

# **Solvency Assessment and Management**

## **Report on the Pillar II Readiness Survey**



June 2013

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# *1. Introduction*

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The Solvency Assessment and Management (SAM) framework is currently being developed to create a risk based framework for South African insurance companies and insurance groups. Although there is still some way to go until the SAM requirements will go live on 1 January 2016, good progress is being made with the development of the SAM framework. Specifically, the SAM framework has already put in place interim measures for the calculation of the assets, liabilities and capital adequacy requirements for short term insurers, as provided for in Board Notice 169 (BN169) of 2011. Further development of the SAM framework will occur through the Insurance Laws Amendment Bill (ILAB) which is expected to take effect from 1 January 2014. The ILAB will deal, amongst others, with enhanced governance, risk management and internal controls requirements, as well as a formal framework for insurance group supervision.

In addition to the ILAB, readers of this report are encouraged to read through Discussion Document 71 (v5) – Systems of Governance which sets out the SAM Governance Task Group's proposals for the governance requirements under the final SAM framework. This discussion document is available on the FSB's website and is open for comment until 31 July 2013.

The Pillar II component is a crucial piece of the SAM framework – it is imperative that all insurers and insurance groups have the appropriate governance and risk management frameworks in place. Past studies have shown that well-capitalised insurers and insurance groups are not immune to insurance failures, highlighting the need for robust regulatory requirements with respect to the governance and risk management frameworks of insurers and insurance groups.

This exercise was primarily conducted to collect more information on the Pillar II readiness of insurers. Whereas the FSB has collected a large amount of data on the preparations for the Pillar I requirements through the Quantitative Impact Studies and Internal Model Approval Process, limited data was available to the FSB on insurers' preparations for Pillar II. Given the importance of Pillar II highlighted above, as well as the changes to be implemented through the ILAB, it was crucial for the FSB to gain a better understanding of how insurers are preparing themselves for the requirements of Pillar II.

## 2. Scope and limitations

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All registered insurers (other than insurers that were in run-off) were requested to complete the SAM Pillar II readiness survey. The focus of the survey was not a compliance checklist or a road map to enable insurers to be compliant with the SAM requirements once it becomes effective. Rather, the survey was aimed at gauging the extent of development work done by insurers to prepare themselves for Pillar II of SAM.

The first phase of the exercise was the completion of a questionnaire. The second phase consisted of targeted and selected follow-up interviews with a representative sample of insurers. The insurers with whom follow-up interviews were conducted were selected based on two key considerations. The first consideration was to ensure a spread across types and sizes of insurers. The second consideration was responses received on the questionnaire for which the FSB deemed it useful to gain further insight into. The interviews were conducted with executive and non-executive directors, as well as other key individuals in control functions.

The questionnaire covered the following dimensions: board composition, board functions, risk management, own risk and solvency assessment, internal control, control functions, and outsourcing.

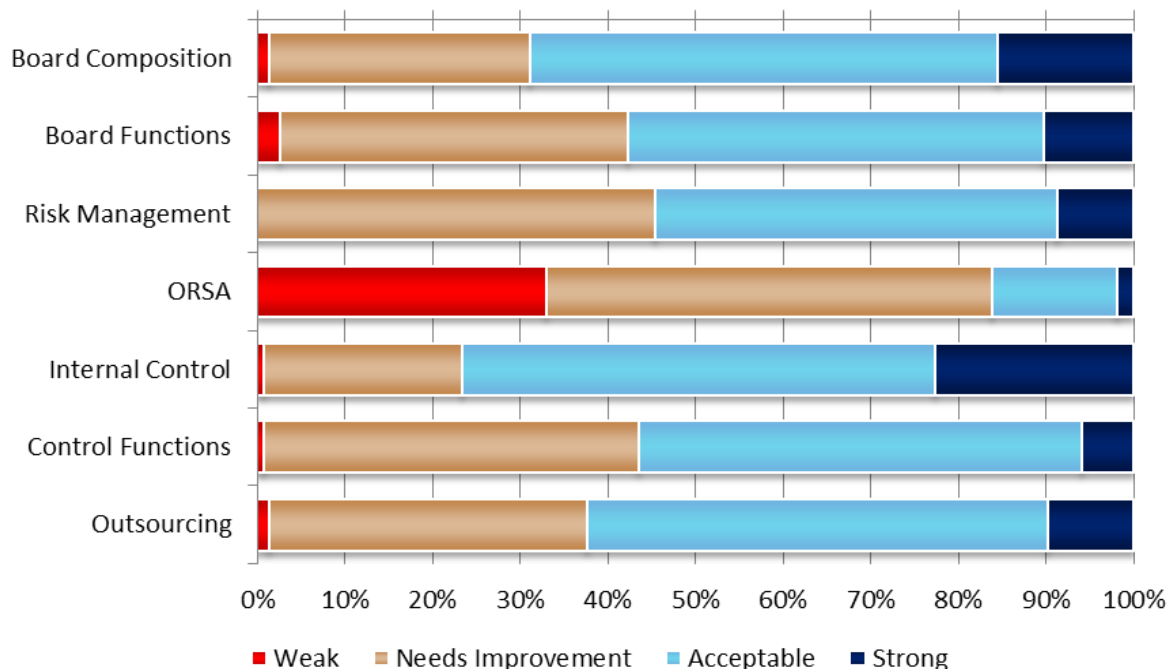
It is important to note that the questionnaire required insurers to make their own assessments of their performance in the various dimensions presented. No independent assessments, auditing or other verification of the responses were required. As such, messages contained in this report are based on the actual responses and feedback received from participants, and do not reflect the views of the FSB or an independent assessment of the insurer.

Throughout the document, the figures depict results on an aggregate industry level, and where deemed relevant some differences between life insurers and non-life insurers are highlighted. For a more detailed benchmarking by industry sub-segment, an additional document (Appendix B – Results by Industry Sub-Sector) has been published in the form of an excel spreadsheet.

### 3. Executive Summary

In the questionnaire insurers were posed a number of closed- and open-ended questions pertaining to the Pillar II aspects of their business, namely: board composition, board functions, risk management, own risk and solvency assessment, internal control, control functions, and outsourcing. At the end of each of these sections, insurers were asked to provide a self-assessment of how they perceive the state of their business to be faring in each dimension.

#### Overall Self-Assessment – All Insurers

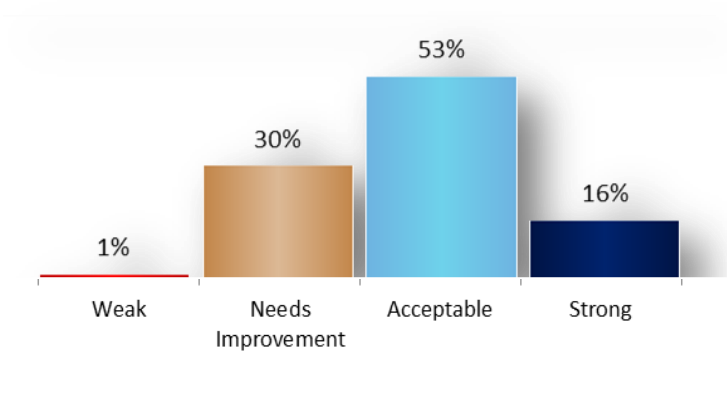


The graph above shows the results of these broad self-assessments for all insurers combined. Performance regarding the ORSA was, perhaps unsurprisingly, the area in which the most insurers indicated their capabilities were weak or in need of improvement. Broadly speaking, between 30% and 50% of all respondents indicated a need to improve capabilities and/or practices in the areas of board composition, board functions, risk management, control functions, and outsourcing. Almost a quarter of respondents indicated this to be the case for internal control as well.

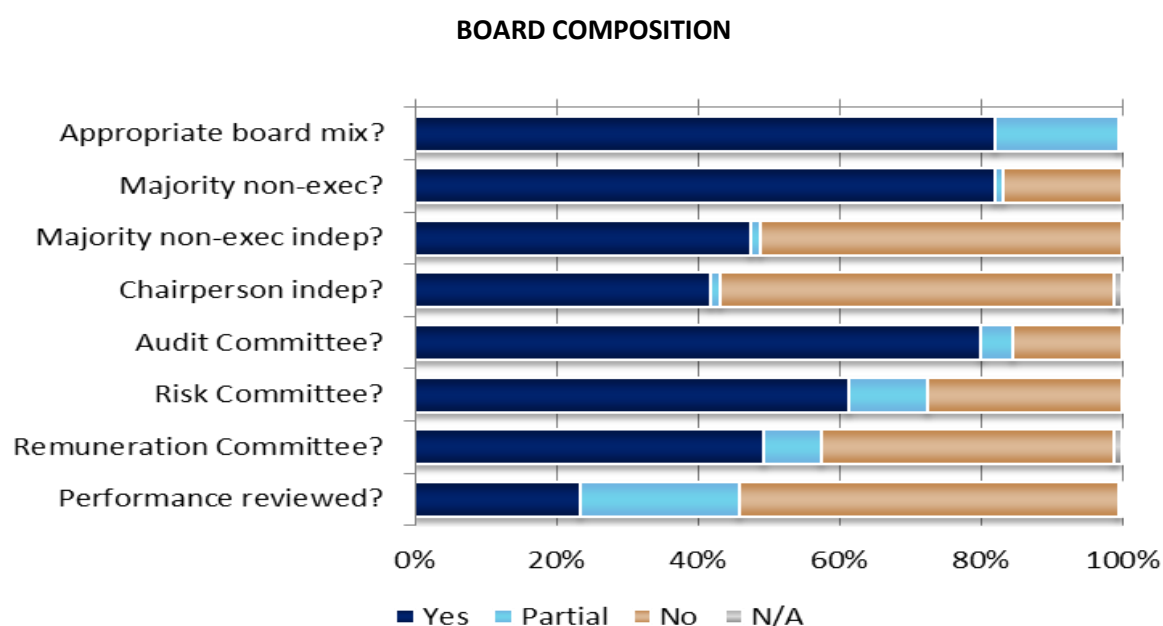
The detailed results within each category as well as the context provided by the follow-up interviews form the remainder of this report.

## 4. Board composition

The **overall self-assessment for Board Composition** was as follows:



From the above assessment it can be seen that close to a third of respondents rated Board Composition as requiring improvement to some extent. Responses to some of the closed-ended questions comprising this dimension are shown below:



Insurers mostly assessed their board mix as appropriate, with more than 80% indicating that the board comprises a majority of non-executive directors. The responses however show that for more than half the respondents the majority of non-executives are not independent. Furthermore, close to 60% indicated that the chairperson of the board is not independent. It should however be noted that, in the context of the questionnaire, individuals represented elsewhere in a group were not deemed to be independent at a licence level.

The following comments made in the responses and the follow-up interviews add further insights to the assessments above:

### ***Appropriate mix and skill on the Board***

- The shortage of actuarial skills, particularly non-life actuarial skills, and to a lesser extent the shortage of IT skills at a non-executive director level was highlighted.
- The level of skill and expertise needed to oversee the implementation of the SAM framework was mostly assessed at the level of the Board as a collective. In many cases respondents commented that further and on-going training would be provided to increase the knowledge base of the Board in this regard.
- In most cases the CEO is an executive director. In about 40% of the responses the CFO was also an executive director.

### ***Majority of non-executive directors and majority of independent non-executive directors***

- A general comment was made around the skills shortage and the challenge to recruit a majority of non-executive directors and independent non-executive directors with sufficient skill and experience to meaningfully contribute at board level.
- The practical difficulty around the definition of an independent non-executive director was raised in a number of responses and interviews. This difficulty is exacerbated in group scenarios where independent non-executive directors at group or holding company level are not considered to be independent (as defined) at subsidiary company level.
- Comments were made during the follow-up interviews that attributes of competency, insurance expertise and an independent frame of mind should perhaps weigh more than pure independence without the other attributes.

### ***Independent Chairperson***

- The proposed requirement of an independent chairperson of the board of directors was challenged particularly in the case of closely held insurers or subsidiaries forming part of a larger group.
- The concept of a lead independent director was raised in a number of responses and interviews - particularly where conflict of interests situations are present or possible such as in group scenarios or where the chairperson is linked to the major shareholder.

### ***Board sub-committees (Audit, Risk and Remuneration sub-committees)***

- Approximately 40% of respondents have separate audit and risk committees.
- In cases where the audit and risk committees are separated, it seems to be driven by a view that the topics may require a different skills set to adequately address agenda



items. Often, memberships of the two committees overlap to facilitate knowledge sharing and an overall view of risks.

- In combined audit and risk committees there often are separate agenda sections for the risk portion and the audit portion of the meeting.
- Certain respondents also commented that considering the nature, scale and complexity of their operations, additional board sub-committees have been formed (eg. policyholder affairs committee, actuarial committee, etc.) to adequately address specific risks or requirements.
- Comments were received that consideration should be given to allow one set of board sub-committees in group scenarios to avoid duplication.
- Suggestions were made during the follow-up interviews that boards and board sub-committees should perhaps be more pro-active in their information requests as opposed to relying substantially on information provided by management.

### ***Board and board sub-committee performance review***

- Most respondents appear to undertake some form of performance review.
- Many respondents felt that the review process should be more formalised and specifically extended to board sub-committees and perhaps also to individual board members as opposed to just the board as a collective.
- In some cases there was evidence that the results of performance reviews have been used in determining whether or not to keep directors on the board.

### ***Future initiatives***

- Some insurers are reconstituting boards to increase the number of independent non-executive directors.
- Many respondents expressed their plans and intent to provide further SAM training to board members.
- Some respondents are adopting more formalised structures (e.g. committees) and policies to enhance their governance structure.
- Many respondents are either considering, or are in the process of, establishing a formal board performance review process.

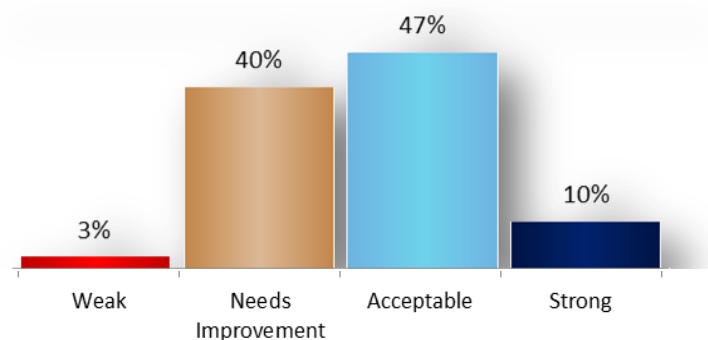
### ***Proportionality and group considerations***

- While many participants highlighted the need for proportional requirements, few if any were able to provide any meaningful suggestions as to how this may be achieved while still fulfilling the requirements of the higher-level principles.
- Some smaller insurers see achieving the independent requirements on the board as highly impractical and not adding value. Some have indicated that the board composition requirements should be relaxed for smaller, simpler insurers.

- Similarly, some smaller insurers have indicated that the requirements pertaining to board committees should be relaxed in line with proportionality.
- In terms of groups, some insurers indicated that they should be able to rely on group resources for board committees and certain control functions.
- It was noted among some insurance groups that board committees are typically established at a group level, with solo entity committees being formed under these group committees rather than under the board of the solo entities.

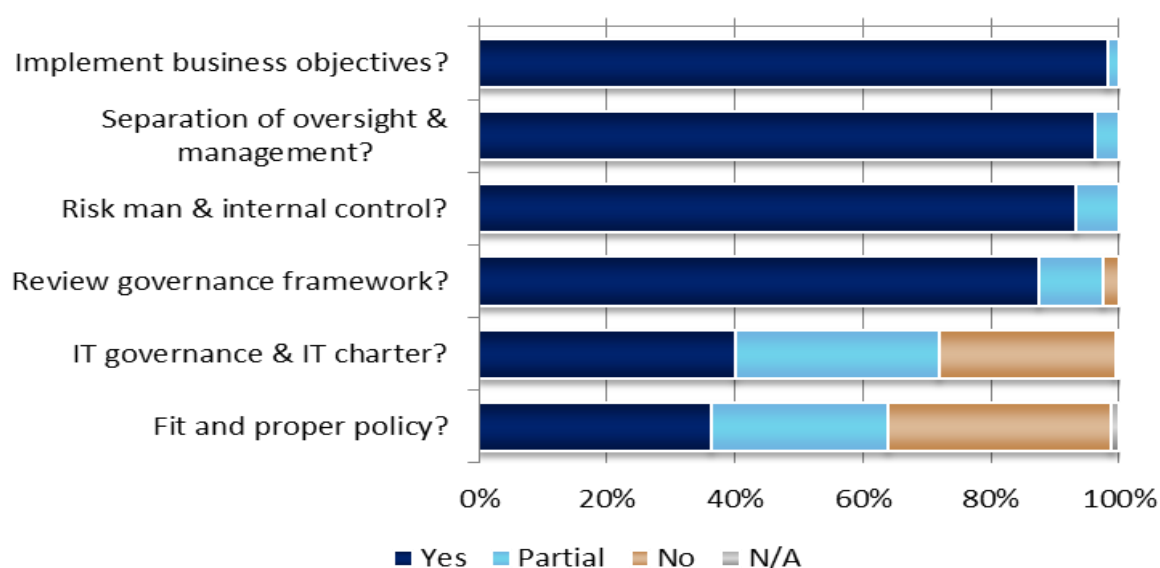
## 5. Board functions

The **overall self-assessment for Board Functions** was as follows:



From the above assessment it can be seen that approximately 45% of respondents rated Board Functions as either weak or needing improvement. Responses to some of the key questions pertaining to board function are given below:

### BOARD FUNCTIONS



It is evident from the graphic above that two of the key areas for development in terms of Board functions are the establishment of specific IT governance and an IT charter, as well as the establishment and embedding of a Fit & Proper policy.

The following comments made in the responses and the follow-up interviews add further insights to the assessments above:

### ***Implementation of business objectives***

- Most respondents indicated that board mandates and board sub-committee mandates are in place.
- Responses and follow-up interviews seem to suggest that there is somewhat of a blurring as to who actually sets the strategy for the insurer:
  - whether it is management who proposes a strategy to the board which is then reviewed and debated; or
  - whether the board sets a broad outline of the strategic direction which is then interpreted by management and presented back to the board for review and approval; or
  - whether the strategy is co-developed between management and the board.

### ***Review of governance framework***

- Most respondents commented that a regular evaluation of the effectiveness of the governance framework was performed. However, there was a view that the evidence gathered during this evaluation and the documentation of findings can be enhanced.
- Certain respondents commented that further work is required to ensure reliable and transparent reporting by control functions to the board.

### ***IT governance and IT charter***

- Most respondents confirmed that IT is being considered at board level, but also commented that it was perhaps not done sufficiently explicitly and that IT charters can generally be improved.
- As noted in the previous section, comments were also made regarding the need for sufficient IT skills at non-executive board level.

### ***Fit and proper policy***

- The responses in this area varied considerably. There were responses that indicated a comprehensive, bespoke and effective policy compared to other responses that referenced back to the requirements as outlined in the Companies Act or King III.
- In certain cases, the fit and proper policy was only applied at a director level and not at shareholder, senior management or heads of control function level.
- Many respondents requested clarification and guidance around fit and proper requirements.

### ***Succession planning***

- Key person risk was commented on specifically where reliance is placed on one board member to understand the more technical SAM issues.

### ***Future initiatives***

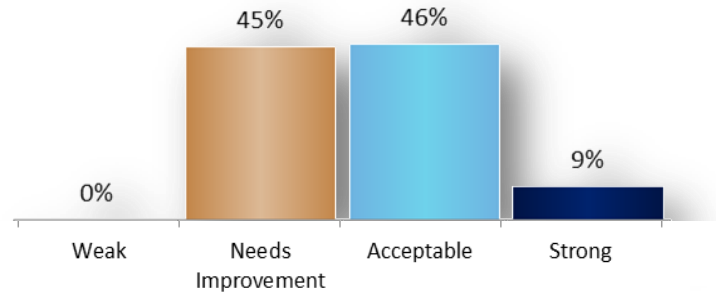
- In the area of board functions, most insurers have indicated that their initiatives are aimed at formalising practices in some way or another:
  - Many indicated that they are in the process of formally constructing and adopting policies;
  - Succession planning was identified as a relatively weak area by some, who are putting in place initiatives to address this gap;
  - Some insurers are in the process of establishing and formalising their IT governance structures.

### ***Proportionality and group considerations***

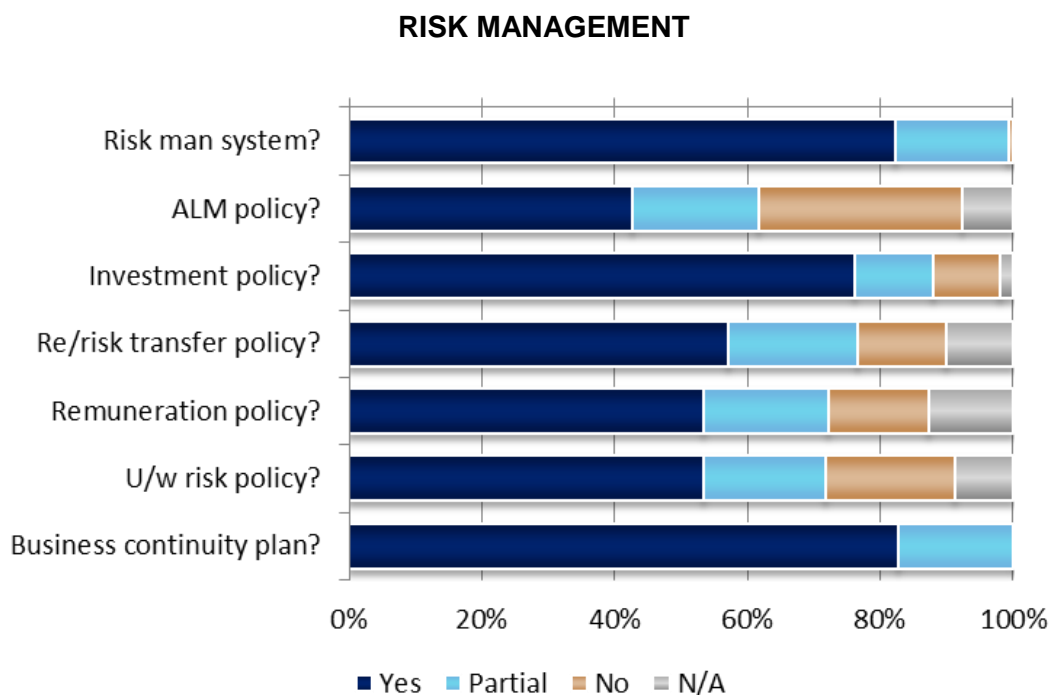
- Some insurers (including larger as well as smaller insurers) expressed the opinion that proportionality should not apply in many of the dimensions covered under board functions, and that all insurers should adopt the practices suggested here.
- One suggestion for proportionality was to allow for a longer transitional period for smaller insurers to aid them in making significant changes to their businesses.
- Some indicated that the possibility of combining board sub-committees was adequate allowance for proportionality.
- Many insurers questioned the need for many of these functions to exist in full at both a solo and a group level, making the suggestion that they should be allowed to leverage off group initiatives/structures in some areas.

## 6. Risk Management

The **overall self-assessment for Risk Management** was as follows:



From this self-assessment it can be seen that close to half of all insurers consider their risk management to require some improvement, although there were no insurers that considered their risk management to be weak. Furthermore, only 9% indicated that they consider their risk management to be strong. The figure below considers responses regarding the extent to which various elements of risk management are to be found in practice:



### ***The Risk Management System***

The risk management system as required under the draft Insurance Laws Amendment Bill (ILAB) comprises the totality of strategies, policies and procedures for identifying, measuring, monitoring, managing, and reporting of all material risks to which the insurer may be exposed. Key issues arising from the self-assessments and interviews are:

- Risk management is mostly not fully integrated into broader control processes and business.
- There are a limited number of insurers where the risk management framework is formalised and well documented.
- Many insurers demonstrate a lack of understanding of certain key elements of a risk management framework.
- Most insurers still need to develop comprehensive enterprise-wide risk reporting.
- Very few insurers currently conduct a regular, robust self-assessment of their risk management system.
- Smaller insurers are concerned with the cost implications of having an independent review of their risk management function.
- A challenge remains with respect to how entities which form part of a larger group structure apply their risk management system most effectively.

Below are more detailed observations pertaining to the elements of the risk management system, namely the risk strategy, risk policies, remuneration, and more general risk management processes, procedures and tools.

### ***The Risk Management Strategy***

Many insurers interviewed were not able to clearly articulate a strategy for identifying, measuring, monitoring, managing, and reporting of all material risks, instead focussing more on compliance with established policies and processes. Multinationals as well as groups highlighted some challenges in establishing local and/or business unit risk management strategies that were consistent with group strategies yet suited to the needs of the business.

### ***Risk Management Policies***

- More than 75% of insurers indicated that they have risk management policies in place, with a further 20% stating that they have this partially in place.
- Approximately half the respondents have ALM policies, reinsurance / risk transfer policies, remuneration policies, and underwriting policies in place.
- More than 75% of respondents have an investment policy.

Some interviewees indicated that their existing policies need to be revised in order to meet the requirements envisioned under SAM. Respondents from insurance groups highlighted the challenge in establishing entity-level policies in the context of group policies, suggesting that proportionality be considered.

### ***Risk Management Processes, Procedures and Tools***

Insurers are in various stages of maturity in terms of their processes, procedures and tools.

- Many insurers have no formal **risk appetite**. For those insurers that did have a risk appetite, many seemed to be based on the risk appetite used in SAM to determine the SCR, instead of a risk appetite unique to the insurer. Some are in the process of defining the concept and drafting statements, while others are yet to start. Insurers are working on establishing target risk profiles based on the organisations' business strategies.
- In terms of **risk limits**, while some insurers have such limits set up and in place, most are somewhat rudimentary, and require formalisation. Many insurers are yet to consider risk limits. For those insurers where risk limits were in place, very few were able to link these risk limits to their risk appetite. In a group context, complexities in translating group limits to subsidiaries were also noted.
- Most insurers continue to formalise and improve their **risk management processes**. Many insurers are in the process of acquiring and developing resources and systems to better relate their risk management practices to the underlying business models.
- Although most insurers have at least some form of risk reporting, few have formally defined their **risk taxonomy**.

## **Remuneration**

More than half of the respondents have a formal remuneration policy in place, and an additional 20% have it partially in place. Of those that have it in place:

- More than 40% do not have the board of directors or one of its committees fully overseeing and implementing the policy.
- 70% of respondents have policies which clearly state to whom it applies.
- Less than half of the respondents have deferred components of remuneration which align with the time horizon of the risks.

## **Future initiatives**

- The broad range of initiatives pertaining to risk management is a clear indicator of the different states of maturity of risk management across the industry.
- Many insurers do not have a formal risk strategy. Some have indicated that this is somewhat implicit.
- Most responses to this question indicate the need to further formalise various aspects of the risk management system.
- Many insurers are improving specific elements of their risk management, including:
  - Adopting IT systems to facilitate their risk management programme;
  - Implementing initiatives to improve the level of risk culture;
  - Enhancing Key Risk Indicators (KRI's);
  - Updating or refining their risk-related policies;
  - Establishing risk limit processes;



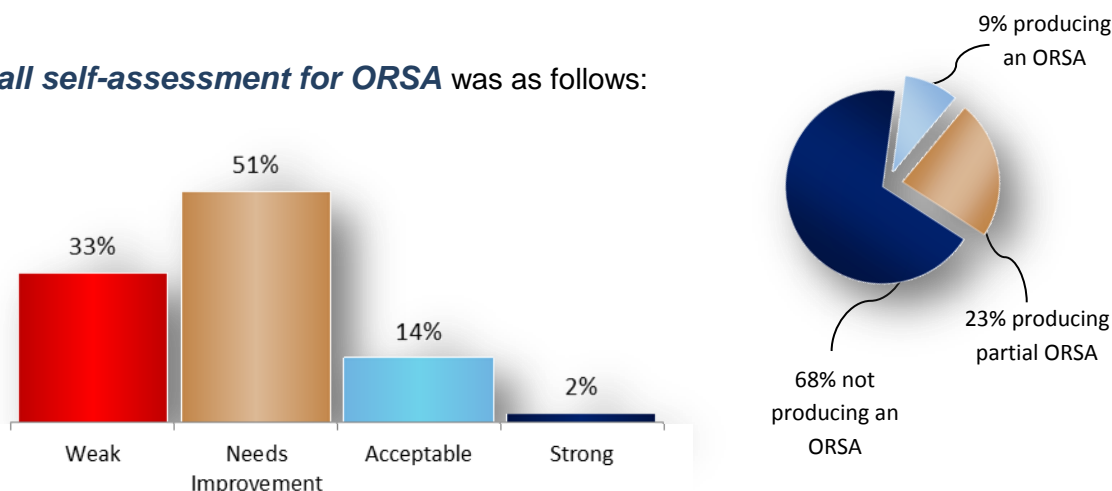
- Improving enterprise-wide risk reporting.

### ***Proportionality and group considerations***

- Many smaller insurers have expressed the need for guidance on what the absolute minimum requirements are pertaining to risk management.
- One insurer suggested being able to combine an ALM policy and the investment policy.
- Some insurers expressed concern over the requirements pertaining to risk management being too prescriptive, and indicated the need to be allowed to focus more on the principles rather than specific policies.
- Insurers forming part of a group noted that in many cases a group policy exists, and that it covers the solo entity. Some of these question the need for additional solo-level policies.

## 7. Own Risk and Solvency Assessment

The **overall self-assessment for ORSA** was as follows:



From the above assessment it can be seen that almost 85% of insurers rated themselves as either weak (33%), or needing improvement (51%), with respect to ORSA preparations. In interpreting the results, it should be noted that many insurers took different approaches in responding to this section. For the overall ratings, while many insurers rated themselves comparing current practice against future requirements, some insurers based their rating on whether they think their development and future plans are adequate to meet the ORSA requirements in future. In terms of the detailed questions, some insurers who do not currently produce an ORSA left the entire section blank, while some responded to the questions based on their future plans for the ORSA as opposed to what is current practice. What has become clear from both responses to the questionnaire, as well as the follow-up interviews, is that the ORSA is an area which is not well understood.

### ***Insurers currently producing a full or partial ORSA report***

- Only 14 insurers have developed an ORSA report to date, with a further 36 insurers indicating that they have produced partial ORSA reports.
- Some of the risks considered as part of the ORSA which do not necessarily explicitly form part of the standard formula include systemic risk, regulatory risk, political risk, legal risk, risks to pension fund liabilities, strategic risk, business risk, outsourcing risk, and employee risk.
- Of the 14 insurers producing a full ORSA report:
  - Only one insurer rated themselves as strong, with 8 rating themselves as acceptable and 5 as needing improvement. This means that three insurers not currently producing an ORSA report have rated themselves as strong in

this category, highlighting the different interpretations used in answering this section of the survey.

- Six of the insurers indicated that their ORSA is independently reviewed.
  - All indicated that solvency/capital implications are explicitly considered when looking at business cases or new products.
  - Some indicated that they incorporate reverse stress tests.
- Of the 36 insurers producing a partial report:
    - Only one insurer rated itself as strong, with 8 rating themselves as acceptable, 19 as needing improvement, and 8 as weak.
    - Three of the insurers have their ORSA's independently reviewed, with a further five indicating that this is partially done.
    - Many have indicated that they are in the early stages of defining their stressed scenarios, with the more advanced of these insurers citing 4 or 5 specific stresses which are considered.

### ***Insurers producing neither an ORSA report nor a partial ORSA report***

- Many insurers believe that they have most components of the ORSA, and they just need to be “pulled together”. However, upon further questioning, it became apparent that there were key parts of the ORSA process that had not yet been considered
- Most insurers have formulated detailed project plans to implement ORSA.
- Some insurers have held off on development as they wait for FSB to publish final ORSA requirements.
- Many respondents have limited knowledge of what ORSA entails.

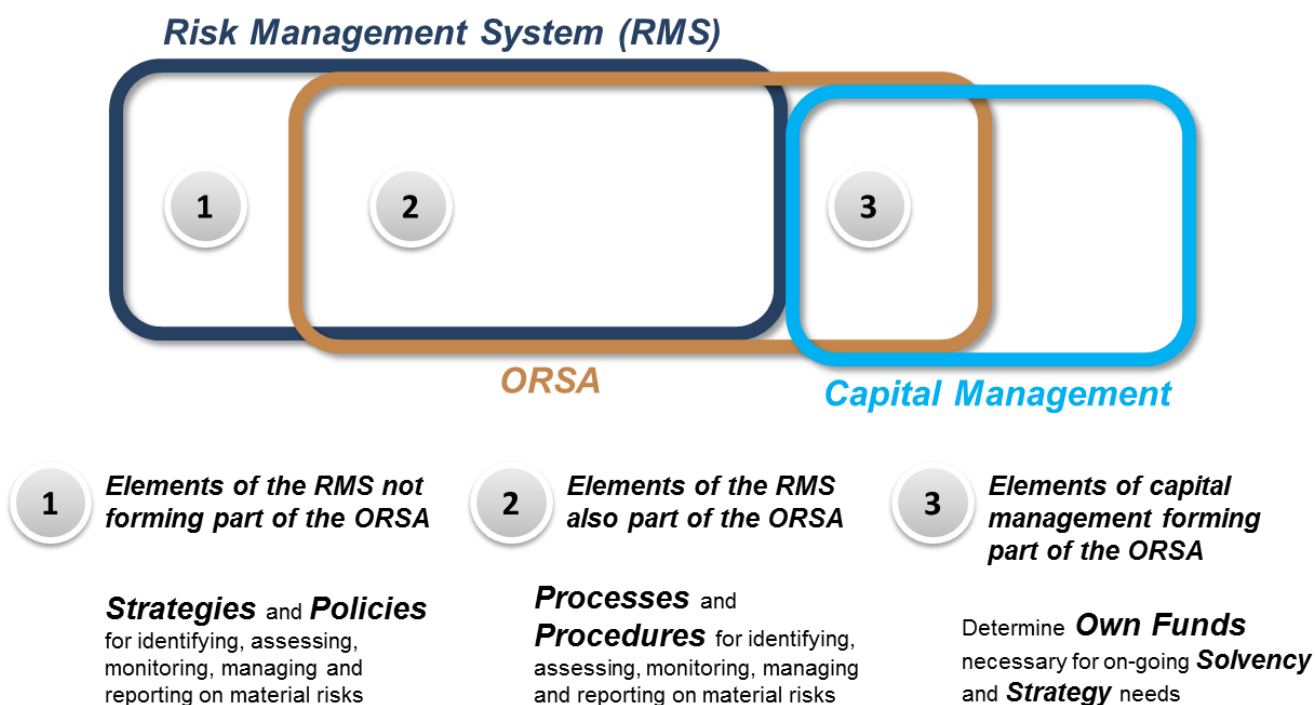
### ***Demystifying the ORSA***

ORSA is defined in Position Paper 34 as “*the entirety of the processes and procedures employed to identify, assess, monitor, manage, and report the short and long term risks an insurance undertaking (and insurance group) faces or may face and to determine the own funds necessary to ensure that insurers’ (and groups’) overall solvency needs are met at all times and are sufficient to achieve its business strategy.*” It should be clear from this definition that the ORSA is not simply a report.

ORSA is thus defined as a significant portion of the risk management system<sup>1</sup> itself, but also includes capital management activities as insurers are required to consider future capital requirements. The figure below shows the interaction between these three dimensions.

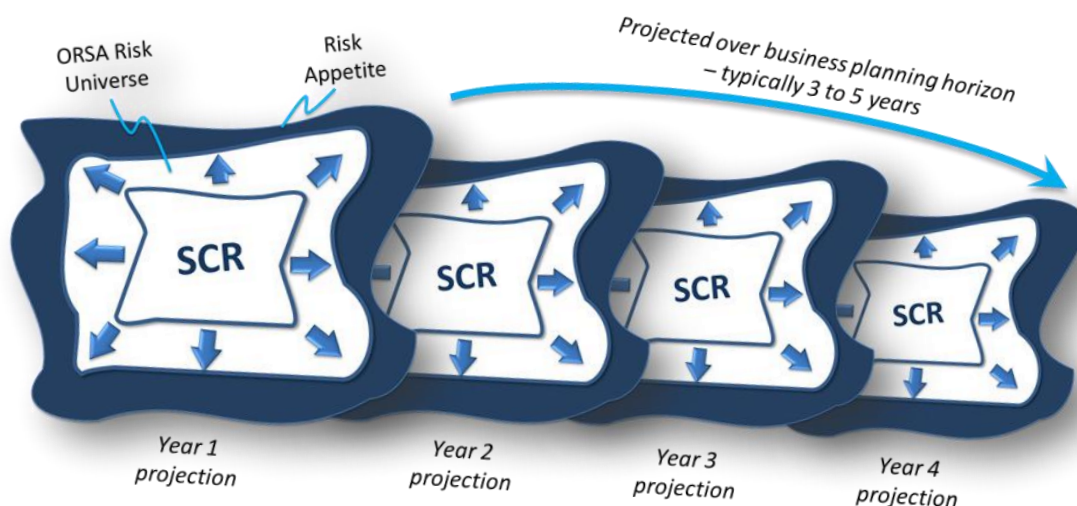
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<sup>1</sup> The risk management system is defined in the draft Insurance Laws Amendment Bill as the totality of strategies, policies and procedures for identifying, measuring, monitoring, managing, and reporting of all material risks to which the insurer may be exposed.



The ORSA is ultimately demonstrated to the board of directors as well as to the FSB by means of an ORSA report.

The ORSA processes may be depicted as follows:



The ORSA risk universe initially considers the risks defined in the regulatory capital model (SCR), and extends this to material risks not considered as part of the SCR. These risks are then quantified by the insurer taking into account the insurer's own view of these risks, which is then compared to the insurer's risk appetite – the amount of risk the insurer is willing to take on in the pursuit of its business objectives. The appetite should take account of restrictions on assets available to cover their regulatory capital requirement

(eligibility of own funds) as well as other business objectives. This resulting own view of risk capital is then projected over the business planning horizon, taking cognisance of regulatory capital requirements. The risk appetite and related available own funds is also then projected to ascertain whether the aims of maintaining solvency and achieving business objectives are likely to be met in the future. Should an insurer have a different definition of own funds for their internal modelling purposes than that implied by the regulatory framework, projections should include both bases.

It is important that insurers approach the ORSA with proportionality in mind. The broader risk management system as well as the techniques employed to project the own view of solvency should reflect the nature, scale and complexity of the risk profile of the insurer. As an example, insurers may project their future SCR values by estimating the relationship between their SCR and their risk drivers, forecasting their risk drivers, and then using the estimated relationship to approximate their SCR in future years.

In summary, some of the key reasons as to why the numbers produced in the ORSA may differ from the standard formula SCR are:

- The ORSA may consider risks which are not considered in the standard formula.
- The ORSA may consider risks differently to the way they are treated in the standard formula.
- The risk appetite of the insurer may differ from that implied by the standard formula. Examples of how this might differ are in terms of time horizon (i.e. different to a 12 month time horizon), confidence level (i.e. different to a 1-in-200 level of confidence), a different valuation basis, or a different risk measure (e.g. tail Value-at-Risk rather than Value-at-Risk).

More details regarding the emerging requirements pertaining to the ORSA are available in Position Paper 34. Furthermore, “Position Paper 34 – further guidance” is currently being produced.

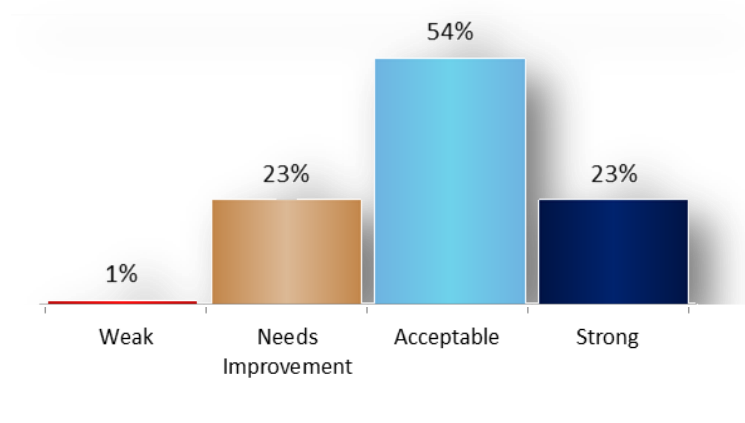
### ***Challenges highlighted***

The following challenges were noted in the responses and the follow-up interviews:

- Extensive use of consultants by the industry to formalise the ORSA process and construct the required models will be costly and may not be readily available.
- Great challenges are faced in the integration and alignment of the strategic plan, risk appetite and control functions into the ORSA process.
- Uncertainty pertaining to the requirements regarding group ORSA requirements versus subsidiary ORSA requirements, including whether capital availability should be considered at group level or at subsidiary level.
- The documentation and reporting in the Group ORSA and also the subsidiary ORSA are deemed by some to be too onerous.
- Participants highlighted the importance of the development of guidance on ORSA, and it was suggested that the FSB provide guidance for the stresses to apply to insurance groups to allow comparability.

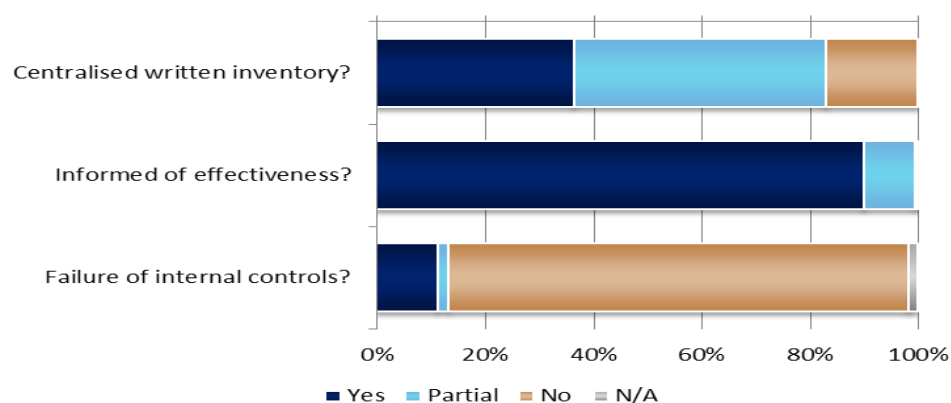
## 8. Internal Control

The **overall self-assessment for Internal Control** was as follows:



From the above assessment it can be seen that only 23% of respondents rated Internal Control as needing improvement, with a further 1% rating it as weak. Further insight into these results is obtained by considering the responses to some of the key questions, as set out below:

### INTERNAL CONTROL



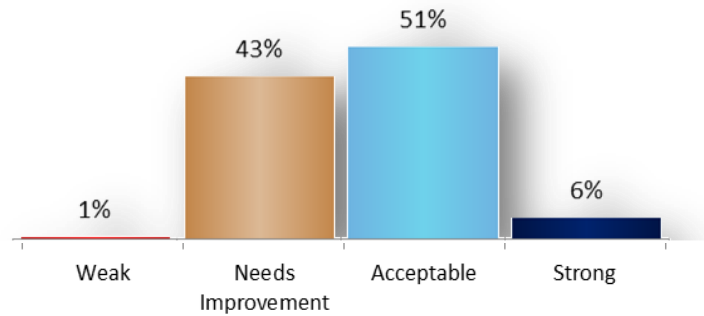
The following comments made in the responses and the follow-up interviews add further insights to the assessments above:

#### **Centralised written inventory of internal controls:**

Most respondents signalled a strong control environment, but commented that there is no central written inventory of company-wide processes, the associated risks of these processes as well as the related internal control measures to mitigate these risks.

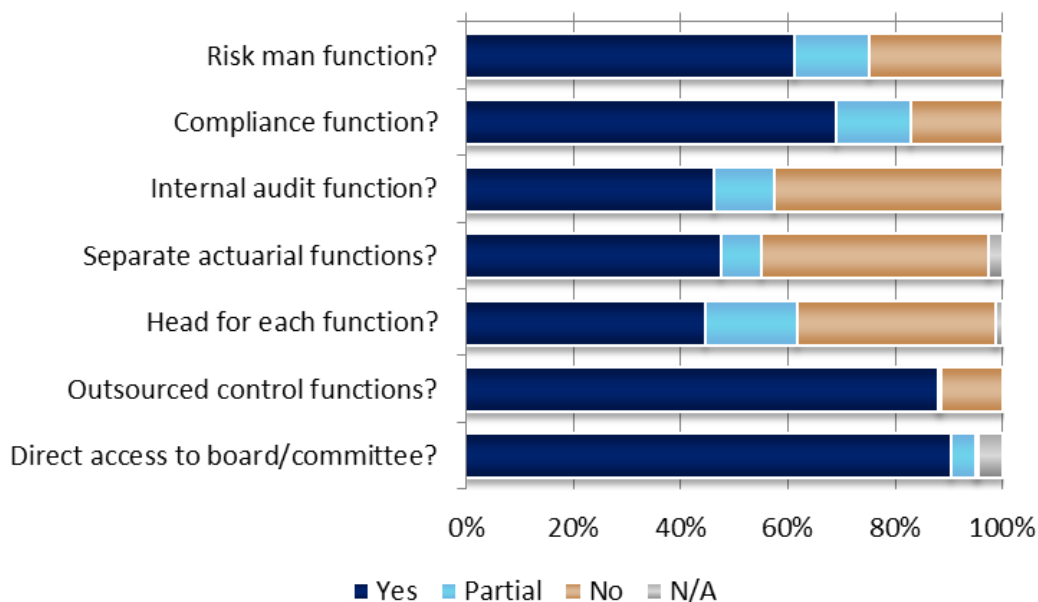
## 9. Control functions

The **overall self-assessments for Control Functions** were as follows:



Based on the above it seems that almost half of the industry has assessed that the control functions in place require improvement.

The table below highlights the level of establishment of the various control functions within the insurance sector:



From the table above it is clear that the compliance function is viewed as the most established control function within insurers, followed by the risk management function. The actuarial control function is seen as being slightly more established than the internal audit function. This is most likely due to the current requirement for all long-term insurers to have an actuarial function.

It is evident that the establishment of the actuarial and internal audit functions will need further attention from various insurers.

Of interest was the fact that a significant percentage of these control functions are outsourced, with almost 90% of respondents indicating that they outsource some control functions.

The following observations were made on the responses from the survey in combination with the follow-up interviews as it relates to control functions in general:

- In the cases where insurers indicated that the control functions are in place, only 20% indicated that some of the control functions are combined.
- Where control functions are combined, the most frequently observed combination is that of the risk management and compliance functions. Some respondents however indicated combinations of the risk management and actuarial control functions or a combination of the risk management and internal audit function (in the latter case perhaps raising questions regarding the independence of the internal audit function).
- It was evident from the follow-up interviews that some insurers were unaware that there is a proposed requirement for the independent assessment of control functions on a regular basis. In terms of practice, however, 55% of the total respondents indicated that the control functions other than the internal audit function are regularly reviewed by the internal audit function. These reviews are typically conducted annually.
- Responses were equally divided in respect of whether the appointment, performance assessment and remuneration of the heads of control functions (other than the head of the internal audit function) are done with the approval of or in consultation with the board of directors or any subcommittee thereof.
- Just more than half of the respondents indicated that the heads of the control functions either report or partially report to the CEO.
- 91% of the respondents indicated that the heads of control functions have direct access to the board of directors or a board committee.
- Concerns were raised regarding the cost implications of establishing all the control functions - both for insurers establishing the control functions within the business as well as those outsourcing one or more functions. In terms of the outsourcing, the rise in costs in light of a limited number of available skills was noted.
- If all or a majority of the control functions are outsourced to external parties and the independent review requirement for these remain, the question was raised in respect of consultancy firms and whether the internal peer reviews would be adequate to meet the “independent review” criteria.
- The responsibility of the board of the insurer to assess the performance of each of the control functions where such functions are outsourced to external parties was highlighted by some respondents as being particularly cumbersome.

### *Future initiatives*



Some areas of further work identified by certain insurers include:

- Addressing the appointment as well as the roles and responsibilities of the heads of control functions.
- The Board of Directors of the insurers implementing a more comprehensive performance review and reporting process for each control function.
- Some reviews of control functions currently take place on a rotational basis; it is the intention of some insurers that all areas will be reviewed independently at least once every two years.
- Implementing fit and proper requirements for control functions.

### ***The Risk Management Function***

- More than 61% of the insurers stated that there is a risk management function within their organisation, with a further 14% indicated that there is a partial risk management function within their organisation.
- The risk management function is more established among non-life insurers than life insurers.
- Of the entire industry, 45% (70 insurers) have appointed a head of the risk management control function, and where such an appointment was made 76% (53 out of 70 insurers) fulfil a dual head function. In most cases it is a joint head of risk management and compliance functions.
- A number of insurers indicated that the risk management and the internal audit functions are combined (again potentially raising questions regarding the independence of internal audit).
- Some participants indicated that financial risk management is dealt with separately from other enterprise risk management functions – perhaps counter-intuitively.

Another interesting observation is that it is not common for insurers to have in place a role of a Chief Risk Officer (CRO). If there is a CRO, the person in general reports to the Chief Financial Officer or the Chief Operating Officer. In these cases the CRO is thus not fully incorporated as part of the executive management team and is also not fully independent from the areas responsible for the day to day activities.

### ***Future initiatives***

Some insurers have identified gaps in their risk management systems and are working to implement solutions to establish a more holistic approach to risk, while others have the elements of the risk management system fairly well established but are working to formalise certain aspects and/or further integrate these elements.

Furthermore, insurers indicated that they will develop a comprehensive reporting framework pertaining to enterprise-wide risks.

## *The Compliance Function*

- Approximately 68% of insurers state that there is a compliance function within their organisation;
- 14% state that there is a partial compliance function within their organisation; and
- Roughly 17% state that there is no compliance function within their organisation.

The following observations were made on the responses from the survey in combination with the follow-up interviews as it relates to the compliance function.

- The compliance function is the most established of the control functions, and is typically better established among non-life insurers than the life insurers.
- In some of the bigger groups the compliance function is done at both group level as well as legal entity level.
- In terms of activities, the main focus for these compliance functions within the regulatory framework is on the Financial Advisory and Intermediary Services (FAIS) Act.

## *Future initiatives*

The most significant issue mentioned was the fact that within some insurers the compliance function does not operate entirely in line with the anticipated requirements of SAM (currently operates as a mixture of first and second line roles as opposed to a fully-fledged second line of defence). Those raising this concern have indicated that it will be addressed.

## *The Internal Audit Function*

- More than 46% of the entire insurance sector states that there is an internal audit function within their organisation;
- 11% states that there is a partial internal audit function within their organisation; and
- 43% states that there is no internal audit function within their organisation.

In most cases the internal audit function is outsourced to a **group internal audit function**; however in some cases this group internal audit function is further outsourced to external parties.

In some cases, when a group internal audit function is utilised for the specific insurer, the group internal audit function lacks financial services internal audit experience (where, for example, the group's core business is in mining or manufacturing). In some cases, and in the particular case of small niche insurers, this is often overcome by the group internal audit outsourcing audit activities related to the insurer to an audit firm.

In addition, in respect of internationally active insurers where the internal audit function is outsourced to the group internal audit function, this is often based in a foreign jurisdiction.

Only 36% of insurers indicated that the appointment, performance assessments and determination of the remuneration of the head of the internal audit function are undertaken by or in consultation with the Board of directors or audit committee.

59% of the insurers indicated that their internal audit function is subject to an external objective review. Furthermore, for these insurers the external objective reviews are performed:

- Annually – 56%
- Every two years – 6%
- Longer than two years – 38%

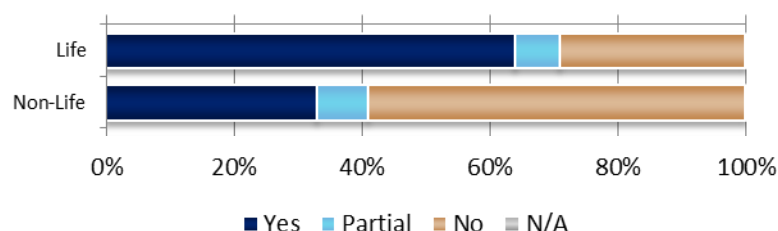
### *Future initiatives*

The following are some of the future initiatives that insurers have indicated they will embark on:

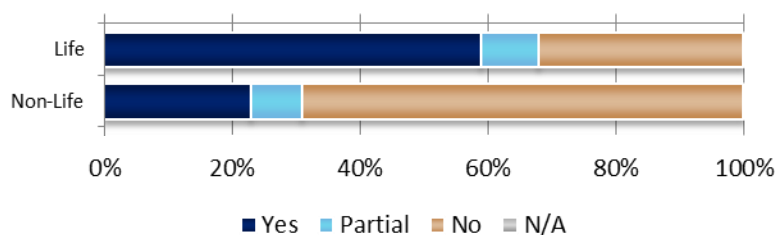
- Many without an internal audit function are planning to formalise the control functions, with some indicating plans to establish such a function.
- Some insurers suggested that future reviews of the other control functions will be included as a requirement for internal audit. There were however those that felt that the review of the other control functions by internal audit is questionable due to the specialised nature of these control functions. For those that had reservations it was indicated that they will be given consideration to alternative assurance.
- The role of internal audit will be re-defined and the reporting line to the audit committee formalised.

### *The Actuarial Control Function*

The figure below highlights the existence of an actuarial control function responsible for the independent review of actuarial assumptions and methodologies which is separate from the actuarial function responsible for performing the calculations within the long-term and short-term insurance sectors:



The following figure highlights whether the functions of the statutory actuary are confined to the independent review of actuarial assumptions, methodologies and calculations only.



The following observations were made from the responses from the survey in combination with the follow-up interviews as it relates to the actuarial control function:

- More than 50% of insurers indicated that they have an actuarial function in place or partially in place. It is clear from the graphs above that this is mainly the case in the long-term insurance industry.
- The actuarial control function is typically outsourced.
- The appointment of a statutory actuary/ appointed actuary is a serious concern to the short-term insurance industry for two main reasons, namely the shortcoming of experienced and qualified short-term insurance actuaries as well as the costs involved.

#### *Future initiatives*

- Short-term insurers are considering the appointment of a statutory actuary.
- Some insurers are in the process of establishing an actuarial control function, as a second line of defence (oversight) function.
- For some long-term insurers, the statutory actuary currently sets the final assumptions in conjunction with an internal actuarial function. It will be investigated to transfer this responsibility to the internal actuarial function.

### ***Proportionality and groups issues***

#### *Proportionality*

The following is a summary of the comments made by the insurers in respect of the principle of proportionality as it applies to the control functions:

- The control function requirements may be onerous for smaller insurers that have a shortage of skills and capacity constraints.
- It is difficult for small insurers to justify, implement and maintain an internal audit function.
- It should be considered appropriate for an insurer to outsource the internal audit function as the requisite skills are often difficult to find and retain.
- The role of the actuarial control function should be carefully considered with specific regards to the associated cost, necessity and availability.

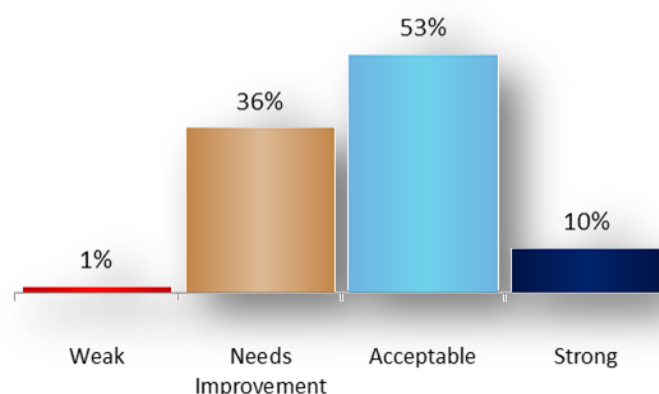
- In terms of the requirement for an independent review of actuarial assumptions, methodologies and calculations, this may be challenging for smaller insurers. Perhaps the specific requirement for “independence” can be aligned with the “proportionality” argument given that there are limited resources with the skills and expertise to perform these reviews in the non-life space. A more practical solution may be to prescribe that only insurers that pose a systemic risk to the sector be obliged/instructed to have an independent person perform this role.
- It should be appropriate to combine heads of control functions where this does not give rise to obvious conflict of interest (internal audit / any other).
- Some pure linked insurers suggested that the governance requirements for such business should be less rigorous compared to the average insurer.
- It is important to ensure that small insurance companies are not burdened with excessive regulation and related costs that make them uncompetitive.

### *Groups*

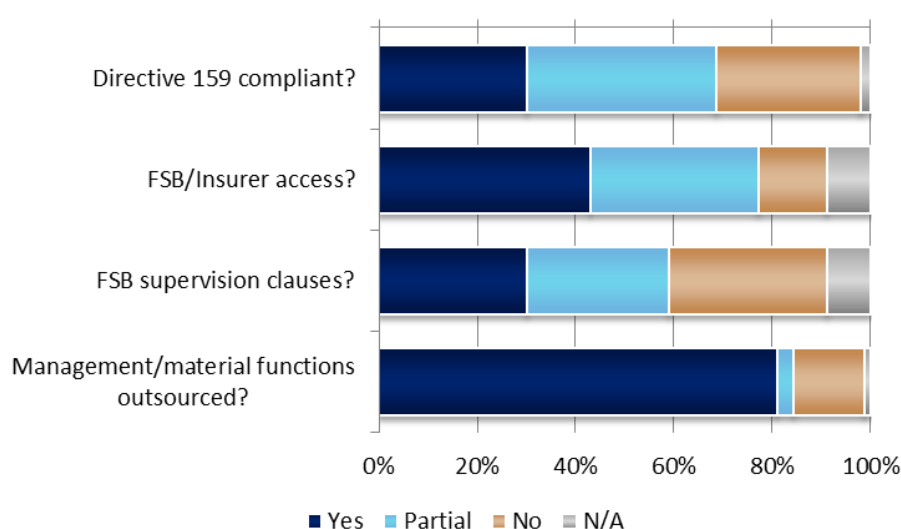
- It is very common within insurance groups for some of the insurers in the group to outsource the control functions to the group holding company or subsidiaries within the group. It is argued that this helps to maintain a level of independence, and should not impact on the function’s impartiality.
- Some groups were of the view that the FSB should allow the use of group resources and processes to meet the requirement to separate the four control functions.
- The solo entity and the group often have arrangements where certain control functions are centralised. However, where this occurs, there are outsourcing considerations that need to be met: the solo entity must ensure that the control function (now outsourced) is performed by the group department/resource to the required regulatory level.
- If the management structure at insurance entity level is not materially different from the group structure (at holding level) then it is argued that the control function requirements should not be applied on a legal entity stand-alone basis, but only on a group basis.
- Group structures and oversight can be utilised for outsourcing control functions to gain a level of independence of these control functions.
- Where a group has control functions in place at the holding company level, there should not be a requirement to replicate control functions at a sub group level.
- For insurance companies that are subsidiaries of a regulated banking group, reliance should be placed on other regulators and the work done across the group by these other regulators e.g. Basel III and ICAAP.

## 10. Outsourcing

The **overall self-assessment for outsourcing** was as follows:



From the self-assessments it is clear that more than a third of participants rated themselves as requiring improvements in their outsourcing practices. Furthermore, only 10% of participants assessed their outsourcing practices as strong.



- At the time the survey was completed Directive 159 was only applicable to new contracts and was intended to be applicable to existing contracts with effect from 1 January 2013. It is expected that the results would look markedly different after this date.
- It was indicated by about 38% of insurers that there is still work to be done. This relates mainly to the outsourcing policy and getting outsource agreements in line with the Directive requirements.

- More than 80% of insurers indicated that management/control functions are outsourced. In most cases, however, this represents outsourcing within the group rather than outsourcing to external service providers. Captives typically indicated that all functions are outsourced.
- Only 20% of insurers indicated that the remuneration paid in respect of outsourced control functions is assessed against the remuneration policy of the company.
- Almost 10% of insurers indicated that they outsource to entities that are affiliated to other service providers, such as external auditors or legal advisors.

### ***Future initiatives***

- Most insurers indicated that they are either in the process of establishing an outsourcing policy or that one had been recently established and is being implemented.
- A few insurers indicated that they have an outsourcing policy and that they are currently working on ensuring that it is compliant with Directive 159.
- A number of respondents indicated that they are furthermore amending or establishing remuneration policies to appropriately cater for the requirements of the directive.

### ***Proportionality and group considerations***

- In terms of proportionality, while many insurers indicated the need for it to be applied, few if any had suggestions as to how this could be applied for outsourcing while meeting the high-level principles.
- A number of respondents requested additional clarity on what is meant in the Directive requirements by the term “material”.
- Many insurers indicated that outsourcing within a group (“insourcing”, or “group-sourcing”) presents a much lower risk to an insurer and thus should not be treated as strictly as outsourcing externally to the group.

# 11. Conclusions

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Although the study was primarily conducted via a self-reported questionnaire which did not require independent validation or review, this exercise provides a useful snapshot of the deemed current state of the industry with regards to Pillar II readiness.

It furthermore highlights a range of current practices in place across the diverse range of insurers.

It is hoped that the questions posed helped to capture current practices, and highlighted areas that may require changes to be made in future. It should also serve as a useful benchmark for insurers in terms of their peers.

This exercise has also highlighted a number of challenges faced by the industry in preparing for Pillar II of SAM. Practices in some areas may be changed relatively quickly and with relative ease. Others, for example requiring an independent chairperson, are more onerous and may take significantly longer to change.

Part of the challenges faced was based on the interpretation of certain areas. An example is the fact that for the purposes of the questionnaire, independent directors at a group level were not recognised as independent on boards of the solo entities within the group.

In order to build on the positive work done in this exercise, the FSB will look into launching a follow-up exercise. Although the purpose and scope for such work would need to be determined, such an exercise would likely focus on areas that have been identified as requiring a significant amount of further work. The FSB will also consider how such a process will best enable both industry and the FSB to better prepare for the implementation phase of the SAM project.

The study has been extremely useful for the FSB, and the FSB would like to thank all participants in this exercise. In achieving a better understanding of the range of practices, challenges faced, and future initiatives of insurers, the FSB is better placed to consider the core Pillar II requirements, group applications thereof, the potential need for transitional measures, and the application of proportionality.



## Appendix A – Pillar II documentation

While interim measures pertaining to governance are being introduced in the ILAB, industry proposals for final SAM measures are currently being formulated within the SAM governance structures. The following table sets out the status and availability of the various documents pertaining to certain aspects of Pillar II:

Document	Status	Availability
<b>Insurance Laws Amendment Bill (ILAB)</b>	Published by National Treasury as part of the Parliamentary process	On FSB website
<b>Discussion Document 81 (v3): Governance, Risk Management, and Internal Controls – Interim Requirements</b>	Published by National Treasury to support the ILAB	On FSB website
<b>Position Paper 34 (v7): Own Risk and Solvency Assessment</b>	Final Position Paper	On FSB website
<b>Discussion Document 71 (v5): Systems of Governance</b>	Discussion Document, open to public consultation until 31 July 2013	On FSB website
<b>Discussion Document 83 (v4.2): The Role of the Appointed Actuary</b>	Discussion Document, under development	Not yet published
<b>Discussion Document 96 (v3): General Stress Testing Guidance for Insurance Companies</b>	Discussion Document, under development	Not yet published
<b>Discussion Document 97 (v3.1): Group Considerations for Stress Testing</b>	Discussion Document, under development	Not yet published
<b>Discussion Document 107 (v5.1): Own Risk and Solvency Assessment – Further Guidance</b>	Discussion Document, under development	Not yet published

The first publicly available version of the new Insurance Act and supporting rules for the final SAM measures is expected to be released by the FSB for public consultation in Q2 2014.