow only high-quality instruments to qualify as capital resources. Prudential standards provide for the classification of the capital resources into three tiers (Tier 1, Tier 2, and Tier 3). Tier 1 comprises the highest quality components of capital that fully meet all the essential characteristics—they must be loss absorbent, subordinated, of sufficient duration, free from any obligation or incentives to redeem, and free from mandatory costs and encumbrances. Total Tier 1 capital must exceed 50 percent of the SCR. While the degree of reliance on lower quality capital varies

[8] Immaterial transitional arrangement is granted to hybrid capital instruments and subordinated debts which have been issued before SAM implementation.

among entities, the average share of Tier 2 and Tier 3 capital to total capital is less than 7 percent on aggregate among life insurers.

41. There are number of regulatory deductions in the capital formula. If intangible assets are recognized in the valuation of assets, 80 percent of the asset value must be deducted from the capital resources, with the remaining 20 percent of the value recognized as Tier 3. An insurer's own shares should be fully deducted from the insurer's capital resources. Listed ordinary shares held by an insurer in any company that holds a direct or indirect controlling stake in the insurer, in excess of 5 percent of the total non-linked assets, must deducted from that insurers' capital resources.

Investment Requirements

42. The PA adopted a 'prudent person' investment principle, which does not specify any quantitative restrictions on insurers' asset allocation. Formerly the FSB-SA imposed certain prescribed investment limits, such as domestic investment requirements to cover the aggregate value of its liabilities. Those requirements were lifted at the time of implementation of the IA, SAM, and governance and risk management requirements. Currently, insurers can only invest in assets and instruments whose risks they can properly identify, measure, monitor, control, report, and appropriately take into account in the assessment of their overall solvency needs. Principle-based investment requirements include diversification criteria (e.g., by type of asset, issuer, group, or geographical area).

43. Insurers are required to have an investment policy. Prudential Standard GOI 3 (Risk Management and Internal Controls) describes that each insurer's explicit investment policy should specify the nature, role and extent of the investment activities and explain how the insurer complies with the limitations on assets. Insurers are also required to invest all assets, specifically those assets covering the minimum capital requirement (MCR), in a manner that reasonably ensures the security, quality, liquidity and profitability of its whole portfolio of assets, as well as their availability. The PA is monitoring the risk management through the ORSA reports.

Recommendations

44. The PA should conduct targeted inspections to evaluate 'best estimate' calculations in insurers with a high reliance on future profits in their calculation of capital resources. While future profits could justifiably reflect the strong business models of some large insurers, overly optimistic assumptions—including for policyholders' behaviors (as reflected in lapse and surrender rates)—will undermine solvency. It is important in ensuring high quality capital standards that the PA actively challenge firms' estimations to ensure they are robust.

45. The PA should conduct an impact study and industry-wide stress test to address the potential impact of IFRS 17 adoption. While the industry is aware of the potential challenges of the IFRS adoption, it is not apparent that all firms have clearly estimated the impact thereof on their net capital and profit at the general-purpose accounting basis. Hence, it is advisable for the PA to conduct an industry-wide impact study. In addition, as firms' net capital position and profit level may become more volatile, some type of simple scenario analysis on an industry-wide basis would also be useful to encourage insurers to improve the resilience and stability of their net capital and profit level in anticipation of the implementation of IFRS 17.

46. The PA and FSCA should enhance data sharing on CIS investment by insurers. Investment in CIS accounts for a significant portion of both non-linked and linked assets. While the PA requires insurers to 'look through' on a best effort basis, the PA has limited information on the underlying assets, which make it difficult for PA to validate capital charges and conduct a proper risk analysis (such as via top-down stress tests). The FSCA receives detailed reporting on the regulated CIS and some information on the foreign CIS that are distributed domestically. Sharing this data on a frequent basis would allow the PA to better analyze the risks of insurers' CIS investments.

47. The PA should ensure appropriate credit risk capital charges by conducting a thematic review on PD estimation with the close cooperation of banking supervisors. Sample analysis shows a potential underestimation of PDs compared with major credit ratings and their historical PD data. The PA should conduct a thematic review on PD estimation and validate firms' historical default observations, as well as the reliability of their internal ratings. The PA's banking supervisors have significant experience in this area, obtained from Internal Rating Based (IRB) model validation, and some transfer of this expertise to the insurance supervisors would improve the quality of their review.

C. Governance and Risk Management

Governance Requirements

48. The IA requires an insurer and a controlling company to adopt, implement and document an effective governance framework. These requirements are further expanded under the Governance and Operational Prudential Standards that apply to all insurers, branches and even micro insurers. High level principles embedded in these standards require firms to establish an effective governance framework, proportionate to the nature, scale and complexity of their business model and risk profile, that (i) protects the interest of policyholders, and (ii) provides effective systems of corporate governance, risk management and internal controls. This standard is limited to requirements for the solo entity—however, once a controlling company is designated by the PA, it would be required to establish the governance framework at the group level.

49. Governance standards stipulates comprehensive duties for the board of directors. Boards must: (i) set, approve and oversee the implementation of business objectives, taking into account the soundness of the insurer and the interests of its policyholders, (ii) act with independence in pursuing the best interest of the policyholders, (iii) regularly review the business strategies, (iv) promote an open environment where employees who communicate concerns about illegal or irregular behavior are properly protected, and (v) regularly review the composition of knowledge, expert skills, and experience of the board of directors and plan for the orderly succession of board member, etc. The standards also require a sufficient number of non-executive directors.

50. The board of an insurer is required to establish the insurer's overall risk appetite. It also required to ensure that the insurer has in place effective systems for risk management and internal control to address the key risks it faces. The Board must set and oversee the effective implementation of a remuneration and incentive model that demonstrably supports prudential decision making, is consistent with the insurer's risk appetite, and does not induce excessive or inappropriate risk taking.

51. **The board is required to establish an audit committee.** The audit committee must perform the following functions: (i) oversee and approve internal and external audit plans to ensure that all material risks are considered, and statutory and financial reporting requirements are met, (ii) monitor the implementation of internal and external audit plans, (iii) review all internal and external audit reports and ensure that issues identified are managed and reflected in an appropriate and timely manner, and (iv) provide input to the scope of audit work.

Enterprise Risk Management (ERM)

52. **All insurers (including micro insurers) are required to establish and maintain a risk management framework approved by the board**. The framework should enable the insurer to identify, assess, monitor, report on, and mitigate the material risks which include both quantifiable and non-quantifiable risks. Risk management tools must, at a minimum, include: (i) a process for identifying and assessing new and emerging risks, (ii) tools for quantifying and managing material risks, (iii) application of scenario analysis and stress testing programs that are commensurate with the size, business mix and complexity of the insurer's business, (iv) information system that provide reliable and informative reports on the measurement, assessment and management of all material risks, and (v) a review process to ensure the risk management system remains effective in identifying, quantifying, assessing and managing material risks.

53. **The risk management framework must comprehensively cover material risks**. The framework should cover, at a minimum, the following risks where relevant: (i) ALM, (ii) capital, (iii) concentration, (iv) credit, (v) fitness and propriety, (vi) information technology, (vii) insurance fraud, (viii) investment, (ix) liquidity, (x) operational, (xi) outsourcing, (xii) reinsurance, (xiii) remuneration, and (xiv) underwriting. PA standards provide high level elaboration on each risk category. For example, ALM policy must clearly specify the nature, role and extent of the ALM activities and their relationship with product development, pricing functions and investment management. It must also recognize the interdependence and correlation of risk between asset classes and different products / business lines. The risk management framework must also take into account off-balance sheet exposures (such as interest rate swaps) and any contingency that risks transferred may revert back to the insurer.

Own Risk and Solvency Assessment (ORSA)

54. **All insurers are required to conduct a forward-looking and risk based ORSA.** The objective of ORSA is to assess: (i) the resilience of solvency across a range of possible stress scenarios, (ii) overall solvency needs of the insure, (iii) compliance, on a continuous basis, with solvency requirements, and (iv) the significance with which the risk profile of the insurer deviates from the implied risk profile underlying the SAM. The ORSA must be conducted over a longer time horizon than conventional risk assessments, which is typically one year. An insurer must undertake an ORSA annually, proportionate to their complexity, risk profile, and nature of their operations.

55. **The PA reviews and provides feedbacks to ORSA reports.** PA line supervisors review ORSA reports and provide feedback to the individual firms. However, the PA has not yet conducted industry-wide analysis and comparison of ORSA reports. As such, assumptions and methodologies used for stress testing have not benefited from thematic or peer analysis. Similarly, the authorities have not

conducted any recent system-wide stress tests of the insurance industry, similar to the SARB's Common Scenario Stress Tests that are periodically conducted for the banking sector (Box 2).

Box 2. Insurance Stress Tests

Beginning in 2010, the FSB-SA required insurers to conduct bottom-up comprehensive stress tests at the solo level. The test incorporated a specific scenario of 100 percent default by the largest reinsurer. Later, the FSB-SA introduced semi-annual stress tests for the six largest long-term and short-term insurers, and annual economic and insurance stress test for all insurers. The stress tests were based on a market risk combined scenario of a steep drop in equity markets, significant adverse developments in the level and volatility of interest rates across the term structure, significant adverse currency movements, and significant drops in price levels of property and investments. Worsening of counterparty risk and concentration risk were also included.

The last stress test was conducted under the pre-SAM solvency regime and found that the industry met capital standards under stress. The stress test was conducted to both life and non-life sector. The test of life insurers was conducted under a severe economic scenario, including a 50 percent drop in equity prices, a 30 percent drop in property prices, and a 30 percent up/down of FX rate. The test also included a non-economic scenario, such as 30 percent increase of mortality and morbidity, a 20 percent increase in expenses, and a 40 percent increase of lapse / surrender rate. Those shocks had a mild impact on the capital adequacy ratio of the industry average—an 18-percentage point decline from economic scenario and 26 percentage point of decline in non-economic scenario, while the average capital adequacy ratio of the life industry was 458 percent.

FSB-SA stress test was suspended in June 2016 to prepare for SAM implementation. SAM implementation required significant preparation on the part of the industry and supervisors, including three quantitative impact studies and parallel run of two capital regimes. The PA was also in the process of institutional reforms.

Instead of supervisory stress test, the PA introduced ERM and ORSA requirements to all insurers in July 2018 that include institution-specific stress tests/ sensitivity analysis or reverse stress testing. ORSA reports should include detail and outcomes of stress testing, scenario analysis used, and frequency of the exercise. The PA analyzes the ORSA reports, including stress testing methodologies and results, and provides feedback to insurers on case-by-case basis. However, there have been no industry wide analysis or feedback on stress testing practices or results yet. The requirements are applicable to the solo entity at this stage, but the PA has received group wide stress testing results from major large insurers on a voluntary basis. While SAM cover comprehensive risks, it does not cover some material and quantifiable risks, such as sovereign bond credit risk, lapse and surrender scenario of a specific line of business (especially those expecting large future profit), and other emerging risks such as cybersecurity risk. While the ORSA stress test is useful if it covers those risks, there is only a few cases where current ORSA stress test covers those material and quantifiable risks.

The PA has a plan to resume its supervisory stress testing of the insurance sector based on SAM. At the time of the mission visit, the plan is still at the early stage of consideration and there is no formal decision in terms of the timing, scope (solo or group), severity of the scenario, either by bottom-up or top-down. However, the ultimate objective is to compliment individual ORSA stress tests and monitor overall sector vulnerabilities, which would provide useful information for both micro-prudential and macroprudential supervision purposes. It is likely that the initial test would focus on large insurance groups which have capacity to handle such a request.

A clear implementation plan for the supervisory stress test that optimizes synergies between ORSA stress testing and sector wide supervisory stress test is important. We recommend the PA devote more resources to validation and discussion of individual ORSA stress tests and encourage firms to improve the scenario, methodology and risk management practices in the ORSA tests. At the same time, a supervisory stress test with a consistent scenario, methodology and scope would assist PA supervisors in analyzing sector wide and individual firms' vulnerabilities more clearly. Both exercises would be quite resource-intensive to both supervisors and industries, and thus PA should have careful plan to implement both in an optimal manner and avoid excessive burden from the duplicative exercises.

Recommendations

56. The PA should encourage insurers to incorporate a sovereign stress scenario in capital and liquidity stress testing within the ORSA report. A sample review of ORSA reports shows that only one group has included a sovereign bond downgrade as a part of their scenario analysis. SAM covers a number of quantifiable risks comprehensively, but sovereign credit and concentration risks are excluded from capital charges. Because insurers have sizable exposures on South African sovereign bonds, it would be important to take into account a sovereign downgrade scenario in stress test and/or scenario analysis.

D. Group Supervision, Interconnectedness, and Conglomerate

57. The IA allows the PA to designate insurance groups, which brings the controlling company and group under PA prudential supervision. Three insurance entities were designated as part of an insurance group as of June 2021, when PA's annual report 2020/21 was published. The IA grants the PA wide discretion to use its designation power. Designated insurers are subject to comprehensive prudential requirements, including fit and proper requirements for individuals in key functions, and governance, risk management and capital requirements. While the FSRA also empowers the PA to designate financial conglomerates, the PA has not yet done so.

58. Group level capital requirements are based on a deduction and aggregation method.[9] The deduction and aggregation method is the default option, wherein capital resources and requirements are the aggregation of those of individual solo entities in the group. For example, to derive capital resources at the group level, first step is to apply all of the restrictions of capital instruments applicable to the solo level. Then, if intragroup transactions generate capital resources, such transactions need to be eliminated from the capital resources of the issuing entity. In addition, if subordinated debt or hybrid capital is not issued or guaranteed by the controlling company, then such instrument is not eligible to be included in capital resources.[10] Finally, the total sum of capital resources (with the adjustments mentioned above) of all entities are recognized as the group capital resources. Similar calculations would be conducted to derive the capital requirements at the group level. For foreign insurance subsidies, their local capital resources and requirements are added to the group calculation if they are domiciled in jurisdictions that the PA are recognized as "equivalent"[11] by the PA. For other foreign insurers, they need to calculate capital resources and requirements based on SAM and add those to the group calculation.

59. Other financial entities and non-regulated entities are treated differently. The capital resources and requirements of PA regulated banks and credit institutions are based on Basel framework. For regulated financial institutions other than banks, credit institutions or insurers, capital resources and requirements are based on the relevant sectoral rules. If there are no sectoral specific

[9] With PA approval, an insurance group can choose accounting consolidation method, which allow the groups to calculate the capital resources and requirements from the consolidated accounting figures.

[10] A Transitional arrangement is granted for insurers to recognize existing instruments until their maturity.

[11] The PA lists 40 foreign jurisdictions whose laws, and supervisory and information sharing framework are determined by the PA as meeting the objects of the Insurance Act and therefore as "equivalent" to the regulatory framework established under the Insurance Act.

capital requirements (e.g., in the case of non-regulated entities), capital resources are calculated on the base of net asset value with deductions for good will or intangible assets. Capital requirements are based on market risk capital charges of the assets held by the entities.

60. **Intragroup transactions are deducted from group capital calculations to avoid multiple gearing.** For example, the effect of intra-group loans should be deducted from capital of all of the group's entities. Non-fungible and transferable instruments (including encumbered assets) also need to be deducted from the group capital resources calculation. The head of the actuarial function of the controlling company is required to ensure that there is no double counting of loss-absorption capacity and management actions, as solo-entity level calculation may consider those individually without taking into account of management actions of other entities within the group.

61. **Capital requirements at the solo level discourage large intra-group transactions.** The SAM includes a concentration risk charge, where exposure over the certain thresholds are subject to additional capital requirements. The threshold depends on the asset class, such as 10 percent of total assets in the case of loans to a domestic bank. Concentration risk charges apply to both intragroup and other exposures.

62. **The PA convened a number of supervisory colleges for the major South African insurance groups.** The PA shares detailed risk analysis of the groups with these colleges. However, the nature and objectives of the colleges are limited to information exchange, and thus have not concluded any concrete actions, such as join inspections or regulatory actions. The PA faces more severe challenges than typical home supervisors of international active insurance groups in the advanced jurisdictions, as host supervisors in the Sub-Saharan African region are more diverse in terms of regulatory system and quality of supervision.

63. **The PA plans to introduce gap analysis to meet the new criteria of the IAIS Comframe.** The IAIS finalized the ComFrame[12] in November 2019. The PA is a home supervisor of two International Active Insurance Groups (IAIGs) and has been actively involved in the development and decision making of the IAIS, representing number of committees and Executive Committee. The IAIS is conducting a comprehensive assessment in the next few years and South Africa is selected among 29 countries whose insurance markets play a significant role in the global financial system.

64. **The authorities have observed that the value of intragroup transactions has increased significantly in 2017.** Designated insurance groups are also subject to reporting requirement. While there is no designated insurance group during the time of our visit, some large groups are voluntarily reporting detail intragroup transactions. According to the data that the PA received voluntarily, their total amount has increase by 27 percent to ZAR 358 billion from second quarter in 2017 to second quarter in 2018. Capital investments constitutes the majority of the total intragroup transactions of South African insurance groups. These transactions could have generated multiple gearing to the related entities at the solo level and would not be addressed properly until the implementation of group and conglomerate regulation.

[12] The Common Framework for Supervision (ComFrame) of Internationally Active Insurance Groups (IAIGs) is established as a set if international supervisory requirements focusing on the effective group-wide supervision of IAIGs. ComFrame is built and expands upon the high-level standards and guidance in the ICPs.

E. Winding-Up and Exit From the Market

65. The 2014 FSAP identified material gaps in the framework for winding up failed insurers, and these gaps remain. Policyholders do not have priority ranking in the event of the winding up of an insurer. This means that policyholders rank *pari passu* with unsecured creditors. In addition, there isn't a policyholder protection scheme in place. Since the last FSAP, several insurers have faced stressed situation, although most cases have been addressed by transferring the business to other insurers. However, there are few cases where stressed firms are under liquidation and in the process for liquidation. In fact, the latest cases of liquidation of an insurer resulted in significant losses (such as 50 percent of their benefits) of policyholders' benefits and substantial delay of the payments of the claim and surrender values.

66. The development of recovery plans for insurance firms is still at very early stage. There is currently no requirements for the preparation of recovery plans for "stand alone" insurance, and no specific rule-making or articulated supervisory expectations as to how insurance entities should be taken into account in group-wide recovery plans. As indicated in international standards,[13] recovery plans serve as a guide for the rehabilitation of a firm following the materialization of a severe stress scenario, and thus seek to reduce the probability of failure. In short, the plans should offer a range of measures that could be taken by the institution to restore its financial strength, possibly including capital raisings, divestitures and balance sheet restructuring. The responsibility for preparing recovery plans lies with firms' senior management, but supervisors have an important role to play in reviewing the plans (with particular focus on their credibility and feasibility) and providing guidance for further improvement. For the larger South African insurance firms, recovery planning is particularly important given the aforementioned gaps in the safety net and potential knock-on effects on other financial sectors (e.g., banks, fund industry) through substantial interconnectedness.

Recommendations

67. Over the medium-term, the PA should consider imposing recovery planning requirements on large insurance groups, especially those which rely on substantial amount of their Tier 1 on future profit. The reliance on future profits creates risks of significant policyholder losses in case of failure of these firms, as majority of capital resources (which are from future profit) will not become available in such a scenario. Lack of policyholder protection schemes and legal priority against unsecured creditors make it quite difficult to protect the interests of policyholders. Material loss of policyholders could cause material reputational contagion to other insurers and other financial sectors, i.e., especially where the insurers are closely linked to other licensed institutions (for example, affiliated banks). Reducing the probability of failure through robust recovery planning will be important for these firms in particular.

[13] Key Attributes of Effective Resolution Regimes for Financial Institutions.

68. It is recommended that high legal priority is given to the protection of the policyholders. The latest cases of liquidation of an insurer confirmed significant risk to the policyholders in the current framework. In the case of liquidation of the firms which rely on significant future profit, the policyholders could suffer from significant loss, which might cause reputational contagion to the other insurers. Authorities is recommended to expedite the changes to the legislative framework such that high legal priority is given to the protection of the rights and entitlements of policyholders.

F. Market Conduct

69. The FSCA continued to implement the outcomes-based customer protection initiative initiated by the FSB-SA in 2011. The "TCF"F) approach has six principle based outcomes; (i) customer confidence, (ii) products meet the need of targeted customer, (iii) proper information to the customers, (iv) fair and appropriate financial advice and distribution models, (v) product performance is in line with the expectation as financial institutions have led customers to expect, and (vi) no post-sale barriers for customers to change product. The FSR Act entrenches the TCF approach by giving the FSCA an explicit objective to promote fair treatment of financial customers by financial institutions and empowering it to make conduct standards aimed at ensuring that this is achieved. The forthcoming COFI Act will further support the TCF outcomes-based approach.

70. While awaiting the implementation of the COFI Act, the FSCA is taking an incremental approach to improve and promote TCF outcomes. The approach entails the following: (i) embedding TCF in existing regulatory frameworks, (ii) prioritizing a number of key TCF-aligned regulatory projects, and (iii) embedding TCF in the supervisory and enforcement frameworks. One example of FSCA work with PA is their joint review of governance-related international standards and applicable South African frameworks—including the King IV Report on Corporate Governance for South Africa, 2016. The exercise conducted a gap analysis which informed the ongoing development of appropriate governance-related standards by FSCA and PA.

71. FSCA is also implementing the RDR that was originally initiated by the FSB-SA. The FSB-SA initiated consultation on the RDR in November 2014, which has been implemented in phases since 2015. The RDR proposed structural reforms to the regulatory landscape for financial advice and distribution of financial products, aimed at: (i) supporting the delivery of suitable products, (ii) enabling customers to understand an compare the nature, value and cost of advice, (iii) enhancing standards of professionalism in financial advice and intermediary services, (iv) enabling customers to benefit from fair competition for quality advice and intermediary service, and (v) supporting sustainable business models for financial advice. The FSCA continues to prioritize the objectives of the RDR as a key contributor to ensuring the delivery of TCF outcomes, in particular TCF Outcome 4 (fair and appropriate financial advice and distribution models).

72. To address conflict of interest between insurers and intermediaries, the FSCA introduced several regulations on fee and commissions. For example, the RDR introduced a cap of 50 percent on initial commissions, and this can be clawed back after 2 years when policyholders lapse or surrender the policy. For investment linked products, the FSCA introduced a prohibition on intermediaries receiving commissions from the insurers, thus intermediaries need to charge appropriate fee to the policyholder with clear disclosure. For risk products, intermediaries are able to receive commissions from insurers for selling and administering risk policies but need to agree fees for advice separately with clear disclosure.

Risk-Based Supervision

73. FSCA has introduced number of conducts of business-specific statutory returns. These returns have generated both the qualitative and quantitative data required to make risk-based assessments. After public consultation, a pilot process and 2 years transition, insurance conduct of business statutory returns were introduced by FSB-SA in December 2016. The information is stored in the "MAGIC" system, through which line supervisors can access data across firms, allowing them to compare the firm they supervise with the industry average or other peers. The FSCA also actively uses ad-hoc information and reporting requests. Insights gained from ongoing monitoring help the FSCA in formulating pre-emptive responses. The FSCA also publishes leading practice benchmarked through comparative assessments.

Corrective Measures and Enforcement

74. FSCA has wide ranging authority over both regulated entities and unregistered business. These include (i) administrative penalties up to ZAR 100 million, (ii) suspension, withdrawal and revocation of license, (iii) debarment of individuals, (iv) enforceable undertakings, (v) directives, (vi) curator, and (vii) statutory manager. In addition, the FSCA is empowered to institute a number of proceedings in the high court, including seizing and removing the assets of an institution for safe custody. FSCA also recently introduced "mystery shopping" when an employee of FSCA (usually a supervisory team member) may approach an institution to evaluate the customer experience, with a main objective is to identify risks facing customers.

75. FSCA is actively using its powers, including suspensions and withdrawals of licenses. FSCA is imposing number of strong actions (especially suspensions and withdrawal of licenses) in the last three years. In addition, FSCA further imposed number of administrative penalties. For example, in 2016 and 2017, the penalties imposed involved more than 20 entities and/or individuals each year and total penalties were over ZAR 10 million each year. In 2017 and 2018, the number and amount of penalties have been declined, which may suggest that a reduction of serious infractions. However, miss-selling remains a concern, even after multiple years of active enforcement.

Figure 11. South Africa: Enforcement Actions

The FSCA actively uses enforcement tools.

Actions	2017	2018	2019
Debarments	106	135	184
Suspensions	621	581	691
Withdrawals	254	8	26

Sources: FSCA.

Dispute Resolution Schemes

76. The FSCA requires all insurers to have a dispute resolution process in place. Case statistics and results are published annually on the insurer's website as well as at the Ombudsman, together with aggregate data for the industry. A policyholder can also take complaints to the applicable Ombudsman's offices. Complaints about funeral benefits and disability insurance have continuously increased through the period 2016 to 2018. Most of these complaints are related to poor communications, poor documentation and denied claims. On the non-life side, auto insurance related complaints account for almost half of cases, followed by homeowner's insurance. The number of complaints in this area have decreased slightly from 2016 to 2018.

77. The FSCA monitors and analyzes complaints received by insurers, ombudsman and the FSCA itself. Such analysis is integrated into FSCA's risk-based supervision framework. In addition, the FSCA encourages financial institutions to use data and findings arising from the complaints management process to identify and remedy poor customer outcomes.

Digitalization

78. Some insurers are actively using complex customer behavioral models and are technically ready to adopt AI and ML. Authorities are carefully monitoring the development of fintech and Insurtech development by establishing an innovation hub. A regulatory sandbox will be launched in 2020, managed not only by financial authorities but number of government agencies. Some insurers have developed the capacity to introduce AI and ML for core business decision-making (such as in underwriting and premium setting), although they have not implemented this capacity due to potential ethical issues and financial exclusion.

Recommendations

79. The PA and FSCA should deepen analysis on high lapse and surrender rates. There are mixed views whether and to what extent high lapse and surrender rates are related with macro-economic trends (e.g., rising unemployment prompting policyholders to cancel existing policies), changes of the policyholders' needs or conduct-related issues (e.g., miss-selling). FSCA has been receiving detailed information from the industries that could be used to conduct further analysis. PA and FSCA should cooperate to analyze the reasons behind high lapse and surrender rates.

80. The FSCA and PA should enhance monitoring of use of big data, AI and ML by insurers and prepare appropriate regulatory responses to address the emerging risks (such as financial exclusion and underestimation of the reserves). Meetings with industry representatives suggest that insurers are competing with each other and could be under pressure to distinguish themselves from other competitors. Technologies are readily available, and it a matter of time before the industry utilizes advanced technologies—with the potential materialization of new risk factors (e.g., financial exclusion, underestimation of the reserves). The FSCA and PA should further enhance its dialogue with the leading companies through both the forthcoming sandbox and the existing innovation hub.

Box 3. COVID-19 Impact on the Insurance Sector and Regulatory Measures

COVID-19 has impacted the insurance sector primarily through the impact on investments. The profitability of life insurers has fallen sharply in the first half of 2020., mainly due to weaker investment income, which turned negative in the first quarter of 2020. Life insurance assets are invested mainly in equities and investment funds, which experienced a significant loss of value during the market dislocation caused by the COVID-19 shock. However, the capital markets recovered in the second half of 2020, which offset most of the losses that insurers recognized.

While SCR ratio of the life insurance sector remained stable throughout 2020, careful monitoring and analysis is needed. The median of SCR ratio remained over 190 percent even at the end of March 2020, when Johannesburg Stock Exchange Index declined by 30 percent. Equity holding (direct equity investment and equity funds investment) account for 33 percent of the total assets of non-linked portfolio, and thus should have material impact on the solvency ratio of insurers underwriting non-linked products. One of the important stabilization factors behind this more muted impacted was the ratings downgrade and corresponding yield increase of South African government bonds in March 2020. During 2020, three rating agencies downgraded the government bonds to non-investment grades, which increased the sovereign bonds' yield substantially in March 2020. This increased the discount rates used in insurance liabilities valuation for solvency calculation and thus reduce the value of insurance liabilities (especially those of long-term policies, such as annuities), which offset losses on the investment side.

The life insurance sector is also facing higher lapses and surrender rates, which has a negative impact on profitability, and liquidity and solvency ratios. Life insurers have recorded a policy lapse ratio in excess of 100 percent, at 126 percent in June 2020, which had happened for the first time in over a decade. PA and FSCA are monitoring lapse and surrender rates of individual companies very closely.

Impact to nonlife insurance sector overall seems moderate. Due to more conservative asset allocation than those of life insurers, nonlife insurers experienced a less severe impact on investments. Many non-life insurers are supported by a favorable insurance claims experience within the two most important lines of business (motor vehicle and property). The median SCR ratio remained 180 percent as of September 2020, which is well above the minimum, and manage to remain over 170 percent throughout the year.

However, increased claims have been observed for certain insurance products, which could pose risks to individual non-life insurers. It is expected that some insurers will experience increased pressure on their solvency levels as a result of losses on lines of business that are sensitive to the current economic downturn. This includes non-life insurers with large exposures to credit insurance or business interruption policies.

The FSCA has provided guidance on how business interruption policies can be interpreted. Following a FSCA policy wording review, the FSCA issued a statement, where it clarified that in general the national lockdown itself was not found to be a trigger for a valid business interruption claim. Instead, under most of the policy wording categories, businesses are required to prove that they were specifically affected by COVID-19 or that it affected a specific area in which their business operates. Various insurers have committed to the provision of interim relief as legal certainly on business interruption claims is awaited.

The PA has heightened it reporting requests to better analyze the impact on the insurance sector. Prudential measures by PA include heighted monitoring of insurers through data requests on the operations, solvency and liquidity impact. With close coordination with FSCA, the PA has also conducted surveys to analyze detail impact on hard hit subsegments, such as credit insurance and business interruption insurance. The PA also intensified its engagements with some distressed entities.

The PA and FSCA have issued joint communications to the industry. Close coordination between the PA and FSCA allowed to issue several joint communications to address the challenges caused by COVID-19. Those include i) outline of regulatory and supervisory actions, ii) order for planning and discussions with affected clients during and after Level 3 of the lockdown period, and iii) regulatory response on business interruption insurance.