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Reinsurance Regulatory Review Position Paper

Deloitte summary and commentary

In September 2016, the Financial Services Board (FSB) released the "Reinsurance Regulatory Review Position Paper". The Position Paper is likely to change the reinsurance landscape in South Africa and therefore all licensed entities involved should be considering its impact on their business. A summary of the key points is provided in this document.

Please note that this is a verbatim reproduction of extracts from said paper. Deloitte commentary has been provided in the green text boxes.

Participation in the Reinsurance Market

Please note that you will be classified as one of the following:

PA – Prudential Authority

Locally registered professional reinsurers	Local direct insurers	Branches of foreign reinsurers	Lloyd's of London	Cross-border supply of reinsurance
The same legislative requirements as local direct insurers will apply, but professional reinsurers will be licensed to conduct reinsurance business only.	Will be permitted to conduct both direct insurance and inwards reinsurance business subject to specific authorisation as part of the licensing requirements.	Foreign reinsurers will be allowed to conduct reinsurance business through a licensed branch established in South Africa.	Licensed to conduct business in South Africa in respect of all non-life classes of insurance and reinsurance business except for direct insurance of personal lines business - requires formal approval from PA.	Local insurers and reinsurers will be allowed to place reinsurance directly with a foreign reinsurer. However, non-equivalence may prohibit recognition of reinsurance for solvency purposes.

Conducting Reinsurance Business

Composite reinsurers

- A reinsurer that is licensed to conduct both life and non-life insurance business may not be licensed to conduct reinsurance business in respect of the investment classes of life insurance business.

Use of reinsurance for purposes other than risk management

- Only reinsurance arrangements that involve effective risk transfer will be allowed to be taken into account in the calculation of the SCR and technical provisions.

The FSB has not yet finalised their view on what qualifies as 'effective risk transfer'. Enhancing your balance sheet without effective risk transfer may be disallowed in the future.

Intra-group and related party reinsurance

- There are no specific further measures that need to be taken into account with regard to intra-group reinsurance in addition to those inherent in the SAM regime.

However note the limits on maximum cession that will apply in intragroup contexts in the next section.

Fronting arrangements

- A licensed direct insurer should not engage in fronting arrangements in respect of a specific class or sub-class of insurance business.

Does this mean that fronting cannot be conducted on a 'per policy' basis? The FSB has not strictly defined fronting. The definition of 'class' and 'sub-class' need also be considered.

- For both a licensed direct insurer (including a microinsurer) and a professional reinsurer, the amount that may be reinsured or retroceded to one reinsurer (whether to a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, a professional reinsurer, another microinsurer or another direct insurer in South Africa) is no more than 75% of the total premiums it has underwritten.

Note that the above limit is set according to 'total premium' of the insurer. Hence the licensed entity must assess its exposure to each entity across all its reinsurance arrangements.

- Where the counterparty is within the same group, the above limit increases to no more than 85%.
- Reinsurance contracts relating to international insurance programs are excluded from the limitations.

Reinsuring linked investment business

- Insurers writing linked business will be permitted to enter into reinsurance arrangements.

Governance, Financial Soundness and Reporting

This section relates to governance, financial soundness and reporting in respect of Lloyd's of London and licensed branches of foreign reinsurers.

Governance

- A representative office must be established that has appropriate risk management, governance and internal control systems.
- An external auditor within South Africa must be appointed.

Financial Soundness

- Security, held in trust in South Africa, must be provided by a branch of a foreign reinsurer and Lloyd's (on behalf of each Lloyd's underwriter) in respect of the insurance business conducted in South Africa and business/risks originating from South Africa. The security may not be accessed without prior approval from the PA.

The trust must abide with trust law and have duly appointed trustees who are deemed fit and proper. The trust deed must comply with prescribed requirements and be approved by the PA.

- A branch of a foreign reinsurer and Lloyd's must at all times maintain its business in a financially sound condition, by providing security to a trust that is at least equal to the technical provisions for the insurance business conducted in South Africa.

Reporting

- Reporting will be the same as for locally-incorporated licensed insurers, including statutory returns and audited financial statements in respect of business conducted in South Africa.

This section implies that requirements similar to those in BN 158 will apply to Lloyd's underwriters (conducting business on behalf of Lloyd's of London) and licensed branches of a foreign reinsurer, but with a number of important exclusions.

Treatment of Reinsurance for Solvency Assessment of Direct Insurers

Since the Position Paper refers only to 'Direct Insurers' we cannot confirm whether the same requirements apply to all licensed entities within South Africa. These issues need to be clarified going forward.

Approved versus non-approved reinsurers

- The concept of "approved" and "non-approved" reinsurance will not be carried through to the Insurance Bill or any Prudential Standards that may be made under the Insurance Bill.

While the concept of 'approved' and 'non-approved' reinsurance will fall away, the new regulations will not be too dissimilar. Additionally, note the introduction of a formal trust for Lloyd's and licensed branches of foreign reinsurers, which may be more complex to set up.

Impact of credit ratings in the solvency calculation for direct insurers

- **Locally registered professional reinsurers**
  - Will be assumed to have an upgrade in their credit quality step to the extent that the sovereign cap in place has resulted in a downgrade.

The sovereign cap refers to the credit rating of South Africa's government debt. (Currently rated BBB- by S&P)

  - The parent's credit quality step may be used if a parental guarantee is in place, or if a novation agreement is in place, subject to approval from the PA.
  - Where the parent's credit quality step is used, the upgrade removing the sovereign cap will not be applicable.
- **Local direct insurers**
  - Will be assumed to have an upgrade in their credit quality step to the extent that the sovereign cap in place has resulted in a downgrade.
- **Branches of foreign reinsurers**
  - The credit quality step of the foreign reinsurer may be used.

Treatment of Reinsurance for Solvency Assessment of Direct Insurers

Continued

- **Cross-border supply of reinsurance**
  - In jurisdictions with regulatory frameworks equivalent to that of South Africa, the credit quality step of the foreign reinsurer may be used.

The process of demonstrating equivalence is not clear as the FSB has not yet released guidance on the matter.

- If the foreign reinsurer is located in a jurisdiction with regulatory frameworks not equivalent to that of South Africa, then such reinsurance may not be taken into account in the financial soundness calculations.

This can become material where direct insurers and professional reinsurers cede risks into, say, Africa. SII allows for reinsurance placed in a non-equivalent jurisdiction to be collateralised. This Position Paper does however not make any reference to collateralisation.

- **Lloyd's of London**
  - The credit quality step of Lloyd's may be used

Reinsurance Contracts

Supervisory framework

- To ensure that operational and legal risks are appropriately managed, reinsurance programmes will be subject to more intrusive supervision, specifically in respect of the legal certainty, effectiveness and enforceability of such contracts.

This may lead to an increase in cost of compliance.

Regulatory framework

- Principles and requirements will be provided to ensure that reinsurance arrangements are appropriate and in the interests of reinsurers, insurers and ultimately policyholders.

Tax Treatment of Reinsurance Arrangements and Reinsurers & IFRS

Given the different governance and risk management frameworks that will be required of the branches of foreign reinsurers, the tax residency of the branches is expected to be South Africa.

Financial accounts need to be prepared in accordance with IFRS and filed together with a South African tax return.

Transparency and Accessibility of Information

The PA will enhance transparency in respect of both inwards and outwards reinsurance by insurers and reinsurers.

A positive obligation will be placed on insurers and reinsurers to:

It is not clear to what extent the regulator expects parties to verify the accuracy of commercially available models. The practical implications may be significant.

- Verify the accuracy of external models and data sourced from third parties.
- Make sufficient information available to reinsurers in respect of risks reinsured.

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