Solvency Assessment and Management

Report on the Pillar II Readiness Survey

May 2015

FSB

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Contents

Introduction

The Pillar II elements of the Solvency Assessment and Management (SAM) regime are key components of the framework. Pillar II includes requirements for insurers[1] pertaining to governance and risk management, as well as the requirement to undertake an Own Risk and Solvency Assessment (ORSA).

An exercise was conducted in 2012 whereby all insurers were asked a range of questions pertaining to their Pillar II practices and preparations for SAM. The questions were based on the SAM guidance available at the time, and included a self-assessment for each of the dimensions of Pillar II, namely board composition, board functions, risk management, the ORSA, internal control, control functions, and outsourcing. For a significant portion of insurers, the survey highlighted various areas for improvement. The one dimension that clearly required a significant amount of development across the industry was the ORSA.

As a result, the FSB conducted a follow-up exercise in 2014. The follow-up exercise was compulsory for all insurers, and had a number of intended outcomes, namely to:

- Ascertain the level of progress made with regards to Pillar II readiness;
- Increase awareness among insurers of the requirements of the ORSA; and
- Use the outcomes of the exercise to inform the requirements of the Mock ORSA to be conducted in 2015.

[1] Throughout the document the word “insurer” will be taken to mean an insurer, reinsurer, or insurance group, unless specifically otherwise stated or it is clear from the context.

Scope and limitations

All registered insurers were requested to complete the SAM 2014 Pillar II readiness survey. Furthermore, insurance groups were also requested to complete a similar survey. This is in line with the ORSA having to be undertaken on both a solo as well as a group basis. Certain insurers were exempted on a case-by-case basis. In most cases exemptions were granted to insurers in run-off.

The questionnaire intended for solo insurance entities (the “solo questionnaire”) consisted of 5 parts, namely:

- Part 1: Systems of governance;
- Part 2: ORSA development self-assessment;
- Part 3: Contextual questions;
- Part 4: The risk management system; and
- Part 5: Additional documentation.

Part 1 posed the same overarching questions posed in the self-assessment exercise conducted in 2012, for each of the seven dimension of Pillar II assessed. Insurers were asked to provide an updated self-assessment, and provide any rationale for changes in the rating from the previous survey. For part 2, insurers were required to select from a drop down box both their state of readiness as at 30 April 2014 as well as the timelines in which they intend to implement any outstanding areas, for 17 aspects of the ORSA. Part 3 entailed open-ended questions, which were intended to provide further insight into the answers provided in part 2. Given that a significant aspect of the ORSA is the risk management system of the insurer, part 4 asked for some details regarding risk management. Lastly, insurers were requested in part 5 to provide sample reports, policies, and other documents which pertain to the ORSA, if they were available.

The questionnaire for groups was very similar to that of insurers; the key differences being the absence of an equivalent part 1, and a few group-specific questions.

Lastly, after receiving the questionnaires, a number of follow-up interviews were conducted. These were conducted by a small team from the FSB and fulfilled the dual role of obtaining further insights into the questionnaires for a number of insurers as well as providing supervisory experience for the FSB team with respect to the ORSA.

With regards to limitations of the survey, as with the first exercise, no specific audit requirements were put in place, and the self-assessment responses are therefore not verifiable. Furthermore, the FSB was not in a position to question specific responses regarding progress made or planned timelines. Sign-off was however required by the CEO as well as a non-executive director, and thus should be a true reflection of the views of the company.

Executive Summary

The results of the survey indicate that insurers have made significant progress towards planning for the ORSA, and more generally in Pillar II readiness. Regarding general governance, it is worth noting that besides the ORSA, no insurers rated themselves as weak in any of the dimensions of governance. Furthermore, there are generally a greater number of insurers reporting ratings of "strong". A number of activities have been undertaken by insurers to improve their overall governance framework, and the overall self-assessment ratings reflect this progress.

Pertaining to the ORSA, insurers vary significantly in terms of current state of development and as well as intended implementation plans. Insurers' plans do however indicate that a significant amount of development was planned to take place over the course of 2014. The ORSA, once fully developed and implemented within an organisation, will represent an integral aspect of risk management for both insurers and for the FSB. For insurers, a well-developed ORSA should aid in confirming intended strategies or providing evidence to the contrary, which would form the basis for rigorous debate. For the FSB, the ORSA will be a key forward-looking tool that will help the FSB to understand the business plan of the insurer along with the risks to which the insurer is likely to be exposed. In addition, the ORSA will inform the risk assessment that the FSB will complete as part of its supervisory process.

The Pillar II readiness exercise conducted in 2014 has shown that a lot of progress has been made in all areas covered by the study since 2012, although further work still remains. The introduction of interim measures for enhanced governance and risk management requirements, along with the Mock ORSA exercise as part of the Comprehensive Parallel Run, will assist insurers in their preparations ahead of the introduction of the SAM Framework in 2016.

The results of the survey as well as key observations made by the FSB are dealt with in the remainder of this report.

General Governance

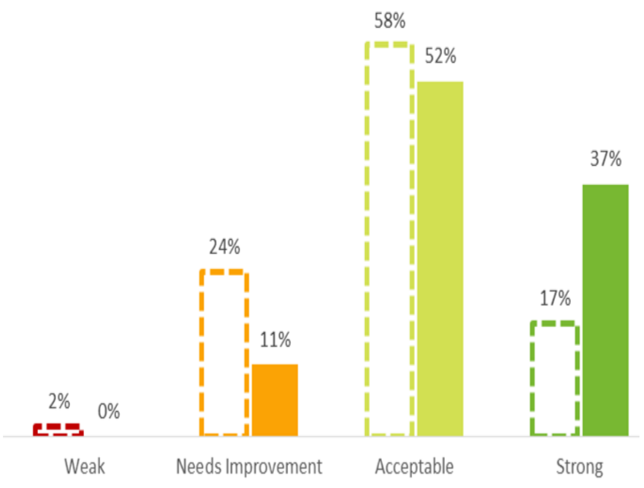
The key dimensions across which Pillar II was assessed in the 2012 survey were board composition, board functions, risk management, the ORSA, internal control, control functions, and outsourcing. As groups were not required to participate in the 2012 study, this section was omitted from the group questionnaire. Insurers were asked to rate themselves on each specific dimension as either “weak”, “needs improvement”, “acceptable”, or “strong”.

Interpretation of graphs below

The graphs below show the percentage of respondents for each level of response. Note further that throughout this section, the dotted lines represent the results of the 2012 survey, whereas the solid bars represent those of the current survey.

Board Composition

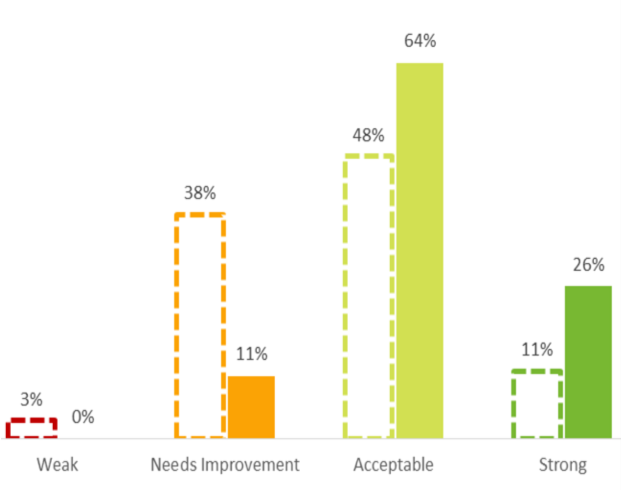
Overall board composition should be a balance between executive and non-executive directors, representing a diverse mix of skills and expertise. An appropriate balance of non-executive independent directors brings objectivity to the decision-making process.



As can be seen from the responses, while only 17% of insurers assessed themselves as strong in this aspect in 2012, that figure has risen to 37% in 2014. Furthermore, while more than 25% rated themselves as weak or needing improvement, the current results show that no insurer rated itself as weak, while only 11% rated themselves as needing improvement.

Some of the key activities taken by insurers to improve their board composition were the appointment of additional non-executive directors, and the appointment of directors with specific skill sets, for example actuarial skills.

Board Functions

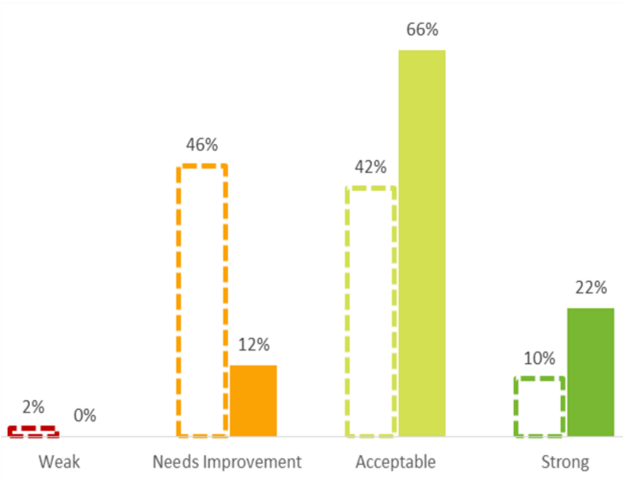


Effective board functioning includes *inter alia* the appropriate establishment of committees and the running thereof, as well as a robust board evaluation process.

On this aspect insurers have made significant progress: while more than 40% indicated in 2012 that further work was to be done, this figure has dropped to only 11%. Furthermore, more than a quarter of the industry consider their board functions to be strong.

A number of insurers have improved their board functions by conducting more formal board assessments as well as establishing dedicated risk committees.

Risk Management



Effective risk management includes not only the day-to-day management of risks, but importantly the formalised structures and policies than enable it.

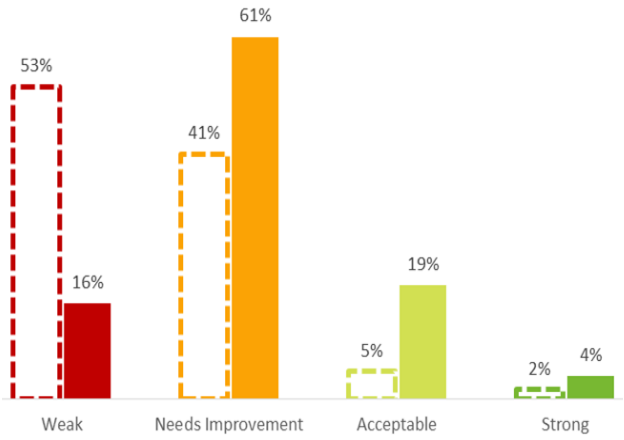
Risk management within insurers has shown a similar development focus as some of the preceding dimensions of Pillar II. Notably, no insurers have rated themselves as weak, and while 46% of insurers rated themselves as needing improvement in 2012, only 12% of respondents did so in 2014. The percentage of insurers who rated themselves as strong also grew from 10% to 22%.

Insurers that have improved their ratings from the previous survey have undertaken activities such as documentation and formalisation of risk management activities, as well as setting up dedicated risk management functions within the organisation.

ORSA

While much of the remainder of this report deals with the details of the ORSA, the overall rating provides a more overarching view as to how insurers view the current status of their ORSA plans.

The 2012 study clearly showed the level of development required across the industry, with a combined 94% of insurers rating their ORSA capabilities as weak or needing improvement. The 2014 survey shows that while a significant portion of insurers are still weak (16%), almost a fifth (19%) of insurers rated themselves as acceptable.

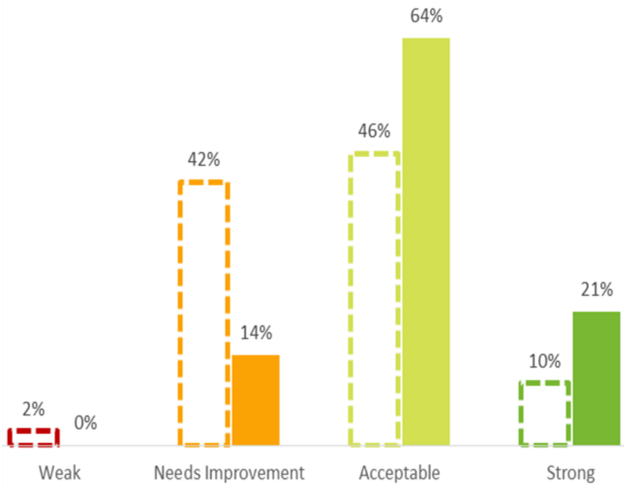


It is expected that the Mock ORSA exercise to be conducted over the course of 2015 will further assist insurers in preparing for the ORSA requirements when they become effective from 1 January 2016.

Control Functions

Control functions refer to the activities as specified in the draft Insurance Bill as well as Board Notice 158 of 2015. They are risk management, actuarial, compliance, and internal audit. The requirements further specify that an independent assessment is required on each of these functions, and that internal audit may be used to assess the remaining three functions should internal audit have the requisite skills and expertise.

The progress made in this dimension mirrors that made for the risk management dimension: more than 20% of insurers now rate themselves as strong, and only 14% as needing improvement.

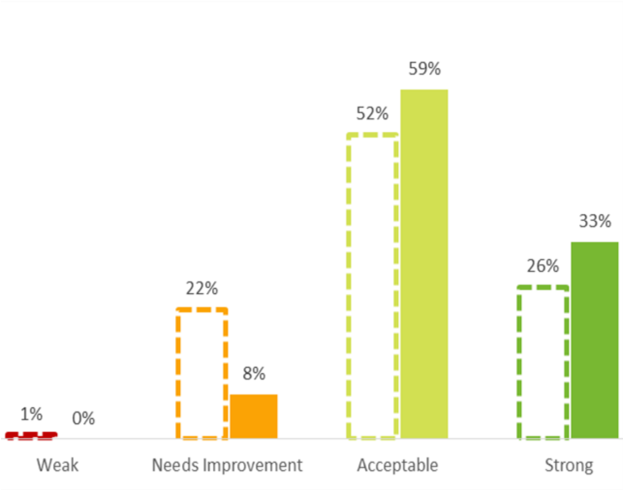


Since the first survey was conducted, a number of insurers have established control functions (either within the insurer or on an outsourced basis). Some insurers who had more loosely established control functions have now appointed adequately skilled and capacitated heads of control functions.

Internal Control

The internal control system is highly related to the risk management system. A significant focus of the internal control system is on financial controls which assist in ensuring the accuracy and integrity of financial reporting.

While this dimension was one of the stronger areas from the 2012 study, the 2014 results still show significant improvement. Almost one third of all insurers consider their internal control systems to be strong, and only 8% deem their internal control systems to require improvement.

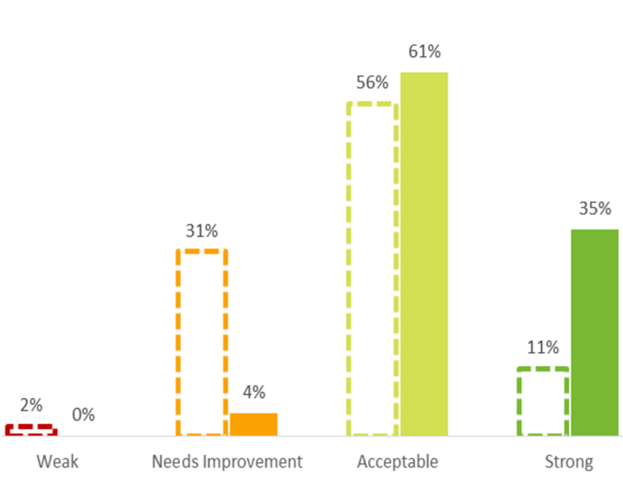


The key area which has been addressed by insurers since the 2012 study has been an improvement in levels of documentation.

Outsourcing

Outsourcing can reduce risks in a business, for example by gaining access to external expertise. Outsourcing does however introduce new risks into the business, and these require proper oversight and management.

At the time of the 2012 survey, the outsourcing requirements contained in directive 159.A.i. had just been introduced. As a result, almost one third of insurers indicated that they required work in this area. In the 2014 survey, only 4% of insurers have indicated that improvements are required.

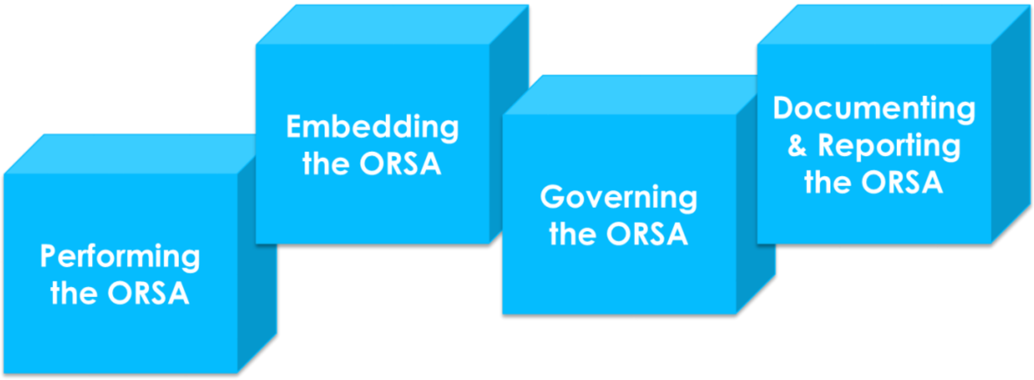


In line with the board notice governing outsourcing, insurers have now formally adopted outsourcing policies at the board level. Insurers are furthermore required to notify the FSB of all material outsourcing arrangements. Outsourcing is a key focus area for FSB onsite visits, and full compliance with the board notice is required.

ORSA Readiness

Part 2 of the survey required insurers to respond to 17 questions dealing with various elements of the ORSA and their stage of development. For each of these questions, insurers were asked to specify the date by which that element is planned for completion, and the current development status.

Part 3 of the survey included 35 open-ended questions aimed at obtaining further context on the current status and plans described in part 2. The results of parts 2 and 3 are provided below, within the structure outlined in the diagram below.



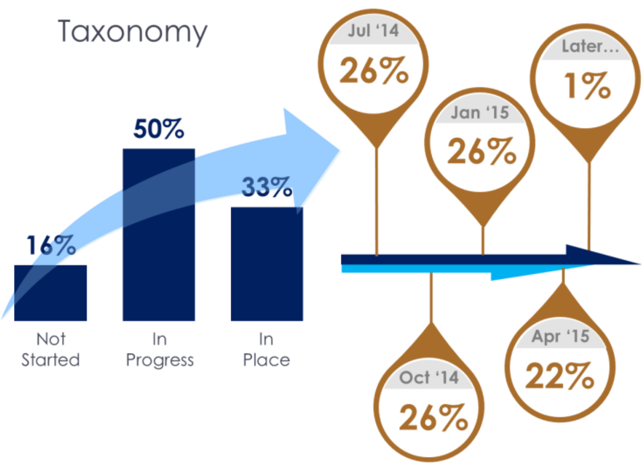
Interpretation of graphs below

The dark blue bars on the left of each diagram show the percentage of total respondents falling into each of the categories in terms of current status. The timeline on the right hand side of the graph shows the intended timelines for completion (number of respondents as a percentage of total respondents who indicated "Not Started" or "In Progress")

Performing the ORSA: *scope and coverage*

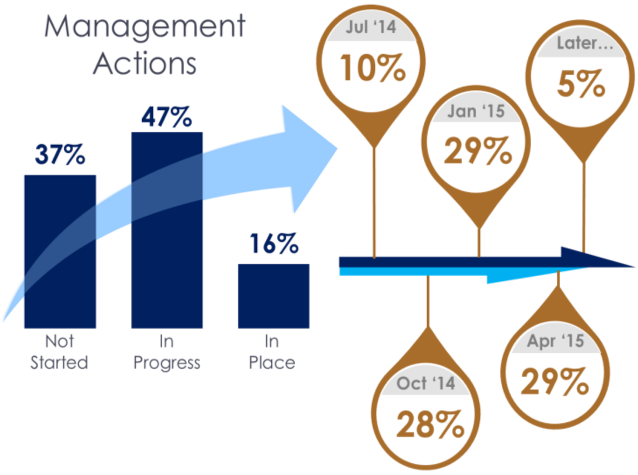
The ORSA requires a clearly understood risk profile[2]. This requires an understanding not only of what risks the insurer is exposed to, but also of the magnitude of such exposures.

All insurers should be clear on the risks faced, and should have already made the decision as to what risks are to be included in the ORSA. As a guideline,



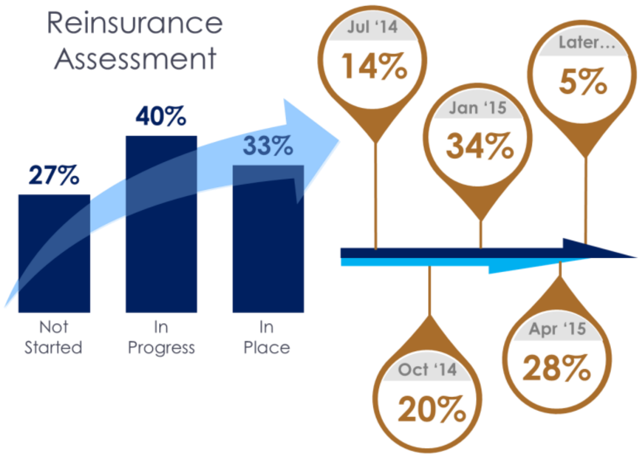
[2] A risk profile is defined as a point in time assessment of the insurer's gross and, as appropriate, net risk exposures aggregated within and across each relevant risk category based on forward looking assumptions. For the purposes of the ORSA it furthermore includes a qualitative assessment of risks faced.

the ORSA should include all risks which are deemed to be material.

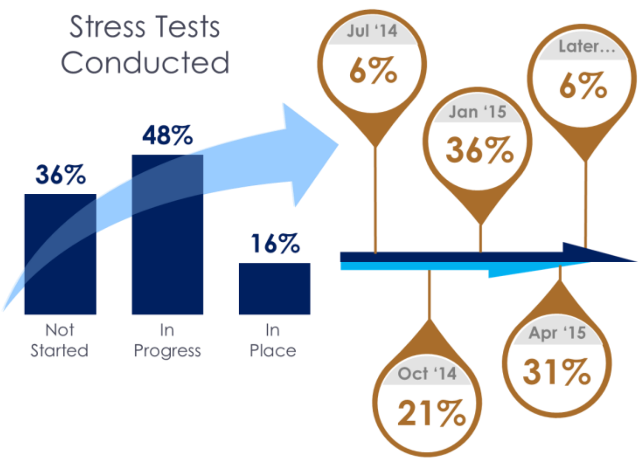


The insurer's own assessment of the capital requirement to meet their risk exposure in line with their risk appetite should be projected, along with the insurer's own assessment of the basic own funds to meet their own assessment of the capital requirement. As part of these projections, a number of aspects have to be considered, and one such aspect is that of management action. The anticipated management actions and responses should be taken into account in the ORSA projections. The ORSA goes further and requires that these assumed actions themselves are made explicit and scrutinised.

The ORSA should furthermore be the activity under which reinsurance is assessed in terms of its purpose, the adequacy thereof, and the appropriateness of its coverage.

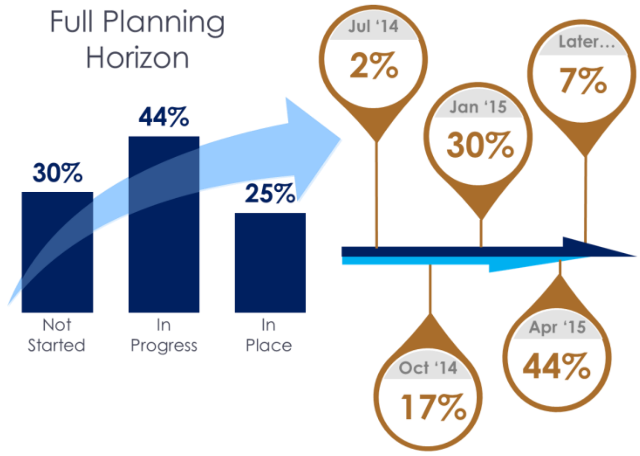


It is clear from the results of the survey that insurers vary with regards to the progress and plans for management actions and reinsurance. These elements require the projection models to already be developed. Insurers should however remain cognisant of the need to evaluate these outcomes as they continue to develop their projections.



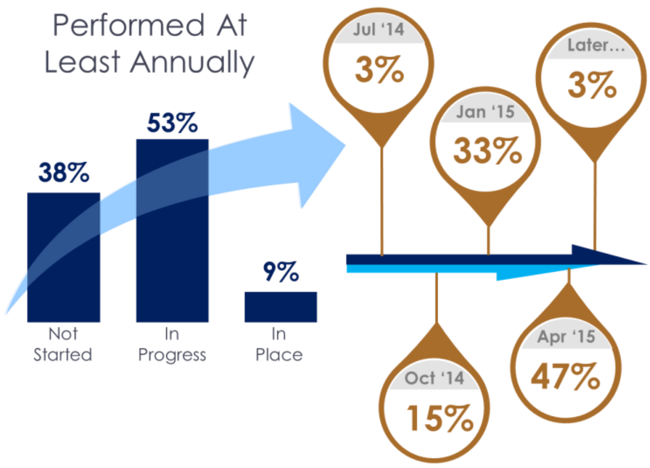
Lastly, in terms of scope and coverage, the ORSA should include a range of stress tests and scenario tests. Reverse stress testing should also be considered to highlight risks and scenarios that show the potential vulnerabilities of the business. A small proportion of insurers have stated that they will use reverse stress testing to identify scenarios that will most likely cause business failure. Projections should not only be performed for expected outcomes, but should also be done for identified negative scenarios. Further detailed guidelines pertaining to stress testing are contained in Position Papers 94 and 95.

Performing the ORSA: horizon



The projections required under the ORSA should match the planning horizon of the insurer. The guideline is provided that this is expected to typically be between 3 and 5 years ahead. Both the capital requirements (regulatory as well as own view) and the own funds should be projected, and the insurer should take cognisance of any factors which could affect tiering or eligibility of own funds. It is not expected that the projections should be done using stochastic models, and this is reflected in the approach taken by insurers. The common tool for the projection of the balance sheet is the use of the projected income statement to determine future balance sheets. In many cases insurers have indicated that the projection will take into account their business plans. The capital requirement for various risks is then most commonly determined by using risk ratios and risk drivers.

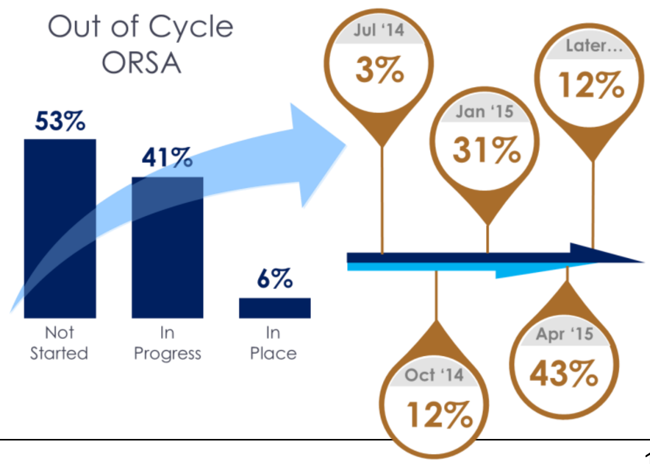
Performing the ORSA: frequency



Insurers are required to produce an ORSA report to be submitted to the regulator on at least an annual basis. The timing thereof is determined by the company, but a strong rationale should support its timing. Typically, this will align with the annual strategic planning activities of the insurer.

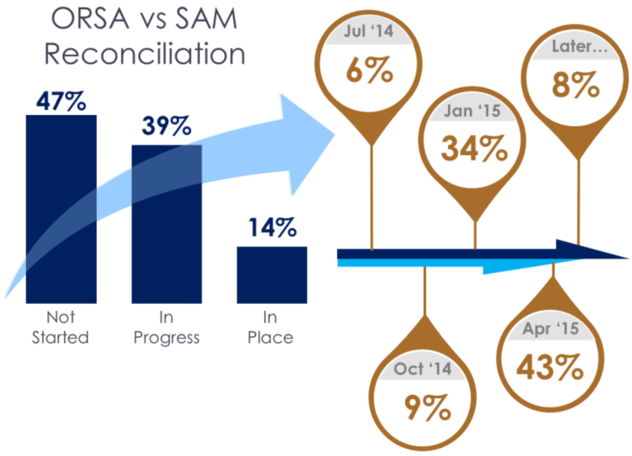
The vast majority of insurers are yet to produce their first ORSA report, and as such are unable to comment on the regularity thereof. Some have however established the frequency in ORSA policies, including the requirements pertaining to the out of cycle ORSA.

Insurers should be very clear on what triggers an out of cycle ORSA. The guidance given is that a significant change in risk profile would be the trigger. These triggers, i.e. what constitutes a material change, should be documented in the ORSA policy. Some insurers have cited major mergers and acquisitions, regulatory

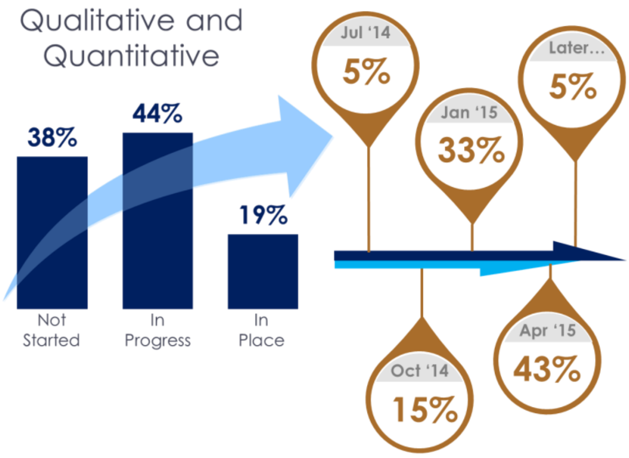


changes, a fall in investments of greater than 30% in a 12 month period or an underwriting loss exceeding 10% of shareholder funds within a 12 month period as examples of events that could trigger an out of cycle ORSA. From a regulatory perspective, a significant change in the governance framework would be deemed to be a material change in risk profile.

Performing the ORSA: calculation

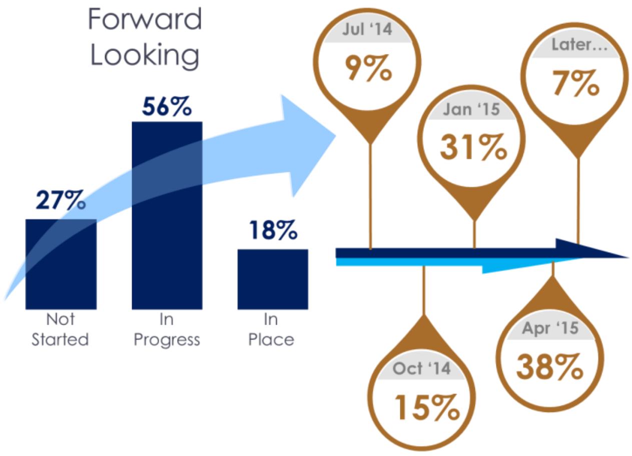


Whereas the standard formula represents the regulator's view of risk to which insurers are exposed, the ORSA requires insurers to establish their own view of the nature of their risk profile. This view may be similar to that contained in the standard formula in some aspects, and may differ substantially for other aspects. Some insurers have indicated that their view is the same as that contained in the standard formula, whereas others have indicated differences. The areas of differences varied between insurers, but tended to be in the areas that were most significant to the particular insurer. Differences related to the number of risks included in the quantification, the dependency between the risks, the methodology and calibration of the risks. In addition to different views on the risks, there were also different views on the calculation of available own funds and the valuation of technical provisions. A key aspect of the ORSA is to ensure that differences between the insurer's own view of risk and that of the standard formula are explicitly analysed and explained, and that reporting on the differences occurs within the insurer.

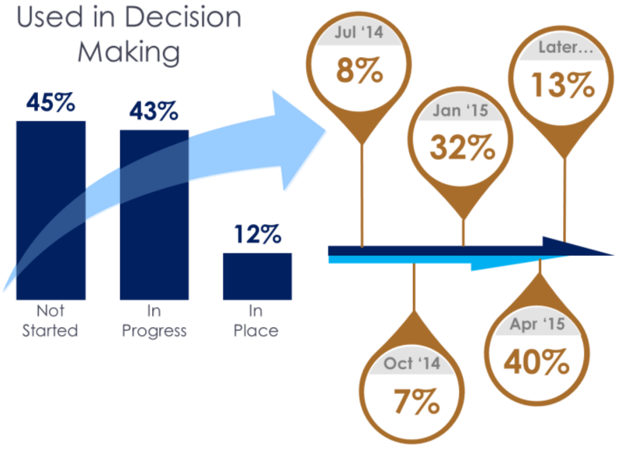


Secondly, while much of the focus of the calculations is on the basis for the projections, it is key that such numerical analysis is complemented with explanations and interpretations. We note that qualitative analysis is generally applied by most insurers in the selection of risks to include in the ORSA in conjunction with quantitative analysis. Risks that are not easily quantifiable are considered on a qualitative basis.

Embedding the ORSA

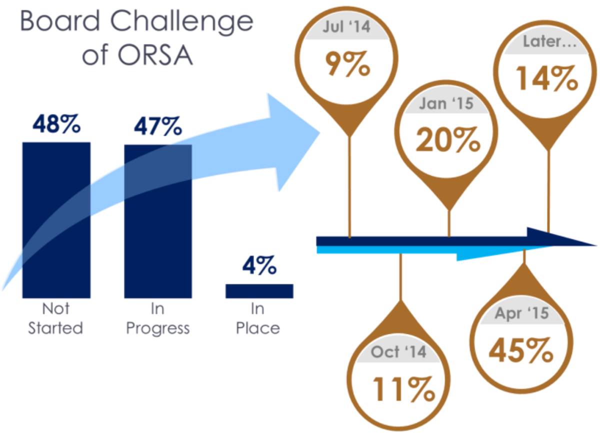


Another key aspect of the ORSA is that it should not be something which is undertaken with only a regulatory compliance perspective in mind. Insurers should avoid creating projections, models and assessments which are done purely with the aim of submitting an ORSA to the regulator. Furthermore, insurers should avoid establishing certain models, assumptions and projections for ORSA purposes and then undertake different models, assumptions and/or projections for the management of the business. Partly to mitigate this risk, and partly to ensure that the potential insights yielded from the ORSA are actioned, insurers are required to demonstrate how the process and results of the ORSA feature in strategy and decision-making.



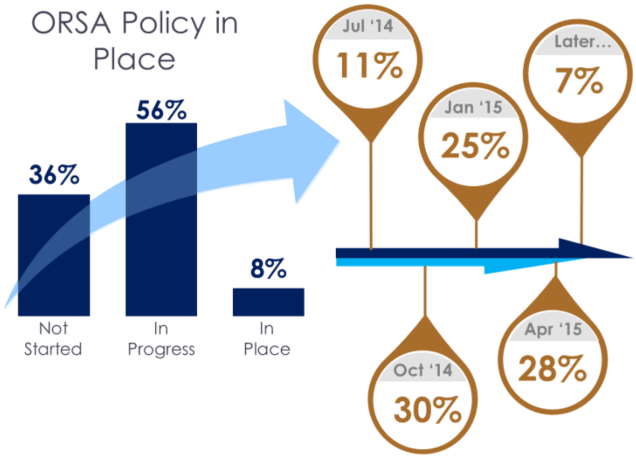
Some insurers find difficulty in the concept of having the outcome of the ORSA influence decision-making, citing that there are multiple aspects of decision-making and that the ORSA does not replace this process. Those insurers that are successfully navigating this requirement have acknowledged that the spirit of this requirement is that the ORSA is embedded as a consideration in the process. In other words, it may be that the outcome of the ORSA does not imply any change to the intended strategy or decisions of the insurer. Embedding the ORSA as an input however ensures that where the ORSA is consistent with the intended path, this is seen as support, and where the ORSA is not consistent, this is carefully considered and analysed.

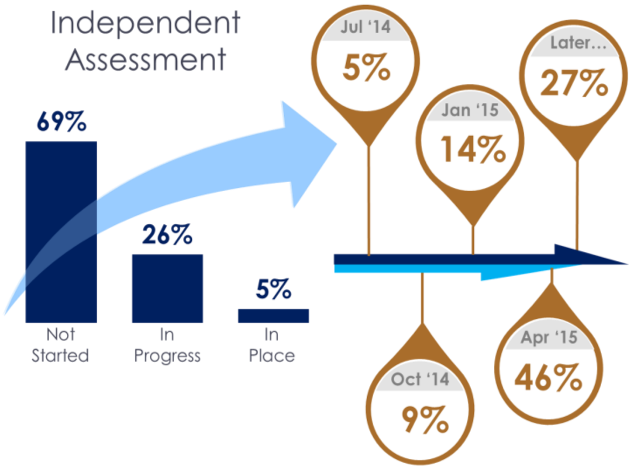
Governing the ORSA



Given the importance placed on the ORSA, it is key that the ORSA is appropriately formalised and governed. Three key aspects of governance are considered. Firstly, the role of the board should be clear, and it should be active. While in the development phase, the board should already be well aware of the concept of the ORSA, and familiar with the ORSA development plans. The board, taking ultimate ownership of the ORSA, together with senior management, should agree the plans and timelines, and be comfortable with the direction taken by the insurer. In terms of the outcomes of the ORSA, the board and senior management should be actively engaged, and should provide sufficient challenge to the process and outcomes. Both the board and senior management should be able to draw conclusions on the accuracy and completeness, and hence sufficiency, of the ORSA outputs. The survey results show that some insurers have initiated training for their board on the purposes of the ORSA as well involving them in the approval process of the ORSA policy. Some insurers also mentioned that their boards are or will be engaged in the review of the ORSA reports. These initiatives are encouraging and the FSB would like to urge all insurers to consider how to get their boards more involved throughout the ORSA process.

The second governance element associated with the ORSA is the establishment of an ORSA policy. A number of aspects are stated in Position Papers 34 and 107 pertaining to what the minimum scope of the ORSA policy is expected to be. Once the scope has been defined, the policy should be approved and implemented.

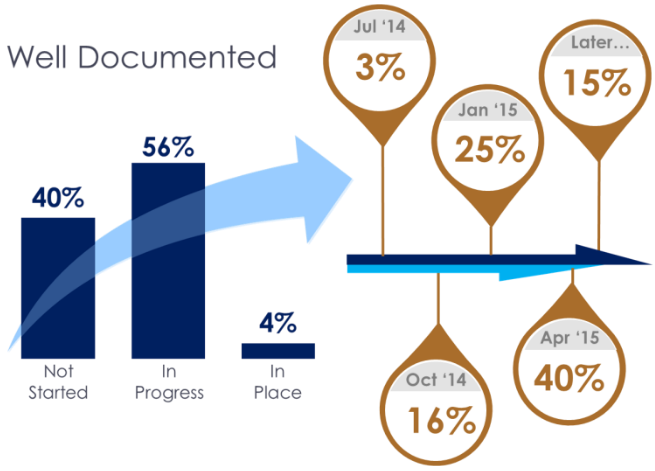




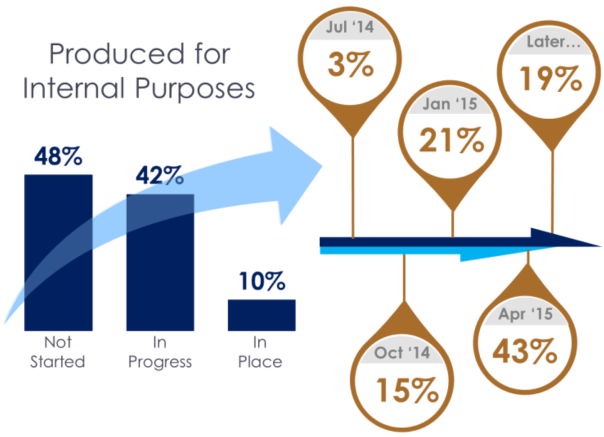
Lastly, in order gain more comfort around the appropriateness of the ORSA, it should be subject to an independent review.

The independent review does not necessarily need to be conducted by someone outside of the organisation. However, those conducting the independent review should not have been involved in the ORSA process, and should have the requisite knowledge and skills to undertake the assessment. Some insurers have opted to involve the internal audit team in leading the independent assessment, and in areas where they may lack the requisite skills, resources either elsewhere within the insurer or external to the insurer are utilised.

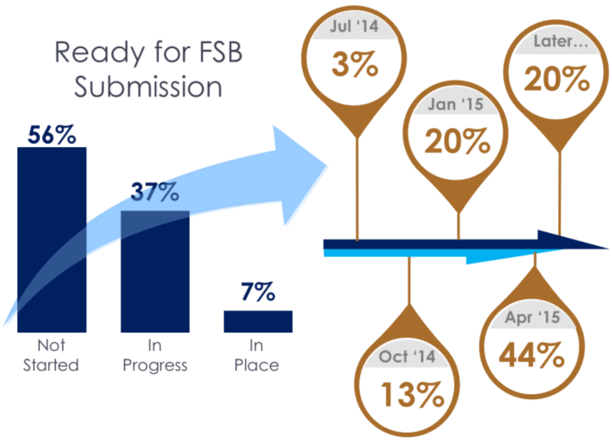
Documenting and reporting on the ORSA



Appropriate documentation of the ORSA is key from a number of perspectives. It ensures that to some extent the outcomes of a specific ORSA cycle are known and are repeatable; it significantly aids the independent reviewer; and it assists the regulator in understanding the process. In terms of reporting, the ORSA should culminate in reports for both internal purposes as well as for submission to the regulator.



The extent to which the reports for internal purposes and for regulatory submission differ from each other is a matter of preference of the insurer: some insurers may choose to adopt a single report for reporting both internally as well as to the regulator, while for others the reports may differ substantially. The survey results show that some insurers have some information included in the internal reporting that is not included in the regulatory submission. This information may include the company's risk management strategy, operational loss management frameworks and other policies. These policies may be referenced within the regulatory report. In general, most insurers highlight that the internal report is much longer as a result of the fact that this additional information on policies is not provided in the regulatory submission.



Group-specific considerations

The ORSA is required at both the solo (individual licence) level as well as at a group level. In this context, “group” means an insurance group as identified by the FSB. As such, this may include subgroups of an insurance group. Insurers may request to be exempted from the requirement to submit ORSA reports pertaining to the solo entities if the group ORSA report supports the adequate oversight and supervision of the solo entities by the FSB. Furthermore, the solo boards are required to sign-off the group report (or relevant portions thereof).

A question which has arisen is to what extent participations should feature in the risk analysis and projections for an insurer or insurance group. Where participations fall below the definition of a subsidiary, these may be treated as investment holdings; however should the insurer be aware of any significant risks associated with such a participation, the risks should be considered as appropriate. Where a holding falls into the definition of a subsidiary, the risks should be fully addressed in the analysis and projections in a manner which is proportional to the risks posed.

Establishing an ORSA at a group level implies having the ability to analyse its quantitative and qualitative risk profile and project its SAM and economic balance sheets. As such, a capital model is required at a group level. Capital models range significantly in complexity, ranging from advanced stochastic simulation models to simple proxy models. The approach taken should be proportionate to the risks and the business of the group, and as such may vary in sophistication not only for the group as a whole but also across the various risk types faced by the group.

Conclusions

The first Pillar II survey conducted in 2012 indicated that significant work would be required ahead of interim measures and the SAM regime. Although requirements were very much in draft stage, these early indications showed that the industry as a whole required much improvement in all seven dimensions measured in order to meet these standards. The Pillar II survey conducted in 2014 has shown that significant progress has been made in all seven dimensions of the survey.

In the first Pillar II survey, the ORSA was highlighted as an area which required significant development by the vast majority of respondents. The ORSA is an exercise that is conceptually new to insurers regulated by the FSB, and furthermore the principle-based nature of the requirements meant that insurers initially found the concepts difficult to understand. Significant work has been undertaken by the FSB and relevant SAM structures, as well as by industry, and the results of the 2014 Pillar II survey confirm this.

The 2014 Pillar II survey furthermore gave some insight into risk management and ORSA at a group level. The interaction between ORSA's of solo entities within a group and that of the group is of great importance, and the surveys conducted on groups deemed to be insurance groups assisted in building this understanding. The information provided will help develop the FSB's supervisory approach to group ORSA and risk management in general.

The 2014 exercise required a significant amount of effort from all insurers, and the FSB would like to thank all participants in this exercise. In achieving a better understanding of progress made in the area of general governance, challenges faced with the ORSA, timelines for implementing various aspects, and general Enterprise Risk Management capabilities of insurers, the FSB has been able to establish requirements for the Mock ORSA exercise and refine its supervisory strategy with regards to the ORSA.