Solvency Assessment and Management - Reinsurance Regulatory Framework Review

June 2013
Reliances and limitations on the use of this report

This report is protected under the copyright laws of South Africa and other countries as an unpublished work. This report contains information that is proprietary and confidential to PricewaterhouseCoopers Incorporated, which shall not be disclosed outside the recipient’s company or duplicated, used or disclosed in whole or in part by the recipient for any purpose other than to evaluate this report and for research. Any other use or disclosure in whole or in part of this information, without the express written permission of PricewaterhouseCoopers Incorporated is prohibited.

Specific reliances and limitations

We have relied on the representations made by the survey respondents. These results include any amendments made to the information provided to us by either of the above parties.

Distribution of our work and reference to our work

Onwards distribution of this report by the Financial Services Board (FSB) to any third parties requires our prior written consent. No reference to our work to other third parties is permitted without our prior written consent.

PwC’s responsibilities

Our responsibilities and liabilities are limited to Financial Services Board and exist only in the context of its use of our report for the purpose set out in our Statement of Work. We will not accept any liability or responsibility in relation to the use of our report by the Financial Services Board for any other purpose. We will not accept any liability or responsibility to the Financial Services Board or any other third party recipients of our reports under any circumstances whether or not we have consented to our report being copied to them.

Context

This report must be read in its entirety. Individual sections of this report could be misleading if considered in isolation from each other. We have performed the work assigned and have prepared this report in conformity with its intended utilisation by a person(s) technically competent in the areas addressed. Members of PwC staff are available to explain and/or amplify any matter resented herein, and it is assumed that the user of this report will seek such explanation and/or amplification about any matter in question.
# Contents

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
</tr>
<tr>
<td>3</td>
</tr>
<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
</tbody>
</table>

## 1 Introduction

1.1 Background to the investigation .......................... 5
1.2 Objectives .................................................. 6
1.3 Terms of Reference ......................................... 7
1.4 Plan of development ......................................... 7

## 2 Research Methodology ............................................. 8

2.1 Investigation methodology .................................. 8
2.2 Literature review of key reinsurance regulations, themes and trends ................. 8
2.3 International survey methodology .......................... 9
2.4 South African survey methodology ........................... 9
2.5 Specific South African survey methodology issues affecting direct insurers ........... 10
2.6 Specific South African survey methodology issues affecting reinsurers ................. 10
2.7 Specific South African survey methodology issues affecting reinsurance brokers .......... 10
2.8 Approach to incorporate Public Policy considerations and goals ......................... 11
2.9 Additional information gained from experts and issued reports .......................... 11

## 3 Key characteristics of the current South African reinsurance regulatory framework ............. 12

3.1 Registration and authorisation of reinsurers .................. 12
3.2 Approved versus non-approved reinsurance ........................ 13
3.3 Subsidiaries versus branch structures ........................... 15

## 4 Literature review and key reinsurance trends and themes ........................................ 22

4.1 Purpose ....................................................... 22
4.2 Mutual recognition ............................................ 22
4.3 Approved versus non-approved reinsurance ........................... 25
4.4 Branches versus subsidiaries ................................ 27

## 5 International Reinsurance Survey Findings ..................................... 35

5.1 Regulatory framework and international best practice ........................................ 36
5.2 Trends and issues ............................................ 48
5.3 Reinsurers’ strategies and challenges ................................ 49
5.4 Insurers' reinsurance needs .................................... 53
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.5 Factors driving reinsurance brokers’ placements</td>
<td>53</td>
</tr>
<tr>
<td>6 South African reinsurance from insurers’ perspectives</td>
<td>54</td>
</tr>
<tr>
<td>6.1 Insurers’ strategies and challenges with regard to reinsurance</td>
<td>55</td>
</tr>
<tr>
<td>6.2 Regulatory framework, current short-comings and desired change</td>
<td>60</td>
</tr>
<tr>
<td>6.3 Key factors influencing reinsurance decisions</td>
<td>74</td>
</tr>
<tr>
<td>6.4 Intermediated versus non-intermediated reinsurers placements</td>
<td>80</td>
</tr>
<tr>
<td>6.5 Costs and value of reinsurance brokers to insurers</td>
<td>81</td>
</tr>
<tr>
<td>6.6 Risk transfer and financial reinsurance</td>
<td>82</td>
</tr>
<tr>
<td>6.7 Trends and issues</td>
<td>89</td>
</tr>
<tr>
<td>7 South African reinsurance from reinsurers’ perspectives</td>
<td>97</td>
</tr>
<tr>
<td>7.1 Reinsurers’ strategies and challenges</td>
<td>97</td>
</tr>
<tr>
<td>7.2 Regulatory framework, current short-comings and desired change</td>
<td>101</td>
</tr>
<tr>
<td>7.3 Key factors influencing reinsurance decisions</td>
<td>105</td>
</tr>
<tr>
<td>7.4 Considerations of group structure, parent supervision and involvement and retrocession</td>
<td>107</td>
</tr>
<tr>
<td>7.5 Risk transfer and financial reinsurance</td>
<td>108</td>
</tr>
<tr>
<td>7.6 Factors driving reinsurance brokers’ placements</td>
<td>110</td>
</tr>
<tr>
<td>7.7 Costs and value of reinsurance brokers to reinsurers</td>
<td>111</td>
</tr>
<tr>
<td>7.8 Trends and issues</td>
<td>112</td>
</tr>
<tr>
<td>8 South African reinsurance from reinsurance brokers’ perspectives</td>
<td>117</td>
</tr>
<tr>
<td>8.1 Reinsurance broker strategies and challenges</td>
<td>117</td>
</tr>
<tr>
<td>8.2 Regulatory framework, current short-comings and desired change</td>
<td>120</td>
</tr>
<tr>
<td>8.3 Key factors influencing reinsurance placement</td>
<td>121</td>
</tr>
<tr>
<td>8.4 Factors driving reinsurance brokers’ placements</td>
<td>122</td>
</tr>
<tr>
<td>8.5 Costs and value of reinsurance brokers to insurers, reinsurers and the insurance industry as a whole</td>
<td>123</td>
</tr>
<tr>
<td>8.6 Trends and issues</td>
<td>124</td>
</tr>
<tr>
<td>9 Analysis of reinsurance regulations and policy issues</td>
<td>127</td>
</tr>
<tr>
<td>9.1 Registration and authorisation of reinsurers</td>
<td>127</td>
</tr>
<tr>
<td>9.2 Mutual recognition agreements</td>
<td>129</td>
</tr>
<tr>
<td>9.3 Approved versus non-approved reinsurance</td>
<td>130</td>
</tr>
<tr>
<td>9.4 Subsidiaries versus branch structures</td>
<td>133</td>
</tr>
<tr>
<td>9.5 Operation of foreign versus local reinsurers</td>
<td>135</td>
</tr>
<tr>
<td>9.6 Capital requirements for reinsurers and capital relief for cedants</td>
<td>139</td>
</tr>
<tr>
<td>9.7 Alternative forms of protection for local insurers</td>
<td>139</td>
</tr>
<tr>
<td>9.8 Financial Reinsurance</td>
<td>140</td>
</tr>
<tr>
<td>10 IFRS 4 Phase 2 (and related) developments in accounting standards</td>
<td>143</td>
</tr>
<tr>
<td>11 Tax implications</td>
<td>145</td>
</tr>
<tr>
<td>12 Conclusions</td>
<td>148</td>
</tr>
</tbody>
</table>
12.1 Results of key review items .................................................................................................................. 149
12.2 End-state regulatory regime for reinsurers ........................................................................................ 154

13 Reference List .......................................................................................................................................... 159

14 Appendices .............................................................................................................................................. 161
14.1 Appendix A – South African Market Trends and Issues ........................................................................ 161
1 Introduction

1.1 Background to the investigation

The development of the Solvency Assessment and Management (SAM) regulatory regime in the South African insurance industry has led to a review of the conduct of reinsurance business in South Africa. The Financial Services Board (FSB) has initiated a project to review the regulatory framework for the conducting of reinsurance business in South Africa.

The FSB has established various SAM project structures including a steering committee, sub-committees corresponding to each of the three pillars of SAM and task groups mandated to produce recommendations, based on Solvency 2, on each of the major elements of the proposed regime. The proposals must be adapted where necessary to South African conditions, whilst ensuring that the SAM regime meets the test of third country equivalence under Solvency 2 and that it is in line with evolving International Association of Insurance Supervisors (IAIS) principles, standards and guidance.

An investigation into the current regulatory regime for reinsurers was required to address specific areas of potential regulatory change (outlined in Section 1.3 below) and to develop a holistic view of an approach to regulation of the South African reinsurance industry. This investigation included the following phases:

- Phase 1: International Scan
  
  A review of reinsurance regulatory regimes in other countries.

- Phase 2: Local Scan
  
  A review of the local reinsurance regulatory regime. This included engaging with industry on:
  
  - Current reinsurance regulation
  - Potential changes to reinsurance regulation
  - Current market dynamics
  - Strategic developments in the industry

- Phase 3: Public Policy Assessment
  
  Interaction with National Treasury and the South African Reserve Bank to test the impact and alignment to national strategy of potential changes.
The final objective of this review was the production of this research paper detailing the results of our investigation.

1.2 Objectives

The purpose of this investigation was to:

- Allow the FSB to test possible changes to the reinsurance regulatory regime (as detailed in the terms of reference section below)
- Understand the appropriateness of SAM for reinsurers
- Ensure a broad understanding of reinsurance market dynamics and reinsurer operations when making regulatory changes.

Both locally registered and offshore reinsurers were considered, as well as brokers and purchasers of reinsurance.

The end-goal of these investigations is the formulation of new regulation that may be specific to companies operating as reinsurers locally, whether as a locally registered entity or as a representative office, and for offshore reinsurance. The recommendations contained in this report take into account a variety of sometimes conflicting perspectives. The goals of development of the local reinsurance industry as a hub for the selling of reinsurance business into Africa, the maintenance and improvement of the current skill levels of the South African reinsurance (and insurance) industry and the enhancement of the regulatory efficiency of the South African framework were at the forefront of any decisions made.

The FSB also wanted to gauge the sentiment of the market toward current reinsurance regulations and to the purchasing and allowance for reinsurance. Within this objective is an intention to discover the impact that structures such as approved versus non-approved reinsurance, reinsurance subsidiary requirements and the legacy of composite reinsurers has had on the market for reinsurance in South Africa.

The intention is also to ensure that any regulatory changes do not have unintended or harmful second-order effects, and the breadth of this report was extended to beyond the domain of reinsurers only. The potential effects on direct writers were important considerations for the FSB, and led to their inclusion in the construction of this report. The impacts on South African tax revenue and skills development were also a consideration when analysing the responses given by the industry.
### 1.3 Terms of Reference

The terms of reference issued by the FSB provide the scope for this investigation and include:

- Whether to allow foreign reinsurers to operate on a branch basis in South Africa in future, and if so, under what circumstances (including local regulatory capital requirements)
- Whether to allow reinsurers to continue to operate on the basis of a composite reinsurer in the future
- Whether to continue with the concept of “approved” and “non-approved” reinsurance as currently defined in the Long and Short-term Insurance Acts or whether an alternative basis should be adopted to protect the financial position of local insurers from non-performance by reinsurers, specifically reinsurers operating outside the Republic, taking into account the different standards of supervision that non-resident reinsurers may be subject to in their home jurisdictions.

Allied to these were a number of secondary concerns that are highlighted within the investigation. These are:

- The recognition of the impact of non-proportional reinsurance
- On-going developments in IFRS reporting requirements and their potential impact on the activities of reinsurers
- The tax implications of reinsurance contracts (reinsurance contracts as a whole and off-shore reinsurance in particular)

### 1.4 Plan of development

**Project development**

In order to develop informed views of the regulatory issues stated in the terms of reference, PwC was required to research international and local reinsurance markets to understand the various impacts of potential changes. The FSB review will further develop from the publication of this report into a set of recommendations for the modification of the local regulatory framework. This will have allowed for the input from FSB stakeholders, National Treasury and the local insurance industry.

**Legislative development**

The output of this report will form an input into a recommendation to be developed by the FSB. This recommendation will be set out in a discussion document and will be subject to public comment. The discussion document and comments on the discussion document will be used in the legislative drafting process which is in place for the development of the new Insurance Act which will give effect to the SAM framework. Such legislative drafting will be subject to the usual National Treasury and parliamentary processes.
# 2 Research Methodology

## 2.1 Investigation methodology

This section provides further detail on each of the stages of this review. The structure of the research process necessitated a number of steps before the requisite knowledge and information had been gathered. This allowed for the following stages of the investigation to be considered:

- Desktop research of current trends in reinsurance regulation, and the development of a brief literature review on this topic.

- Overview of international regulatory framework using the PwC network of experts and an international survey, where the international regulatory structure (and its development) in a number of important countries in the global reinsurance market was considered.

- A local survey developed in consultation with the FSB and SAIA that was distributed to all reinsurers, reinsurance brokers and insurers. This aimed to allow all organisations who would be directly affected by changes to the composition of reinsurance regulation the opportunity to give their views and assist policy development. The responses to these questionnaires were consolidated and analysed to understand the views given by the various respondents.

- Interviews with all the reinsurers operating in South Africa and a selection of reinsurance brokers, life insurers and non-life insurers.

- Consultation with the FSB and National Treasury in order to assess the potential impacts of changes to reinsurance regulation on Public Policy objectives.

## 2.2 Literature review of key reinsurance regulations, themes and trends

The methodology for identification of appropriate literature was:

- Desktop research
- Finding publications provided by international and local reinsurers
- Finding academic publications listed on academic databases
- Asking reinsurers if they are aware of additional relevant literature
The information was summarised in Section 4 below and provides an introduction into the considerations and conclusions drawn on reinsurance regulatory change in other parts of the world.

### 2.3 International survey methodology

The international scan leveraged off of the PwC international network of firms. The intention was to understand the structure of reinsurance operations and regulation in other countries, regional differences that may exist between the major reinsurance markets and where there were any commonalities.

The survey was sent to various PwC offices with the instruction to complete the survey with the deepest level of detail possible. The issue that was found with the structure of this survey was that the answers were given on a country-wide level, which did not allow for company-level detail. This gave a general perspective that was potentially not representative of all the companies involved in these insurance markets, and may have led to some distortions.

### 2.4 South African survey methodology

The methodology adopted in the local scan was the development of a comprehensive survey applicable to all sectors of the reinsurance market. The topics considered within the survey were intentionally broad to obtain a surplus of information, rather than a limited scope of responses.

The individual questions were allocated to a specific type of respondent to ensure that the questions asked remained applicable to respondents. Inevitably within different categories of respondents, say within life insurers, some respondents were better placed to answer certain questions than others.

The survey was divided into sections aimed at focussing the thinking of the respondents around each theme. In some cases, it was intended for the questions within specific sections to develop into one another. There may have been repetition within the questions asked overall however the completeness of the survey was enhanced through this structure.

The development of the survey involved input and review by PwC, the FSB and the SAIA.

Analysis of the survey results was done by consolidating all responses question by question, and understanding which issues that were raised were the most significant. PwC was able to identify the key response themes that were produced and to highlight the most important points raised by the respondents. The consolidation was both qualitative and quantitative, and allowed PwC to develop an in-depth understanding of the functioning of certain aspects of the local reinsurance market.
As a follow-up to the questionnaire, industry participants were selected for face-to-face interviews in order to delve deeper into the main areas of potential change. All reinsurers in the market were interviewed. Life and non-life insurers as well as reinsurance brokers were selected on a sample basis.

Different respondents (i.e. reinsurers, brokers or insurers) exhibited different vested interests in the development of reinsurance regulation. As a result, potential bias must be considered when analysing the answers given; this does however provide insight into the potential impacts on different parties.

### 2.5 Specific South African survey methodology issues affecting direct insurers

The main issue resulting from the methodology employed was the difficulty in consolidating the more than one hundred questionnaires, and in producing concise analyses of all the answers.

Certain questions or topics required higher levels of technical expertise from the respondents than others. This meant that some respondents did not have the expertise required to offer sufficiently detailed replies. Examples of where these technical deficiencies sometimes applied were in the questions requiring detailed knowledge of SAM and the intricacies of the local (and international) reinsurance markets. This led to some of the smaller insurers being unable to complete the questionnaire with sufficient detail.

### 2.6 Specific South African survey methodology issues affecting reinsurers

The answers provided by the reinsurers contained the most detail of all the respondents, as was expected given that the results of this investigation may have the most significant impact on their business. A difficulty encountered was the diversity of views of the reinsurers, depending on their current operational structure, and their planned structure given the possible changes to regulations. The answers given reflected the company-specific views on the operation of the local reinsurance market and in some cases have led to there being significant diversity in responses.

### 2.7 Specific South African survey methodology issues affecting reinsurance brokers

The brokers were able to give a different perspective of the reinsurance market from their position as an intermediary rather than seller or buyer of reinsurance. Their often international nature also meant that they were able to give insights on what had been seen elsewhere in the world with regard to regulatory changes and development. It was apparent that there was some bias in the answers given, depending on the respondent’s
position in and opinion of the market. However this is expected, and was taken into consideration when drawing conclusions from the responses.

### 2.8 Approach to incorporate Public Policy considerations and goals

The goals of National Treasury will be considered when developing the proposals that will emanate from this report. Consultation with Treasury will occur via workshops and discussions stemming from this report and during the legislative drafting process.

Further feedback on alignment with national strategy will be provided during the next stages of the FSB’s review.

### 2.9 Additional information gained from experts and issued reports

There was additional input offered by a variety of parties, such as the South African Insurance Association (SAIA), the FSB, National Treasury, PwC local and international experts and the local insurance industry. Through this process PwC was able to include the perspectives of those entities closest to the South African reinsurance market.
3 Key characteristics of the current South African reinsurance regulatory framework & market

This section aims to provide a brief outline of the current regulatory environment for reinsurance including changes envisaged under SAM (where formal recommendations have been proposed).

3.1 Registration and authorisation of reinsurers

The current regulatory environment for registration and authorisation of reinsurers is provided below. Note that the registration of a reinsurer refers to the process of obtaining a reinsurance licence.

Registration

Existing requirements

Currently reinsurers operate as either “long term”, “short term” or “composite” reinsurers. New entrants to the South African reinsurance market may register as a long term insurer, a short term insurer or as both a long term and short term insurer and will have to comply with the Long Term and Short Term Insurance Acts. These acts specify which sections are relevant to reinsurers. The FSB has confirmed that, for reinsurers only, companies would be allowed to operate as a composite i.e. one legal entity holding both short-term and long-term licences.

Composite reinsurers in South Africa have to comply with both the Long Term and Short Term insurance acts which includes submitting separate regulatory returns (LT and ST) for the applicable classes of business. At present, some reinsurers hold long term and short term licences in separate legal entities as opposed to via a composite entity.

SAM requirements

Insurance licences are expected to be referred to as “life” and “non-life” licences under SAM, and reinsurers are expected to be licenced under the same overall legislation as insurers.

Composite reinsurers could be treated as a ‘solo’ or ‘group’ entity under SAM. The treatment of composite reinsurers causes additional complexity under SAM with regard to capital requirements and group reporting and supervision. As a result, the SAM licensing arrangements for reinsurers have not yet been finalised.

The potential licensing issues under SAM are discussed in further detail in Section 9 below.
Authorisation

Reinsurers are required to be authorised to write different classes of business within each insurance licence.

SAM requirements

Authorisation requirements for life and non-life insurers under current SAM proposals are shown in the tables below.

The below information has been extracted from the SAM discussion document titled “Solvency Assessment and Management: Pillar I - Sub Committee - Technical Provisions Task Group - Discussion Document 29 (v 4) - Authorisation classes of business under SAM”.

<table>
<thead>
<tr>
<th>Life Insurance - Class of Business</th>
<th>Non-Life Insurance - Class of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life insurance</td>
<td>Accident</td>
</tr>
<tr>
<td>Investment related insurance</td>
<td>Sickness</td>
</tr>
<tr>
<td>Disability and health insurance</td>
<td>Land vehicles</td>
</tr>
<tr>
<td></td>
<td>a. Personal lines</td>
</tr>
<tr>
<td></td>
<td>b. Commercial lines</td>
</tr>
<tr>
<td></td>
<td>Other than railway rolling stock</td>
</tr>
<tr>
<td>Capital redemption operations</td>
<td>Railway rolling stock</td>
</tr>
<tr>
<td>Management of group funds</td>
<td>Aircraft</td>
</tr>
<tr>
<td>-</td>
<td>Ships</td>
</tr>
<tr>
<td>Sea, lake and river and canal vessels</td>
<td></td>
</tr>
<tr>
<td>-</td>
<td>Goods in transit</td>
</tr>
<tr>
<td>Including merchandise, baggage, and all other goods</td>
<td></td>
</tr>
<tr>
<td>-</td>
<td>Property</td>
</tr>
<tr>
<td>a. Personal lines</td>
<td></td>
</tr>
<tr>
<td>b. Commercial lines</td>
<td></td>
</tr>
<tr>
<td>Other damage to property</td>
<td></td>
</tr>
</tbody>
</table>

The potential authorisation issues for reinsurers are discussed in further detail in Section 9 below.

3.2 Approved versus non-approved reinsurance

The FSB regulates the transfer of risk via reinsurance to other countries using approved reinsurance requirements.
If a reinsurance arrangement is approved by the registrar, the cedant may reduce their statutory liabilities (and consequently their capital requirements) by appropriately allowing for the risk transfer provided by the reinsurance arrangement.

Local reinsurers

Most reinsurers based in South Africa are subsidiaries of foreign reinsurers and are capitalised locally or are South African insurers/reinsurers also capitalised locally. Reinsurance arrangements with locally registered subsidiaries gain approved status.

Lloyd’s underwriters operate on a cross-border basis from London, or onshore with a local representative office provided by agency/binder agreements with South African entities (as per Part VII Short Term Insurance Act, 1998). Reinsurance arrangements with Lloyd’s gain approved status as Lloyd’s maintains assets in South Africa (effectively collateralise) via the Lloyd’s South African Trust Fund in accordance with Section 60 of the Short Term Insurance Act of 1998.

Offshore/cross-border reinsurers

Branches of foreign reinsurers are currently not allowed to operate in South Africa i.e. setting up of operations and canvassing for business in South Africa is not allowed. However, reinsurance directly (by insurers and reinsurers) with offshore reinsurers (‘cross-border reinsurance’) is allowed.

For cross-border reinsurance to be approved, the foreign reinsurer must post collateral in the form of deposits with the cedant or an irrevocable guarantee or letter of credit with a South African bank.

The supervisory requirement for collateral as per Board Notice 169 of 2011 is that the collateral held must be at least equal to the relief taken on technical provisions.

If the cross-border reinsurance arrangement is not collateralised, and hence not approved by the FSB, the cedant will not be allowed to reduce statutory liabilities with regard to the unapproved reinsurance arrangement.

In addition, the approval process for cross-border reinsurance varies by type of insurance as follows:

- Cross-border reinsurance arrangements for long term insurers require a separate application for approval (by the registrar) for each arrangement.
- Cross-border reinsurance arrangements for short term insurers are allowed (without separate approval) provided collateral is posted in line with Board Notice 169 of 2011.
- Mortality and morbidity risk transfer do not require exchange control approval.
- Investment risk transfer requires exchange control approval.
3.3 Subsidiaries versus branch structures

Reinsurers wishing to set up operations in South Africa are required to register a South African subsidiary and must meet local insurance legislative requirements including local capitalisation.

A branch reinsurer is not set up as a locally registered subsidiary and may have different capital and governance requirements to a direct subsidiary. A branch does not have a legal personality which is unique to that of the parent reinsurer. As stated above, branches of foreign reinsurers are currently not allowed to operate in South Africa.

Cross-border reinsurance is allowed on the basis that the arrangement is concluded with a foreign legal entity.

The IAIS has provided the following definitions of types of insurer cross-border activities (IAIS, 2013):

(i) Subsidiaries - legal entities which are wholly or majority owned or controlled by another legal entity, such as an insurer or insurance holding company
(ii) Branches - operating entities which are not legal entities separate from an insurer but part of the insurer in terms of its organisation
(iii) Joint ventures - legal entities jointly established by two or more parent institutions, at least one of which is incorporated in a different jurisdiction, and not all of which are necessarily insurers
(iv) Cross-border provision of services - in some jurisdictions insurers also provide services on a cross-border basis without establishing a subsidiary, branch or joint venture.

The references to subsidiary and branch reinsurers throughout this paper are consistent with the above IAIS definitions for subsidiaries and branches.
### 3.4 Reinsurance market statistics

Reinsurer statistics as at the end of the 2011 calendar year have been extracted and provided below. These statistics are provided for reference purposes whilst using this report. Further details on the life and non-life insurance and reinsurance markets can be obtained from the FSB’s industry reports on the LT and ST regulatory returns.

#### Life reinsurance

<table>
<thead>
<tr>
<th>Individual ranking of life reinsurers</th>
<th>Total net premiums (R'000)</th>
<th>% of total</th>
<th>Total assets (R'000)</th>
<th>% total</th>
<th>Total liabilities (R'000)</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>GenRe</td>
<td>1,541,750</td>
<td>26.1%</td>
<td>2,782,037</td>
<td>23.5%</td>
<td>2,328,701</td>
<td>23.1%</td>
</tr>
<tr>
<td>Hannover Life Re</td>
<td>1,273,600</td>
<td>21.5%</td>
<td>2,387,055</td>
<td>20.2%</td>
<td>2,022,932</td>
<td>20.1%</td>
</tr>
<tr>
<td>Munich Re</td>
<td>1,637,268</td>
<td>27.7%</td>
<td>2,184,512</td>
<td>18.5%</td>
<td>1,734,410</td>
<td>17.2%</td>
</tr>
<tr>
<td>RGA</td>
<td>318,683</td>
<td>5.4%</td>
<td>1,352,568</td>
<td>11.4%</td>
<td>1,300,797</td>
<td>12.9%</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>12,995</td>
<td>0.2%</td>
<td>43,624</td>
<td>0.4%</td>
<td>29,660</td>
<td>0.3%</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>22,463</td>
<td>0.4%</td>
<td>45,941</td>
<td>0.4%</td>
<td>19,237</td>
<td>0.2%</td>
</tr>
<tr>
<td>Swiss Re</td>
<td>1,104,769</td>
<td>18.7%</td>
<td>3,042,604</td>
<td>25.7%</td>
<td>2,629,798</td>
<td>26.1%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5,911,528</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>11,838,341</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>10,065,535</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Individual market share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net premiums received and outstanding (%)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>GenRe</td>
</tr>
<tr>
<td>Hannover Life Re</td>
</tr>
<tr>
<td>Munich Re</td>
</tr>
<tr>
<td>RGA</td>
</tr>
<tr>
<td>Saxum Re</td>
</tr>
<tr>
<td>SCOR Africa</td>
</tr>
<tr>
<td>Swiss Re</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>
### Net premiums received and outstanding (in RSA)

<table>
<thead>
<tr>
<th>(R’000)</th>
<th>Assistance business</th>
<th>Disability business</th>
<th>Fund business</th>
<th>Health business</th>
<th>Life business</th>
<th>Sinking fund business</th>
<th>Total net premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td>GenRe</td>
<td>-</td>
<td>464,211</td>
<td>5,573</td>
<td>164,541</td>
<td>845,298</td>
<td>-</td>
<td>1,479,623</td>
</tr>
<tr>
<td>Hannover Life Re</td>
<td>11,953</td>
<td>206,052</td>
<td>-</td>
<td>142,499</td>
<td>819,795</td>
<td>876</td>
<td>1,181,175</td>
</tr>
<tr>
<td>Munich Re</td>
<td>61,942</td>
<td>221,815</td>
<td>242,549</td>
<td>-1,245</td>
<td>1,073,633</td>
<td>-</td>
<td>1,598,694</td>
</tr>
<tr>
<td>RGA</td>
<td>11,153</td>
<td>26,021</td>
<td>13,472</td>
<td>21,798</td>
<td>243,078</td>
<td>-</td>
<td>315,522</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>-</td>
<td>1,312</td>
<td>109</td>
<td>-</td>
<td>10,800</td>
<td>-</td>
<td>12,221</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>-</td>
<td>99</td>
<td>-</td>
<td>-</td>
<td>22,364</td>
<td>-</td>
<td>22,463</td>
</tr>
<tr>
<td>Swiss Re</td>
<td>-</td>
<td>361,483</td>
<td>-</td>
<td>93,047</td>
<td>582,056</td>
<td>-</td>
<td>1,036,586</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>85,048</strong></td>
<td><strong>1,280,993</strong></td>
<td><strong>261,703</strong></td>
<td><strong>420,640</strong></td>
<td><strong>3,597,024</strong></td>
<td><strong>876</strong></td>
<td><strong>5,646,284</strong></td>
</tr>
</tbody>
</table>

### Net premiums received and outstanding (R’000)

#### Individual

<table>
<thead>
<tr>
<th></th>
<th>Recurring business</th>
<th>Non-recurring business</th>
<th>All business</th>
<th>Total premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>GenRe</td>
<td>1,102,381</td>
<td>-</td>
<td>439,369</td>
<td>1,541,750</td>
</tr>
<tr>
<td>Hannover Life Re</td>
<td>1,192,619</td>
<td>5,787</td>
<td>75,194</td>
<td>1,273,600</td>
</tr>
<tr>
<td>Munich Re</td>
<td>625,071</td>
<td>-</td>
<td>1,012,197</td>
<td>1,637,268</td>
</tr>
<tr>
<td>RGA</td>
<td>309,954</td>
<td>-</td>
<td>8,729</td>
<td>318,683</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>12,886</td>
<td>-</td>
<td>109</td>
<td>12,995</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>22,463</td>
<td>-</td>
<td>-</td>
<td>22,463</td>
</tr>
<tr>
<td>Swiss Re</td>
<td>768,271</td>
<td>-</td>
<td>336,498</td>
<td>1,104,769</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,033,645</strong></td>
<td><strong>5,787</strong></td>
<td><strong>1,872,096</strong></td>
<td><strong>5,911,528</strong></td>
</tr>
</tbody>
</table>

### Summary of statutory valuation method of assets and liabilities

<table>
<thead>
<tr>
<th></th>
<th>Total assets</th>
<th>Total liabilities</th>
<th>Excess assets</th>
<th>CAR</th>
<th>Free assets</th>
<th>CAR Cover</th>
</tr>
</thead>
<tbody>
<tr>
<td>GenRe</td>
<td>2,782,037</td>
<td>2,328,701</td>
<td>453,336</td>
<td>142,620</td>
<td>310,716</td>
<td>3.18</td>
</tr>
<tr>
<td>Hannover Life Re</td>
<td>2,387,055</td>
<td>2,022,932</td>
<td>364,123</td>
<td>137,185</td>
<td>226,938</td>
<td>2.65</td>
</tr>
<tr>
<td>Munich Re</td>
<td>2,184,512</td>
<td>1,734,410</td>
<td>450,102</td>
<td>124,769</td>
<td>325,333</td>
<td>3.61</td>
</tr>
<tr>
<td>RGA</td>
<td>1,352,568</td>
<td>1,300,797</td>
<td>51,771</td>
<td>24,980</td>
<td>26,791</td>
<td>2.07</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>43,624</td>
<td>29,660</td>
<td>13,964</td>
<td>10,000</td>
<td>3,964</td>
<td>1.40</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>45,941</td>
<td>19,237</td>
<td>26,704</td>
<td>10,000</td>
<td>16,704</td>
<td>2.67</td>
</tr>
<tr>
<td>Swiss Re</td>
<td>3,042,604</td>
<td>2,629,798</td>
<td>412,806</td>
<td>133,909</td>
<td>278,897</td>
<td>3.08</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>11,838,341</strong></td>
<td><strong>10,065,535</strong></td>
<td><strong>1,772,806</strong></td>
<td><strong>583,463</strong></td>
<td><strong>1,189,343</strong></td>
<td><strong>3.04</strong></td>
</tr>
</tbody>
</table>
### Non-life reinsurance

#### Percentage share of gross premiums written in the segment

<table>
<thead>
<tr>
<th></th>
<th>Property</th>
<th>Transportation</th>
<th>Motor</th>
<th>Accident And Health</th>
<th>Guarantee</th>
<th>Liability</th>
<th>Engineering</th>
<th>Misc</th>
<th>Total gross premium written (R'000)</th>
<th>Market share of premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Africa Re</strong></td>
<td>20%</td>
<td>32%</td>
<td>42%</td>
<td>30%</td>
<td>11%</td>
<td>24%</td>
<td>20%</td>
<td>3%</td>
<td>1,761,394</td>
<td>25.0%</td>
</tr>
<tr>
<td><strong>Flagstone Re</strong></td>
<td>4%</td>
<td>6%</td>
<td>4%</td>
<td>10%</td>
<td>5%</td>
<td>0%</td>
<td>9%</td>
<td>0%</td>
<td>261,827</td>
<td>3.7%</td>
</tr>
<tr>
<td><strong>Gen Re</strong></td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>32,291</td>
<td>0.5%</td>
</tr>
<tr>
<td><strong>Hannover Re</strong></td>
<td>35%</td>
<td>24%</td>
<td>32%</td>
<td>13%</td>
<td>30%</td>
<td>26%</td>
<td>17%</td>
<td>5%</td>
<td>2,098,174</td>
<td>29.8%</td>
</tr>
<tr>
<td><strong>Munich Re</strong></td>
<td>31%</td>
<td>36%</td>
<td>20%</td>
<td>32%</td>
<td>35%</td>
<td>49%</td>
<td>47%</td>
<td>85%</td>
<td>2,367,119</td>
<td>33.6%</td>
</tr>
<tr>
<td><strong>Saxum Re</strong></td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>6</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>SCOR Africa</strong></td>
<td>10%</td>
<td>2%</td>
<td>2%</td>
<td>15%</td>
<td>20%</td>
<td>1%</td>
<td>8%</td>
<td>8%</td>
<td>528,404</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

#### Review of overall business

<table>
<thead>
<tr>
<th></th>
<th>Assets less liabilities</th>
<th>Investment income</th>
<th>Gross premiums written</th>
<th>Gross underwriting profit</th>
<th>Net premiums written</th>
<th>Net underwriting profit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Africa Re</strong></td>
<td>278,852</td>
<td>74,663</td>
<td>1,761,394</td>
<td>152,436</td>
<td>509,692</td>
<td>14,672</td>
</tr>
<tr>
<td><strong>Flagstone Re</strong></td>
<td>84,685</td>
<td>21,477</td>
<td>261,827</td>
<td>11,383</td>
<td>17,829</td>
<td>-174,913</td>
</tr>
<tr>
<td><strong>Gen Re</strong></td>
<td>90,587</td>
<td>25,178</td>
<td>32,391</td>
<td>86,368</td>
<td>-7,425</td>
<td>15,350</td>
</tr>
<tr>
<td><strong>Hannover Re</strong></td>
<td>488,102</td>
<td>133,688</td>
<td>2,098,174</td>
<td>220,751</td>
<td>932,857</td>
<td>65,605</td>
</tr>
<tr>
<td><strong>Munich Re</strong></td>
<td>1,115,220</td>
<td>66,269</td>
<td>2,367,119</td>
<td>107,952</td>
<td>611,292</td>
<td>-25,510</td>
</tr>
<tr>
<td><strong>Saxum Re</strong></td>
<td>6,270</td>
<td>-1,357</td>
<td>7</td>
<td>2,774</td>
<td>4</td>
<td>-280</td>
</tr>
<tr>
<td><strong>SCOR Africa</strong></td>
<td>121,343</td>
<td>15,026</td>
<td>528,404</td>
<td>79,015</td>
<td>206,110</td>
<td>57,420</td>
</tr>
</tbody>
</table>
Review of overall business cont.

<table>
<thead>
<tr>
<th>Insurer</th>
<th>Retention</th>
<th>Claims Incurred</th>
<th>Commission</th>
<th>Expenses</th>
<th>Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa Re</td>
<td>29%</td>
<td>66%</td>
<td>20%</td>
<td>12%</td>
<td>3%</td>
</tr>
<tr>
<td>Flagstone Re</td>
<td>7%</td>
<td>0%</td>
<td>1%</td>
<td>141%</td>
<td>-981%</td>
</tr>
<tr>
<td>Gen Re</td>
<td>-23%</td>
<td>0%</td>
<td>118%</td>
<td>-82%</td>
<td>-207%</td>
</tr>
<tr>
<td>Hannover Re</td>
<td>44%</td>
<td>57%</td>
<td>31%</td>
<td>6%</td>
<td>7%</td>
</tr>
<tr>
<td>Munich Re</td>
<td>26%</td>
<td>72%</td>
<td>24%</td>
<td>8%</td>
<td>-4%</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>67%</td>
<td>-38125%</td>
<td>-2900%</td>
<td>48125%</td>
<td>-7000%</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>39%</td>
<td>28%</td>
<td>29%</td>
<td>7%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Retention is expressed as a percentage of gross premiums, and represents the net premium retention. Claims incurred is a percentage of net premiums earned. Commission, expenses and profit/loss are expressed as percentages of net premiums written.

Gross underwriting results

<table>
<thead>
<tr>
<th>Insurer</th>
<th>Gross written premiums</th>
<th>Gross Underwriting profit/loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic</td>
<td>Foreign</td>
</tr>
<tr>
<td>Africa Re</td>
<td>1,531,607</td>
<td>229,787</td>
</tr>
<tr>
<td>Flagstone Re</td>
<td>249,107</td>
<td>12,720</td>
</tr>
<tr>
<td>Gen Re</td>
<td>24,658</td>
<td>7,633</td>
</tr>
<tr>
<td>Hannover Re</td>
<td>2,023,189</td>
<td>74,985</td>
</tr>
<tr>
<td>Munich Re</td>
<td>2,302,550</td>
<td>64,569</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>496,785</td>
<td>31,619</td>
</tr>
</tbody>
</table>
### Net underwriting results

<table>
<thead>
<tr>
<th>Reinsurer</th>
<th>Net written premiums</th>
<th>Net underwriting profit/loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic</td>
<td>Foreign</td>
</tr>
<tr>
<td><strong>African Re</strong></td>
<td>443,140</td>
<td>66,552</td>
</tr>
<tr>
<td><strong>Flagstone Re</strong></td>
<td>18,266</td>
<td>184</td>
</tr>
<tr>
<td><strong>General Re</strong></td>
<td>-7,425</td>
<td>-8,753</td>
</tr>
<tr>
<td><strong>Hannover RE</strong></td>
<td>893,410</td>
<td>284,587</td>
</tr>
<tr>
<td><strong>Munich Re</strong></td>
<td>591,921</td>
<td>149,369</td>
</tr>
<tr>
<td><strong>Saxum Re</strong></td>
<td>4</td>
<td>-116</td>
</tr>
<tr>
<td><strong>SCOR Africa</strong></td>
<td>192,585</td>
<td>60,739</td>
</tr>
</tbody>
</table>

### Split of reinsurer liabilities

<table>
<thead>
<tr>
<th>Reinsurer</th>
<th>Liabilities with A.A.R</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic</td>
</tr>
<tr>
<td><strong>African Re</strong></td>
<td>440,977</td>
</tr>
<tr>
<td><strong>Flagstone Re</strong></td>
<td>218,119</td>
</tr>
<tr>
<td><strong>Gen Re</strong></td>
<td>123,580</td>
</tr>
<tr>
<td><strong>Hannover Re</strong></td>
<td>1,503,282</td>
</tr>
<tr>
<td><strong>Munich Re</strong></td>
<td>1,040,737</td>
</tr>
<tr>
<td><strong>Saxum Re</strong></td>
<td>24,306</td>
</tr>
<tr>
<td><strong>SCOR Africa</strong></td>
<td>573,113</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3,924,114</td>
</tr>
</tbody>
</table>
### Split of total premiums

<table>
<thead>
<tr>
<th>Reinsurer</th>
<th>Gross premiums</th>
<th>Domestic Re (incl. Lloyds)</th>
<th>Foreign Re</th>
<th>Net premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R'000</td>
<td>Domestic</td>
<td>Foreign</td>
<td>Total</td>
</tr>
<tr>
<td>Africa Re</td>
<td>1,531,607</td>
<td>229,787</td>
<td>1,761,394</td>
<td>1,232,950</td>
</tr>
<tr>
<td>Flagstone Re</td>
<td>249,107</td>
<td>12,720</td>
<td>261,827</td>
<td>241,007</td>
</tr>
<tr>
<td>Hannover RE</td>
<td>2,023,189</td>
<td>74,985</td>
<td>2,098,174</td>
<td>1,015,261</td>
</tr>
<tr>
<td>Munich Re</td>
<td>2,302,550</td>
<td>64,569</td>
<td>2,367,119</td>
<td>1,656,983</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>6</td>
<td>-</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>496,785</td>
<td>31,619</td>
<td>528,404</td>
<td>290,794</td>
</tr>
</tbody>
</table>

### Split of reinsurer liabilities

<table>
<thead>
<tr>
<th>Reinsurer</th>
<th>Unexpired risks</th>
<th>Outstanding claims</th>
<th>IBNR</th>
<th>Contingency</th>
<th>Re Balances</th>
<th>Provision for taxes</th>
<th>Other creditors</th>
<th>Total without A.A.R.</th>
<th>Total with A.A.R.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa Re</td>
<td>54,038</td>
<td>172,637</td>
<td>97,186</td>
<td>51,702</td>
<td>1,155,272</td>
<td>6,494</td>
<td>53,578</td>
<td>1,590,907</td>
<td>1,657,378</td>
</tr>
<tr>
<td>Flagstone Re</td>
<td>41,772</td>
<td>48,098</td>
<td>86,368</td>
<td>2,527</td>
<td>144,670</td>
<td>744</td>
<td>10,114</td>
<td>334,293</td>
<td>372,186</td>
</tr>
<tr>
<td>Gen Re</td>
<td>29,173</td>
<td>22,633</td>
<td>-</td>
<td>-</td>
<td>76,166</td>
<td>-变异 primer</td>
<td>2,427</td>
<td>130,399</td>
<td>135,399</td>
</tr>
<tr>
<td>Hannover RE</td>
<td>241,590</td>
<td>459,762</td>
<td>397,291</td>
<td>89,732</td>
<td>782,029</td>
<td>-变异 primer</td>
<td>51,733</td>
<td>2,112,137</td>
<td>2,247,938</td>
</tr>
<tr>
<td>Munich Re</td>
<td>138,861</td>
<td>272,718</td>
<td>198,582</td>
<td>61,129</td>
<td>243,441</td>
<td>7,021</td>
<td>56,702</td>
<td>978,454</td>
<td>1,067,243</td>
</tr>
<tr>
<td>Saxum Re</td>
<td>5,855</td>
<td>1,854</td>
<td>-</td>
<td>-</td>
<td>23,131</td>
<td>-变异 primer</td>
<td>12,730</td>
<td>43,570</td>
<td>48,570</td>
</tr>
<tr>
<td>SCOR Africa</td>
<td>53,985</td>
<td>-69,074</td>
<td>186,599</td>
<td>20,611</td>
<td>355,246</td>
<td>2,863</td>
<td>7,099</td>
<td>557,329</td>
<td>586,217</td>
</tr>
<tr>
<td>Total</td>
<td>530,246</td>
<td>1,009,169</td>
<td>990,513</td>
<td>225,701</td>
<td>2,779,955</td>
<td>17,122</td>
<td>194,383</td>
<td>5,747,089</td>
<td>6,114,931</td>
</tr>
</tbody>
</table>

“A.A.R.” is the additional asset requirement in terms of Section 29(1)(b) of the Short-term Act.

Please see the FSB LT and ST reports from 2011 and 2013 for further detailed statistics on the life and non-life insurance and reinsurance markets.
4 Literature review and key reinsurance trends and themes

4.1 Purpose

The purpose of this literature review is to give a brief introduction to some of the current literature that is available on the structure of other countries’ reinsurance regulations. This is intended to provide a concise background for PwC’s research. The literature available is vast and considers a variety of viewpoints; therefore it is difficult to consolidate all this information into a brief literature review. However, the purpose of the section below is to highlight some of the more important points and ideas.

4.2 Mutual recognition

One of the papers that have been considered is the “Discussion paper on the mutual recognitions of reinsurance of reinsurance supervision” (International Association of Insurance supervisors (IAIS) Reinsurance Mutual Recognition Subgroup, 2007). This document considered the issue of mutual recognition, and helped to build PwC’s opinions in this report.

One of the important points raised in this report was that reinsured risks should be spread using a risk-based approach and this may result in increased diversification. It is important that unnecessary barriers are removed to prevent the hindering of cross-border global diversification. Major reinsurance companies have subsidiaries located around the world which themselves retain very little risk; rather the risk is centralised and then diversified through the capital investment programmes of the parent company.

The main barrier to a global regulatory co-operation is that current reinsurance supervision is limited to individual jurisdictions. However, there has been a global movement towards consistent regulation of reinsurers, and it is possible to have either a practice of supervision of entities on a group-wide basis, or reliance on the work of the supervisors of the entity’s home country. Regulators all over the world want to ensure adequate security of their local insurance industry, and thus the base nature and intentions of the individual regulations will be similar.

France, Germany, Ireland, Japan, Switzerland, the UK and the USA (which are all developed economies with sophisticated supervisory structures) are some of the countries that supply the majority of reinsurance capacity globally. These countries support the concept that the reliance on home supervision may be appropriate. The home supervisor may be in a better position to assess the security of a global entity’s centralised functions, and could provide assurances to the supervisor of the country where the reinsurer’s subsidiaries/branches exist (host supervisor).
An important concept is that the cedant is responsible for assessing the security of the reinsurer rather than the host supervisor. This may be useful if the host supervisor feels that it is unable to provide comfort on the home-regulation of the reinsurer. Instead the local cedant becomes responsible for assessing the security of the reinsurer since it is the user of reinsurance that is ultimately responsible for paying claims to policyholders.

The correct structure and implementation of mutual recognition agreements would provide capital savings for the reinsurers involved.

A well-defined structure for mutual recognition would be expected to:

- Maintain financial system security
- Increase global diversification
- Improve the ease of entry for reinsurers into regulatory-equivalent markets
- Remove administrative duplication for reinsurers and insurers
- Assist developing markets in obtaining more secure reinsurance agreements

These characteristics suit the global nature of the reinsurance industry since reinsurance allows for spreading risks such that there is a reduction in the concentration of risk in any one territory. Mutual recognition would allow for easier facilitation and propagation of this risk transfer.

Increased levels of mutual recognition may decrease the presence of regulatory arbitrage through a greater level of transparency and consistency in regulation across all the countries that participate in the mutual recognition programme. The mutual recognition structure allows for more appropriate overall regulation for reinsurance groups, as the individual subsidiaries and/or branches do not have any duplicate regulatory requirements.

The potential benefits of mutual recognition, as indicated by the IAIS Mutual Recognition Subgroup (2007) may not emerge because:

- Information sharing and consistency between regulators may be limited.
  - Individual regulators may have different goals, leading to a lack of consistency between the various regulatory bodies.
- During times of global financial stress, co-operation between regulators may break down as each party focuses on their own industry rather than considering the international situation.
  - This could be countered if regulators appoint specific resources/supervisory bodies to the continued co-operation between regulators; however the associated costs to ensure such structures have authority may make this difficult.
- It may be difficult to rely on foreign regulators to uphold the acceptable standard.
  - Each regulator would need to be responsible for any failure (to adhere to the required standards of supervision) in their jurisdiction.
There are practical difficulties with items such as accounting standards and the treatment of equalisation reserves.

- Before mutual recognition is implemented, the industry would need to identify these differences and create a standard approach (or some form of fair conversion between the various regulations).

The extent of mutual recognition may be “unilateral, bilateral or multilateral”, and this would then influence the direction of regulatory reliance. This paper found that communication between supervisors is key, because it gives strength and security to mutual recognition agreements.

Supervisors should consider the common bases on which legal, regulatory and political systems can interact in order to develop an effective mutual recognition agreement. Supervisors would also need to determine a means whereby continual evaluation of each other’s standards can be performed. All of these activities would require a strong communication channel between the supervisors involved in order to develop effective mutual recognition systems.

Regulators may need to assess other jurisdictions’ regulatory systems and this process would be easier if the regulatory structures are similar. However it may still be difficult to evaluate the work of another supervisor. Regulators could create a set of minimum standards and use this to assess the quality of supervision, and how appropriate this supervision is across jurisdictions. There may be scope to use the independent evaluations performed by global financial organisations (such as the International Monetary Fund), however these assessments may need further analysis in understanding the real regulatory competence of a specific jurisdiction.

Under a mutual agreement arrangement, there are issues around whether supervisors in one jurisdiction could be accountable to a government in another.

The Committee of European Insurance and Occupational Pensions Supervisors’ (CEIOPS) paper gives advice on the measurement of equivalence (2010). It is said that when considering equivalence, it is important to establish whether the other supervisory regime:

- Provides equivalent policyholder protection
- Is capable of ensuring stability and fairness in the market

This paper discusses the specific principles that should be considered in the mutual recognition process. The principles stated are:

- Authorisation requirements
  - Relating to the requirements of entities wishing to conduct reinsurance business.
- Powers and responsibilities of the supervisory authority
- Relating to the requirements for supervisory authorities to have appropriate skills and capacity to conduct their “supervisory mandate”.

  - System of governance
    - Relating to the presence of an appropriate governance structure in order to ensure policyholder security.

### 4.3 Approved versus non-approved reinsurance

Approved and non-approved reinsurance structures vary internationally (Bell, Imbert & von May, 2011). A prime example is the difference between how external reinsurers are allowed to operate in the United Kingdom and France. In the UK, “non-admitted reinsurance” is allowed, and this means that a non-European Economic Area (EEA) reinsurer is able to sell reinsurance freely. Non-admitted reinsurance is equivalent to non-approved reinsurance in South Africa. In France, however, a “pure reinsurer” from outside the EEA is only able to sell reinsurance subject to specific conditions, such as the requirement for the reinsurer to post collateral as “pledged assets or a cash deposit”. The reinsurer could then be subjected to solvency checks by the local regulator.

Brazil (Affat, 2011) has a different view on the idea of approved/non-approved reinsurance through the structures of its reinsurance licences. There are three types of companies, each with different capital and rating requirements. These are local reinsurers, admitted reinsurers, and occasional reinsurers.

**Local reinsurers:**

- A compulsory cession of 40% of each reinsurance cession to local reinsurers (CNSP Resolution 225). The previous right of first refusal of local reinsurers was removed effective from 31 March 2011.
- CNSP Resolution 232 prohibits local insurers and reinsurers from transferring more than 20% of premium from each cover to equivalent companies outside of Brazil from 31 March 2012.
- Must be locally established as a joint stock company
- Must have a minimum capital of 60 million Brazilian Reis.
- Can retrocede up to 50% of a portfolio’s premium.

**Admitted reinsurers:**

- Require a local representative office with an escrow account with USD 5 million for all lines of business, or USD 1 million for life reinsurance only.
- Have a minimum credit rating of BAA3/BBB-.
Occasional reinsurers:

- Do not have to set up a local office or have minimum capital requirements, but direct writers are only allowed to cede up to 10% of premiums to these occasional reinsurers.
- Have a minimum credit rating of BAA2/BBB.

The admitted and occasional reinsurers effectively keep all of the risk taken on offshore, with no reserves held locally in Brazil.

Affat describes this tiered approach to reinsurance-company structure as “cumbersome”, indicating that it might not be the most efficient of methods for differentiating between reinsurers. The structure was intended to keep the local reinsurer (IRB-BrasilRe) as a viable business, but may lead to difficulties in foreign reinsurers entering the Brazilian market. Argentina copied certain aspects of the Brazilian structure, and this has made it difficult to conduct business in Argentina.

An important point, raised during the interview process, relating to the South American market was:

- Where local reinsurers did not have capacity to accept ‘compulsory cessions’ the risk would often be accepted anyways and then retroceded to foreign reinsurers. The effect of doing so was to add an additional layer of cost for the primary insurer purchasing reinsurance.

The Australian situation was described by Richard Smith, the Chief Manager of General Insurance of the Australian Prudential Regulation Authority (APRA), and he showed that the Australian regulator attempts to ensure the security of its insurers through a number of methods.

These include the following requirements for insurers:

- A minimum retention level for liability accepted, in order to encourage responsible underwriting.
- A limit on the exposure to individual risks.
- Solvency surpluses such that they could survive a catastrophe and remain solvent.
- The use of offshore reinsurers is regulated.
  - The regulator does not want to exclude the use of offshore reinsurers as this appears to go against the principle of spreading the risk through reinsurance. However, the regulator also does not have the capacity to consider the entire offshore market, and thus uses a ‘spread rule’. The spread rule stipulates the maximum amount of risk that can be placed with each of the offshore reinsurers, subject to a maximum of 10% placed with the lead reinsurer (see definition below), and 5% for all others. The regulator may relax this spread rule when dealing with offshore reinsurers known to have high security since the regulator prefers to have the local insurer place more of its risks with a respected international reinsurer than spread its risks among a number of potentially less secure local reinsurers.
Note: A lead reinsurer is the reinsurer who agrees the terms, conditions and premium rates of the reinsurance programme with the client and makes key decisions (often relating to claim quantification) on behalf of all reinsurers on the reinsurance programme. Following reinsurers are reinsurers who accept those terms and conditions when reinsuring part of the risk.

### 4.4 Branches versus subsidiaries

Bell, Imbert and von May (2011) state that in Switzerland (where all of representative offices, branches and subsidiaries are an allowable presence for reinsurers), pure reinsurers are not regulated by the local regulator (FINMA); instead they are regulated by their home regulators.

Ahn and Hwa Paik (2011) state that the same situation exists in South Korea, and show that there are allowances for subsidiaries and branches (which require a local reinsurance business licence), or for unlicensed foreign reinsurance companies to conduct business “subject to cross-border regulations”. The foreign reinsurers are only able to sell their products through mail, telephone, facsimile, over the internet and through Korean insurance brokers. The most significant difference between branches and subsidiaries’ regulations in South Korea is the minimum capital requirements. The requirements for branches are approximately one-tenth (in monetary values) of the requirements for subsidiaries. In order to gain a licence to operate in South Korea, both branches and subsidiaries need to demonstrate that they have sufficient resources in terms of human resources “physical facilities”, and an appropriate business plan for the selling of reinsurance.

Cerutti et al (2007) provide observations from two perspectives: exogenous and endogenous. They identify four exogenous factors: regulation, taxation, degrees of penetration and economic and political risks in host jurisdictions. Cerutti et al (2007) note the following:

- Regulations may prohibit the establishment of foreign branches
- Branches are favoured in jurisdictions with higher corporate taxes
- Branches are also more likely in jurisdictions with smaller scale operations
- Subsidiaries are more common in jurisdictions where political and economic risks are high so as to isolate the group from these risks.

Fiechter et al (2011) also examine endogenous factors and the exogenous factors highlighted above. Fiechter et al (2011) note the following:

- Banks tend to set up branches in jurisdictions where they target corporate clients, while they prefer subsidiaries when their targets are retail customers.
- Branches are often associated with the centralised form of organisation where capital flows within a group are managed by the parent, while a group with a decentralised structure tends to set up subsidiaries which are independently managed and financially and operationally self-sufficient.
• Both branch and subsidiary structures have advantages from a supervisory perspective, however conflicts of interest may exist between the home and the host supervisor. They find that the host supervisor has greater supervisory control over and oversight responsibility for subsidiaries than branches and the opposite is true for the home supervisor.
• During times of stress a banking group with a centralised organisation structure that operates through branches outside the home jurisdiction is able to transfer funds from healthy entities to a troubled entity, or draw on the excess capital from the host jurisdiction.
• Host supervisors prefer the subsidiary structure when facing adverse external shocks but prefer the branch structure when facing domestic shocks, while the opposite is true for the home supervisor.
• The subsidiary structure may serve to protect the interests of individual subsidiaries, while the branch structure may receive financial support from the parent.

**IAIS Issues Paper on Supervision of Cross-border Operations through Branches**

The final paper considered for this review was the IAIS “Issues Paper on Supervision of Cross-border Operations through Branches” as at June 2013.

The IAIS Issues Paper on Branches (2013) cited the following two objectives:

(i) To identify how foreign branches are supervised, highlighting differences as well as similarities in supervisory practices.
(ii) To consider (possible) challenges in the supervision of foreign branches.

*The key points raised in this paper, and relevant to branches of reinsurers, have been extracted from IAIS paper and are re-stated or summarised below.*

**Business practices**

In addition to the above exogenous and endogenous factors identified by Cerutti et al (2007), the establishment of branches was said to be driven by the following factors (IAIS, 2013):

• Access to the capital of the parent which is particularly important for reinsurance business where size is critical
• Branch structure seems to be more common among insurers conducting wholesale business in other jurisdictions. A number of reinsurers operate cross-border through branches, or through cross-border provision of services
• Branches are less costly to operate than subsidiaries
• Branches may also be the preferred option for operations in jurisdictions with high economic and political risks
• Branches may be a preferred option for initial market penetration as set up costs are often lower than that for subsidiaries
• Taxation

**Supervisory requirements**

The IAIS paper has identified three types of differences in the supervision of foreign branches:

(i) Differences among jurisdictions
(ii) Differences between foreign branches conducting primary insurance and those conducting reinsurance
(iii) Differences between domestic insurers (including foreign subsidiaries) and foreign branches

The most prominent difference among jurisdictions was observed between the European Economic Area (EEA) and other jurisdictions. The unique supervisory regime adopted in the EEA is based upon freedom of establishment and freedom to provide services.

For reinsurance branches, the following was observed:

• Reinsurers tend to operate through branches rather than subsidiaries
• Within the EEA reinsurers establish branches as well as subsidiaries
• Foreign reinsurance branches are likely subject to similar regulation and supervision as foreign primary insurance branches

The IAIS paper highlighted three major differences between the supervision of subsidiaries and branches:

(i) Foreign branches are generally subject to requirements regarding location and control of assets (in many jurisdictions, foreign branches are required to hold assets covering financial commitments and backing their insurance liabilities in host jurisdictions), and in a very few jurisdictions foreign branches are required to obtain approval from the host supervisor prior to accessing the assets backing insurance liabilities.
(ii) Foreign branches are not required to establish Boards of Directors as branches are not legal entities and in some cases certain control functions of a branch can be performed by the insurer in its home jurisdiction where the company has a board.
(iii) Several jurisdictions do not conduct suitability checks of representatives of a foreign branch.

**Licencing**

• Most jurisdictions require foreign branches, including reinsurance branches, to be licensed. In a number of jurisdictions the requirements are the same as those for foreign subsidiaries and domestic insurers. Some jurisdictions have different licensing requirements for foreign branches and may, for
example, require less paid-in capital and/or deposits, while other jurisdictions have common licensing requirements for foreign branches.

- Where cross-border provision of services is permitted, scope is usually limited.
- The establishment of an agency or branch in the territory of an EEA Member State is one of the conditions for authorisation of the foreign insurer.

**Financial commitments**

- In most jurisdictions a foreign branch is required to make financial commitments, i.e. to hold a certain amount of assets when it is set up, as one of the licensing requirements. They are backing (part of) capital (or assets over liabilities) and thus are different from assets backing liabilities. All jurisdictions (except for Bermuda) require foreign branches to hold such assets in the host jurisdiction, but details of the requirements vary by jurisdiction.
- There are various ways to hold such assets - many jurisdictions require the assets to be deposited in an account of a bank in the host jurisdiction, while others require them to be held in trust with a trustee.
- In the EEA, pursuant to relevant EU directives, foreign branches (excluding intra-EEA branches) are required to possess assets of the value equal to at least one-half of the minimum amount of guarantee funds the EEA and to deposit one-fourth of the minimum amount as security.
- Intra-EEA branches are not required to lodge financial commitments in EEA jurisdictions.

**Business**

- Most jurisdictions do not permit an insurer to write both life and non-life business within a single entity. In a few jurisdictions, however, a foreign branch may engage in both life and non-life business within a single entity under certain conditions.
- Compared to foreign subsidiaries and domestic insurers, foreign branches tend to carry out fewer operations. Material operations, such as underwriting, claims management, record keeping, and management of policyholders’ information, are mostly performed at the foreign branch level, while few foreign branches engage in intermediation (brokerage). This is because insurance companies do not necessarily sell their products themselves but do so through brokers.

**Governance**

- While there may be some elements of oversight and governance requirements imposed on a foreign branch in the host jurisdiction, critical governance and oversight functions of the branch are generally located in the head office.
- In most jurisdictions, a foreign branch is required to have in place functions such as external audit, compliance, actuarial, risk management and internal audit. At the same time, however, in some jurisdictions legislation on the mandatory functions provides for exceptions (e.g. control functions can be established at the level of a parent insurer).
Solvency

- Solvency requirements for branch operations can be similar to those of foreign subsidiaries.
- In almost all the jurisdictions, supervisors require branches to calculate a solvency margin and report a branch solvency margin.
- In some jurisdictions, when the host supervisor recognises the home solvency regulation of the branch as equivalent, a solvency margin can be calculated following the principles of the home jurisdiction.
- In most of the cases, branches are required to book contracts that they underwrite for residents in the host jurisdiction on the branch balance sheet.

Assets backing insurance liabilities

- In most jurisdictions foreign branches are required to hold assets backing insurance liabilities (in some jurisdictions such assets are called “tied assets”) in the host jurisdiction.
- Unlike the financial commitments mentioned above, many jurisdictions do not require assets backing insurance liabilities to be deposited in a bank account or held in trust in the host.

On-site and offsite monitoring

- In most jurisdictions a host supervisor has an explicitly granted power to conduct an on-site inspection of a foreign branch located in its jurisdiction.
- In most jurisdictions a host supervisor has the power to carry out off-site monitoring of a foreign branch.
- According to the EU law, financial supervision of an EEA insurance or reinsurance company, including that of the business carried out through branches, is the sole responsibility of the home Member State supervisor. If the EEA host supervisor has a reason to consider that the activities of an (re)insurer carried out through a branch might affect its financial soundness, it shall inform the home supervisor.

Supervisory reporting and public disclosure

- Most host jurisdictions require the submission of audited financial statements on a branch basis.
- As a general rule, foreign branches are required to disclose information to the public. Most jurisdictions require audited financial statements to be disclosed, while in some jurisdictions branches are also required to disclose financial statements for solvency purposes, information on risk management systems, on parent company and group structure or on governance systems. Usually, the disclosures required of branches are the same as those for foreign subsidiaries and domestic insurers.
- In most jurisdictions a host supervisor has the power to intervene in a foreign branch.
Prohibition of assets transfer

- In some cases, especially at the time of crisis, assets held by a foreign branch could be transferred to other jurisdictions (sometimes subject to a direction of its parent). Many jurisdictions have the power to prohibit the transfer of assets to other jurisdictions in order to protect policy holders.
- Some supervisors have a permanent power to prohibit the transfer of assets to the parent, while others may exercise such power only in distress situations such as the case where an insurance company is put under a special administration regime due to financial difficulties.

Imposition of additional capital or provisions

- When it is likely that capital or technical provisions of the foreign branch would breach minimum requirements, the host supervisor in many jurisdictions has the power to require the foreign branch to hold additional capital or increase technical provisions. Many jurisdictions have predefined triggers for capital increases.
- The host supervisors typically have the power to require increases to both capital and technical provisions.

Suspension of branch operations

- Suspension is typically triggered where the branch fails to meet its regulatory obligations. In most jurisdictions it is possible for the business operations of a foreign branch to be (temporarily) suspended. In most jurisdictions, the host supervisor has such power.
- The home supervisor usually does have the option of instructing the head office to suspend the activities of the foreign branch in a host jurisdiction where it is deemed appropriate to do so.

Closure of a branch

- Non-EEA respondents noted that the host has the power to close a foreign branch. In three jurisdictions, both home and host supervisors have this power. Triggers for closing a branch include the failure to comply with regulatory obligations or having written no business for a specified period of time.
- With regard to intra-EEA branches, the home supervisor has the prime responsibility to act in closing a branch, however, host supervisors may act to close a branch where there is an immediate need to avert a risk to the interests of the insured's.
Resolution of foreign branches

According to the IAIS paper, mandates and powers of resolution authorities differ among jurisdictions. While there are also differences among jurisdictions with respect to the (legal) resolution frameworks applicable to foreign branches, such frameworks applicable to a branch seem generally to be similar to those of a subsidiary.

Branch resolution options can be summarised as follows:

- Rehabilitation: management, whether on its own or with assistance from authorities and compensation schemes, works to address identified issues in order to return the institution as a whole to a sound footing. This may involve exiting lines of businesses or activities through run-off, portfolio transfer, or partial sales.
- Run-off: allow the policies in force to run-off. In some jurisdictions there are specialist firms or the branch itself may administer the run-off. This may apply to a book of business, a specific branch or the entity as a whole.
- Restructuring: as a branch cannot be sold as a legal entity, the primary restructuring option available is via a transfer of the insurance business through portfolio transfer/assumption agreements.
- Wind-up: a final solution resulting in the liquidation of the assets of the branch.

Possible challenges in supervision of branches

- The home supervisor does not have a direct supervisory power over foreign branches in the host jurisdiction, although it may impose additional requirements in regulated entities (such as an insurer) in the home jurisdiction considering the situation of the foreign branch.
- In general, foreign branches are required to hold assets corresponding to insurance liabilities and required capital (corresponding assets) in the host jurisdiction. From the home supervisor’s point of view, such corresponding assets are not always available to solve financial problems in a Parent or Other Group Entities.
- One of the (possible) challenges for a host supervisor may be legal uncertainty in relation to the effect of applying the supervisory tools to a branch. Some supervisory tools may have a different effect when applied to a branch than a legal entity within the jurisdiction.
- Material gaps in regulation and supervision could also be a challenge to the host supervisor. Where the host supervisor deems that the parent in the home jurisdiction is not subject to the appropriate level of supervision, the host supervisor may need to take actions to protect policyholders of the foreign branch. In an extreme case, an insurer could be considered solvent based on the solvency regime in one jurisdiction, and at the same time could be considered insolvent based on another jurisdiction’s solvency regime.
- Access to and transferability of corresponding assets are critical to the host supervisor.
- Even where the foreign branch is required to hold its assets in the host jurisdiction, the branch may not be required to obtain prior approval from the host supervisor to access the assets. Where prior approval
is not required such assets could be transferred from the host jurisdiction to other parts of the group, where they may not be available for the protection of the foreign branch’s policyholders.

- Information asymmetry may also be a concern. Host supervisors do not always receive timely information on the Parent or the group as a whole.
- Governance should not be overlooked. A branch is not a legal entity and thus in most jurisdictions a branch does not have a board of directors in place at the branch level. The lack of a board of directors at the branch level might limit the host supervisor’s ability to supervise governance arrangements effectively. Most jurisdictions have established suitability requirements for a representative of the foreign branch, but the representative person does not have the same legal responsibility as that of a board of directors.

Possible approaches in supervision of branches

The IAIS paper has identified the following distinct approaches/principles towards supervision of branches:

(i) Strengthening communication and cooperation between the home and the host supervisors
(ii) Enhancing regulation and supervision of foreign branches
(iii) Where legally permissible, setting requirements about the legal form an entity may take based upon a risk assessment.

Conclusions

Both operation through subsidiaries and that through branches have pros and cons. Supervisors currently use a range of supervisory tools and requirements in order to apply prudential supervision to branches in a way that could achieve the same outcomes with respect to policyholder protection and financial stability as supervision of foreign subsidiaries. Such tools and requirements are very similar to those used for foreign subsidiaries however the different legal structures could mean these tools may not have same effect. To understand this, it could be worthwhile analysing and comparing practices of the supervision of foreign branches and subsidiaries more carefully.
5 International Reinsurance Survey Findings

The International Scan aimed to cover at least the major markets where reinsurance is commonly available. The results from the scan include comments on the expected impact of changes related to Solvency 2 and IFRS reporting requirements. We sought to identify global trends in reinsurance operations and regulation, especially in terms of expected changes to the regulatory framework.

This section summarises our findings from the International Scan and includes analysis of responses from the following ten countries:

1. Singapore
2. Australia
3. Canada
4. Japan
5. Switzerland
6. The UK
7. Bermuda
8. Germany
9. United States
10. Ireland

The initial questionnaire consisted of questions relating to the following sections:

A. Regulatory and Supervisory Framework – Insurance
B. Regulatory Framework – Reinsurance
C. Reinsurance market
D. Market Dynamics
E. Tax
F. Management
G. Other

The responses of these sections are summarised and discussed below.
5.1 Regulatory framework and international best practice

The purpose of this section of the International Scan was to provide a general regulatory context of the insurance industry, per country surveyed. The appropriateness of a reinsurance framework is highly dependent on the existing insurance industry structure. Solvency 2 developments have clearly steered insurers towards managing and reporting their businesses via a more risk-based approach. The introduction of risk-based technical provisions, capital requirements and governance regimes has also significantly influenced how insurance industries globally are developing.

It is evident that insurance industries around the world exist in a regulated environment based on policyholder protection requirements. Regulations governing the insurance industry vary between different countries in terms of:

- Principle or rules based
- Risk or compliance based
- Similarities to Solvency 2

The South African SAM regime is aiming for third-country equivalence to Solvency 2 and it is important to recognise that other countries are also moving in (or already part of) this direction. The International Scan also addressed the following Solvency 2 equivalence areas:

- Group solvency equivalence
- Group supervisory equivalence
- Reinsurer equivalence

In addition, the international survey gathered information regarding:

- Reinsurance legislation compared to insurance legislation
- Legislative requirements for foreign and local reinsurers
- Reinsurer capital requirements
- Potential impacts of Solvency 2 and IFRS 4 developments
- Expected changes to the international reinsurance landscape

Regulatory framework

Every country surveyed has a regulatory authority overseeing the insurance industry. In addition, each country has legislation specifically dedicated to insurers.
South African insurance legislation currently is separated into long-term and short-term insurance regulations. The long-term insurance regulations are currently principle and risk based whereas the short-term insurance regulations (current interim measures) are more rules and compliance based. SAM aims to align both long-term and short-term insurance industries into a principle and risk based approach.

**Regulatory regime**

Across all countries surveyed, reinsurers are monitored by the same regulators which oversee the insurance industry, with the following results relating to the legislation in force:

- 8 respondents do not have separate reinsurance legislation.
- Bermuda’s insurance regulations are largely directed at reinsurers (as they make up the majority of the market) but there is no separate legislation between reinsurance and primary insurance.
- Switzerland and Ireland do have separate legislation that applies to reinsurers.
- Germany has portions of the overall insurance legislation dedicated to reinsurance.
- The rest of the respondents did not have any legislative distinction; the insurance regime that applied to primary insurers also applied to reinsurers.

A summary of the results of this section of the international survey is provided below.

<table>
<thead>
<tr>
<th>Country</th>
<th>Principle or Rules</th>
<th>Risk or Compliance</th>
<th>Similarities to Solvency 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>Principle</td>
<td>Risk</td>
<td>Quantitative elements</td>
</tr>
<tr>
<td>Australia</td>
<td>Principle</td>
<td>Risk</td>
<td>Quantitative and qualitative</td>
</tr>
<tr>
<td>Canada</td>
<td>Principle</td>
<td>Risk</td>
<td>In process of adopting</td>
</tr>
<tr>
<td>Japan</td>
<td>Rules based</td>
<td>Compliance</td>
<td>In process of adopting</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Principle</td>
<td>Risk</td>
<td>Quantitative elements</td>
</tr>
<tr>
<td>UK</td>
<td>Principle</td>
<td>Risk</td>
<td>Quantitative and qualitative</td>
</tr>
<tr>
<td>Bermuda</td>
<td>Rules</td>
<td>Risk</td>
<td>Quantitative and qualitative</td>
</tr>
<tr>
<td>Germany</td>
<td>Rules</td>
<td>Compliance</td>
<td>In process of adopting</td>
</tr>
<tr>
<td>United States</td>
<td>Both</td>
<td>Both</td>
<td>Quantitative and qualitative</td>
</tr>
<tr>
<td>Ireland</td>
<td>Principle</td>
<td>Risk</td>
<td>In process of adopting</td>
</tr>
</tbody>
</table>

From the above table, it is evident that globally insurance industries are moving to principle and risk-based regulatory regimes.

The results in terms of third-country equivalence were less definitive as some respondents were uncertain whether their industry was aiming for various levels of equivalence. However, we expect that most countries will be aiming to achieve some level of recognition between each other.

The table below summarises the respondents’ views on achieving equivalence.
Solvency Assessment and Management - Reinsurance regulatory framework review

<table>
<thead>
<tr>
<th>Country</th>
<th>Insurance equivalence agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>None currently</td>
</tr>
<tr>
<td>Australia</td>
<td>None currently</td>
</tr>
<tr>
<td>Canada</td>
<td>None currently</td>
</tr>
<tr>
<td>Japan</td>
<td>Yes</td>
</tr>
<tr>
<td>Switzerland</td>
<td>None currently (aiming for Solvency 2 equivalence)</td>
</tr>
<tr>
<td>UK</td>
<td>None currently (aiming for Solvency 2 equivalence)</td>
</tr>
<tr>
<td>Bermuda</td>
<td>None currently (aiming for Solvency 2 equivalence)</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes, currently limited (aiming for Solvency equivalence)</td>
</tr>
<tr>
<td>United States</td>
<td>None currently (in discussions with the European Commission)</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes, currently limited (aiming for Solvency equivalence)</td>
</tr>
</tbody>
</table>

The above table suggests that 70% of respondents have or are aiming to achieve some sort of equivalence in insurance and reinsurance regulatory regimes.

The International Scan asked if countries require separate life and non-life licences in order to conduct reinsurance business.

<table>
<thead>
<tr>
<th>Country</th>
<th>Separate life and non-life licences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>Yes</td>
</tr>
<tr>
<td>Australia</td>
<td>Separate authorisation process</td>
</tr>
<tr>
<td>Canada</td>
<td>Yes</td>
</tr>
<tr>
<td>Japan</td>
<td>No (taken as non-life)</td>
</tr>
<tr>
<td>Switzerland</td>
<td>No (slightly different supervisory requirements)</td>
</tr>
<tr>
<td>UK</td>
<td>Yes</td>
</tr>
<tr>
<td>Bermuda</td>
<td>No (intends to have separate licences in the future)</td>
</tr>
<tr>
<td>Germany</td>
<td>No</td>
</tr>
<tr>
<td>United States</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Approved versus non-approved reinsurance

The concept of approved reinsurance does not exist in all markets.

<table>
<thead>
<tr>
<th>Country</th>
<th>Concept of ‘approved/non-approved’ reinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>No</td>
</tr>
<tr>
<td>Australia</td>
<td>Yes</td>
</tr>
<tr>
<td>Canada</td>
<td>Yes</td>
</tr>
<tr>
<td>Country</td>
<td>Concept of ‘approved/non-approved’ reinsurance</td>
</tr>
<tr>
<td>----------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>Japan</td>
<td>Yes</td>
</tr>
<tr>
<td>Switzerland</td>
<td>No</td>
</tr>
<tr>
<td>UK</td>
<td>No</td>
</tr>
<tr>
<td>Bermuda</td>
<td>No</td>
</tr>
<tr>
<td>Germany</td>
<td>No</td>
</tr>
<tr>
<td>United States</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>No</td>
</tr>
</tbody>
</table>

The four countries that currently do support the approved/non-approved regulatory requirement, believe that this concept helps to protect policyholders from reinsurers defaulting; especially if the reinsurer is of a lower credit rating or is exposed to risks not approved by the regulator. The use of non-approved reinsurers is generally allowed but is subject to additional capital requirements and higher statutory liabilities.

**Cross-border reinsurance**

Of the countries surveyed, only Germany required approval before placing reinsurance business offshore. Switzerland and the UK specify requirements for offshore business placement but formal regulatory approval was not necessary.

Swiss reinsurers are required to specify the objective of placing reinsurance business offshore in the business plan forming part of the application process for a reinsurance licence.

In the UK offshore placement of reinsurance is guided by specific reinsurance disclosure rules and provisions in the FSA Handbook, most notably the following:

- IPRU (INS) 9.25-28: This requires general insurers to disclose all “major treaty reinsurers” alongside its regulatory filings. The principal or registered office of the reinsurer must also be stated.
- INSPRU 2.1.28: An insurer must limit the gross earned premiums ceded to a single reinsurer or group of closely related reinsurers in each financial year to the higher of 20% of the projected gross premiums for that year or £4m.

**Collateral**

In some countries, reinsurers are required to post collateral before taking on liabilities from domestic insurers. Seven respondents said that they do not require any form of collateral. The countries that required collateral, relate the collateral to the reinsurer not being approved.

The below countries do require collateral.
Country | Legal collateral requirements for local reinsurance
---|---
Australia | Bank guarantees or other collateral can be used to reduce the additional capital requirement against non-approved reinsurers.
Canada | Assets in Canada must be held to support the liability assumed.
United States | Letters of credit from approved banks, cash and investment grade securities in the amount of assumed losses, loss adjustment expenses and unearned premium.

Other countries do not formally require collateral to be posted. However, each reinsurance arrangement is negotiated individually and collateral arrangements may exist in practice.

**Branches of foreign reinsurers**

All countries surveyed allow branch reinsurers to operate in their respective countries with the following specific results:

- The UK needs the reinsurer to have a licence to perform the work in the UK and only requires the global returns of the parent company to be filed with the FSA.
- Germany requires non-EU reinsurers to get approval and requires the co-operation of the reinsurer’s home country authorities.
- Branch applications for six respondents (Singapore, Australia, Canada, Switzerland, UK, and Ireland) are considered on a case-by-case basis.
- In general branches are mainly regulated (in terms of solvency) by the same regulatory and governance authority as other reinsurers.
- The remainder either require full compliance with insurance regulation, or submission of documents required by law to the relevant regulatory authority.

**Capital requirements**

Capital requirements in the insurance industry often consist of a minimum absolute capital requirement or a minimum capital ratio.

The surveyed results are shown in the table below.

<table>
<thead>
<tr>
<th>Country</th>
<th>Absolute capital requirement</th>
<th>Capital ratio requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>Yes</td>
<td>Yes (100% solvency margin ratio)</td>
</tr>
<tr>
<td>Australia</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Canada</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Japan</td>
<td>No (formula based solvency regulation)</td>
<td>Yes (200% solvency margin ratio)</td>
</tr>
<tr>
<td>Country</td>
<td>Absolute capital requirement</td>
<td>Capital ratio requirement</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------------</td>
<td>---------------------------------</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Yes</td>
<td>Yes (100% solvency margin ratio)</td>
</tr>
<tr>
<td>UK</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Bermuda</td>
<td>Yes</td>
<td>No (risk-based capital regime)</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>United States</td>
<td>Yes</td>
<td>Yes (150% to 200% of Solvency 1 capital requirements)</td>
</tr>
<tr>
<td>Ireland</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

**Question**  
**Results**  
7 of the respondents indicated that capital requirements for reinsurers are calculated in the same manner as for insurers. Reinsurers in Switzerland are required to build their own model. In the US, the formula is the same but reinsurers have different factors and inputs.

Direct insurers are also often required to hold capital to guard against possible reinsurer default. Under Solvency 2, this capital will be compulsory for all insurers.

The table below summarises the responses on whether or not insurers held capital to protect against reinsurer default.

<table>
<thead>
<tr>
<th>Country</th>
<th>Direct insurer capital against reinsurer default</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>Yes (risk charge to reinsurance recovery)</td>
</tr>
<tr>
<td>Australia</td>
<td>Yes</td>
</tr>
<tr>
<td>Canada</td>
<td>Only if unlicensed reinsurer</td>
</tr>
<tr>
<td>Japan</td>
<td>No (reinsurance default risk is currently allowed for by limiting reinsurance cessions to 50% of risk)</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Yes (calculated based on a default rating of reinsurer)</td>
</tr>
<tr>
<td>UK</td>
<td>Yes</td>
</tr>
<tr>
<td>Bermuda</td>
<td>Yes (capital held for default of reinsurance balances receivable)</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes</td>
</tr>
<tr>
<td>United States</td>
<td>Yes (charge against ceded reinsurance balances)</td>
</tr>
<tr>
<td>Ireland</td>
<td>No (not currently required by Solvency 1, will be required under Solvency 2)</td>
</tr>
</tbody>
</table>
The results of the survey indicate that most countries do not require different levels of capital to back foreign and local reinsurers. Switzerland was the only country that had specific legislation dictating the level of default capital required for foreign and local reinsurers.

For the all the countries surveyed, other than the UK and Australia, the capital requirements for subsidiaries and branches do not differ. The capital requirements for branches and subsidiaries in the UK and Australia are summarised in the table below.

<table>
<thead>
<tr>
<th>Country</th>
<th>Differing capital requirements for subsidiaries and branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>Subsidiaries must hold capital in excess of the required CRR (Capital Resource Requirement) and ICA (Individual Capital Assessment) and full governance requirements apply. For a pure reinsurer that is a branch of a parent company in the EEA, only a global return is required to be filed with the FSA and some localisation of assets is required.</td>
</tr>
<tr>
<td>Australia</td>
<td>All insurers in Australia, branch or subsidiary, must hold a Minimum Capital Requirement of the greater of AUD 10 million for life-insurance and AUD 5 million for non-life insurance and the result of the internal model or supervisory risk-based capital calculation. Assets backing the MCR must be held in Australia. In addition, Australian insurers are required to hold “eligible capital”, being capital in excess of the MCR. For capital to be recognised as “eligible capital” the assets must meet specific “Tier 1” and “Tier 2” asset requirements. The Australian requirements for branches differ slightly from subsidiaries with regard to the required assets that back the MCR. Assets backing the MCR must be held in Australia with the foreign insurer’s custodian or agent.</td>
</tr>
</tbody>
</table>

**Reinsurer specific requirements and regulatory relaxations**

Insurance regulations may require the appointment of specific control functions such as a statutory actuary. 9 of the 10 respondents replied that they do have control functions in place however a statutory actuary is not always required. Bermuda was the only country with no legislated control requirements.

Regulatory reporting requirements may differ between reinsurers and insurers. 6 respondents do not have different requirements. Singapore uses different reports, but with the same frequency. Switzerland base reinsurance reports on insurer reporting requirements but attach minor adjustments. Bermuda and Germany have less regulated reinsurance reporting requirements. Countries suggested that additional reporting
requirements may be useful only if currently reporting standards appear inadequate. Singapore suggested more technical reporting whereas Ireland suggested Solvency 2 style reporting.

South African reinsurers are permitted to calculate provisions and capital based on average membership data figures (as opposed to individual figures). These types of concessions also exist internationally. Seven of the respondents do not, however, have specific concessions for reinsurers. The UK stated that in respect of their asset valuations, reinsurers are subject to the “prudent person” principle and so do not have to satisfy certain admissibility requirements (as set out in GENPRU Annex 7). Ireland has a lower minimum capital requirement for reinsurers.

**Industry changes**

The International Scan asked respondents what they believed were recent or imminent changes to the reinsurance regulatory framework and the responses varied.

- Germany and Ireland responded with Solvency 2
- Most responses indicate that there will not be reinsurance specific changes to the regulatory framework - the imminent changes are targeted at the entire industry.
- Other countries mentioned changes to reinsurance capital requirements, technical provisions and increased stress testing - seemingly in line with Solvency 2.

Changes to the reinsurance and insurance industry were viewed as required. Countries stated that these changes were required so as to be in line with Solvency 2 (as a response to recent catastrophic loss experiences around the world) and to be in line with international trends. The aim is to improve regulations and thus enhance risk management, transparency, supervision and monitoring of the insurance industry. Reinsurers found it important to be on par with international trends, to run a business focussing on better risk management and to calculate capital requirements that better reflect risk.

Bermuda stated that initially many companies were reluctant to have additional reporting and regulatory requirements; however, given comparisons in Europe, companies in Bermuda are beginning to realise that new requirements although more onerous in some other territories, are necessary and valuable. In the United States, changes were generally well received except that some US ceding companies opposed the changes since it reduces the amount of collateral unauthorised reinsurers must hold in trust.

It is important to analyse if these changes produced the desired effects. Most respondents confirmed that the changes were successful in improving the industry. Other countries commented that it was too early to conclusively say if the new regulations were valuable.
Upcoming industry changes include two main elements: IFRS4 phase 2 and Solvency 2. The International Scan attempted to draw out opinions and expectations of the impact of these two changes to the industry. The responses are discussed in further detail below.

**IFRS 4 Phase 2**

Most respondents indicated that they are unable to assess or deduce the impact of IFRS 4 Phase 2 yet. Some countries believe that the impact of IFRS 4 Phase 2 will be in line with the impact of Solvency 2 given the similarities between the two reporting requirements. Switzerland described a number of impacts due to the differences between reporting requirements under IFRS and current standards. They point out that there is likely to be increased volatility in financial statements (due to the regulatory capital more closely representing the economic capital, calculations are likely to be more complex). There is also likely to be a need to upgrade administrative systems to handle the increase in quantity and quality of information required to be disclosed.

**Solvency 2**

As for the expected IFRS impact, it is difficult to fairly deduce what the consequences of Solvency 2 will have on the reinsurance market. Respondents indicated that the impact of heavier reporting requirements and risk management (capital calculation) requirements will impact how reinsurers manage business in the future. The focus on economic capital (as opposed to previous balance sheet based regulatory capital) will turn the business focus to risk and capital management. Changes in capital requirements, reporting standards and risk management strategies will change how reinsurers operate and how reinsurance is viewed by insurers. This will have an impact on business administration and management systems.

Switzerland expressed a detailed opinion:

- Solvency 2 aligns the internal view of economic capital with regulatory capital requirements.
- Previously many insurers focused on balance sheet issues e.g. profit and loss volatility, accounting volatility and budget. Under Solvency 2 insurers will be making decisions from a risk and capital perspective.
- The risk-based approach will create greater transparency regarding capital usage emphasising the use of reinsurance as a capital management instrument.

**Treatment of non-proportional reinsurance**

The international scan aimed to investigate how various countries allowed for non-proportional insurance and reinsurance in terms of:

- Technical provisions
- Capital requirements
Specific rules and limits

The responses varied by country and are summarised below.

<table>
<thead>
<tr>
<th>Country</th>
<th>How to allow for non-proportional reinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>No specific regulation for this. Calculation is decided by appointed actuaries based on professional judgment.</td>
</tr>
<tr>
<td></td>
<td>Direct insur: Non-proportional reinsurance is recognised by a reduction in the level of technical provisions and capital requirements for insurance risk. Capital required for counterparty risk increases in respect of recoverable.</td>
</tr>
<tr>
<td>Australia</td>
<td>Reinsurer: Capital is required to be held against reserves.</td>
</tr>
<tr>
<td></td>
<td>There are also counterparty concentration limits.</td>
</tr>
<tr>
<td>Canada</td>
<td>Credit is given to the extent that liabilities are ceded, including IBNR</td>
</tr>
<tr>
<td></td>
<td>No capital credit is given for reinsurance ceded in excess of 75% of the direct and assumed written premium.</td>
</tr>
<tr>
<td></td>
<td>For technical provisions, the unearned premium reserve can be deducted by payable reinsurance premium and reserves can be deducted by expected reinsurance recovery. Risk amount can be reduced to net amount in solvency margin calculation.</td>
</tr>
<tr>
<td>Japan</td>
<td>There is no limits/restriction applied to non-proportional reinsurance. But, in the calculation of solvency, if the ceded portion is over 50%, this ceded risk should be applied a 2% risk coefficient instead of 0%.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Uncertain</td>
</tr>
<tr>
<td></td>
<td>Direct writer: an outwards non-proportional reinsurance arrangement would be recognised as an asset and so would fall outside of the gross technical provision assessment.</td>
</tr>
<tr>
<td>UK</td>
<td>Reinsurer: inwards reinsurance written would be a liability. The value of the reinsurance asset/liability will be assessed using standard actuarial techniques for both life and non-life business. The assessment will be consistent with the base technical provisions calculation. Recognition within the capital requirements is via inclusion of the reinsurance asset/liability within the balance sheet to be stressed under the standard formula or internal model approach to assessing SCR.</td>
</tr>
<tr>
<td>Bermuda</td>
<td>Solvency calculations considered on a net basis. Classes of business split out for non-proportional business.</td>
</tr>
<tr>
<td>Germany</td>
<td>Uncertain</td>
</tr>
<tr>
<td>United States</td>
<td>Technical reserves and capital requirements for the direct reinsurers are reduced for non-proportional reinsurance ceded and the reinsurer must establish the reserves and hold the capital.</td>
</tr>
</tbody>
</table>
Solvency Assessment and Management - Reinsurance regulatory framework review

Solvency 2 QIS 5 made no specific mention of needing to assess obligations in respect of non-proportional reinsurance agreements differently from other such obligations. EIOPA did however concede that the approach outlined in the Standard Formula CAT risk sub-module Method 1 may be less appropriate for writers of non-proportional reinsurance. Non-proportional reinsurance also needed to be partitioned by business class.

Currently in South Africa, there is no specified method to allow for non-proportional reinsurance (although current SAM proposals include allowances for non-proportional reinsurance). In the life industry, SAP104 requires the reinsurance to be allowed for through a discounted cashflow model. In practice, many insurers choose not to allow for non-proportional reinsurance because the data required to model the reinsurance asset is not available. Furthermore, SAP104 provides concessions for short duration contracts. Reinsurers are likely to use very approximate methods to calculate non-proportional reinsurance, as these contracts can be fairly short term.

Under SA QIS 2, non-proportional reinsurance is addressed in more detail. Calculations for capital requirements and technical provisions are more specific and are in line with the Solvency 2 QIS 5 requirements. Non-proportional reinsurance is handled in more detail with segmentation requirements, different stress testing and allowed for in different types of risk. Under SAM, the treatment for non-proportional reinsurance will likely be in line with Solvency 2. Compared to the current requirements, SAM presents a more prescriptive and detailed allowance for non-proportional reinsurance.

**Treatment of financial reinsurance**

The treatment of financial reinsurance varied per country. Typically, countries have detailed guidelines on financial and finite reinsurance.

The countries’ responses are summarised below.

<table>
<thead>
<tr>
<th>Country</th>
<th>Treatment of financial reinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>Contracts that do not transfer risk need to be treated as deposit accounting</td>
</tr>
<tr>
<td>Australia</td>
<td>Reinsurers first need approval from APRA. Guidelines for life and non-life reinsurers are provided (GPS 230 and LPS 230)</td>
</tr>
<tr>
<td>Canada</td>
<td>There are no special guidelines on financial reinsurance</td>
</tr>
<tr>
<td>Japan</td>
<td>Uncertain</td>
</tr>
</tbody>
</table>
Country | Treatment of financial reinsurance
--- | ---
Switzerland | There are no special guidelines on financial reinsurance
UK | FSA conducted a consultation on proposed changes to the treatment of financial reinsurance contracts in CP05/14. Feedback on this consultation was summarised in CP 06/16 in Q4 2006, draft amendments to the FSA handbook were included to improve the treatment of financial reinsurance arrangements under the rules.
Bermuda | There are no special guidelines on financial reinsurance
Germany | Yes, guidelines are available. More detail can be found in section 121e of the Insurance Supervision Law.
United States | All reinsurance contracts must transfer risk to obtain reinsurance accounting. Contracts that do not transfer risk are accounted for as deposit/investment contracts under both US GAAP and statutory accounting.
Ireland | Yes, detailed guidelines are available (refer below for details).

Ireland

Irish guidelines on finite reinsurance are available on the Central Bank of Ireland’s website. Requirements are specified separately for life and non-life insurers in the following guidelines:

- Additional Requirements for Non-Life Finite Reinsurance and
- Additional Requirements for Life Finite Reinsurance.

The guidelines cover:

- Contract documentation; the prescription of mandatory policy conditions which finite reinsurance contracts should comply with.
- Available and required solvency margins and Internal Capital Model requirements.
- Systems and controls including administrative and accounting procedures, internal control mechanisms and risk management requirements.

Overall

Financial and finite reinsurance does appear in South Africa. For statutory purposes, there are no specific rules, restrictions or guidelines on their treatment. IFRS reporting requirements would expect financial reinsurance to be reported at fair value. From the above table, it appears that most countries do provide guidelines on the treatment of financial reinsurance and South Africa will need to decide if similar guidelines would be required or appropriate.
5.2 **Trends and issues**

**Location of reinsurer**

The respondents all had the presence of major reinsurers such as Allianz, Hannover Re, Munich Re, Swiss Re and others. The table below shows some of the countries that house the headquarters of international reinsurers.

<table>
<thead>
<tr>
<th>Respondent</th>
<th>United Kingdom</th>
<th>Germany</th>
<th>USA</th>
<th>Switzerland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurer</td>
<td>Lloyd’s</td>
<td>MunichRe, HannoverRe, Allianz SE</td>
<td>GenRe, EverestRe, RGA</td>
<td>SwissRe</td>
</tr>
</tbody>
</table>

**Structure of reinsurance operations**

There was no dominance of any structure (branch, subsidiary, representative office). One interesting result was from the UK where it was said that the EEA had a trend of branch structures being favoured. No separate treatment for global reinsurers was described in most cases; Australia’s response said that corporations needed to get a licence from the local authority and global reinsurers were required to obtain the permission from the UK financial authorities to conduct business there.

**Global trends**

There were no consistent global trends given by the respondents of the International Scan, so the answers were mainly region-specific. Bermuda said that there had been a move to reinsurers re-domiciling in Ireland or Zurich, but keeping operations in Bermuda. Canada noted a move toward more branch-type operations, and Germany gave an indication that the advent of Solvency 2 would lead to greater streamlining of insurance business, thus resulting in the outsourcing of diverse business to reinsurers.

**Default of reinsurers**

The history of reinsurer default was detailed, where only the following countries experienced reinsurer default in the recent past.

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Bermuda</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurer</td>
<td>Majestic Capital, BluePoint Re, Enron Re</td>
<td>Trenwick</td>
</tr>
<tr>
<td>Reason for default</td>
<td>Failed Merger and Acquisition; defaults on securitised mortgages; the collapse of Enron</td>
<td>Soft pricing, September 11</td>
</tr>
</tbody>
</table>
Australia has said that the domiciled businesses have stopped writing international business. While this did not constitute a reinsurer default it did indicate difficulties in the market. This was due to a lack of understanding of the international markets that business was sold to.

This section looked at the following factors relating to the economic environment:

- Country Rating
- Currency
- Exchange Controls
- Impact of Public Policies
- Changes to Public Policies
- Specific Reinsurer Concerns

The majority of respondents had strong credit ratings (as determined by major credit rating agencies), which confirmed that the markets that were examined in this questionnaire were of an appropriate strength to ensure that their regulatory structures are credible and their markets were developed. The countries surveyed all had independent currencies and an absence of exchange controls (save for Bermuda, whose currency is pegged to the United States dollar, and have some exchange restrictions).

Based on survey responses the legislative regimes of a country have had the largest influence on insurance and reinsurance business. Tax rules were also mentioned as reasons why the reinsurance markets of some of the respondents had seen significant development (cases in point Ireland and Bermuda having lower company tax rates than other countries, which then attracted large amounts of foreign direct investment).

The only respondent which stated that there were imminent changes to the regulatory regime (excluding Solvency 2) was the UK, who discussed the changes to the FSA, leading to the regulation of UK financial services being split between various agencies.

European respondents said that Solvency 2’s implementation was the main concern for their local regulator, whereas other respondents had local regulation being the major issues for their regulator. Within these were issues of risk based capital and the security of insurance policyholders.

### 5.3 Reinsurers’ strategies and challenges

#### Placement of reinsurance business

The respondents were asked to indicate the relative importance of different aspects of the reinsurer when placing business with them, ranked on a scale from 1 to 10. The table below shows these results.
This shows that credit quality and price were ranked as the two most important aspects of a reinsurer when deciding on which company to place reinsurance with. An option was given to the respondents for “Other” factors, but these were ranked as having an importance of 3. This shows that regulations should focus on strengthening and maintaining the credit quality of reinsurers in South Africa, as this could be the biggest determinant of the amount of business placed with the reinsurers.

**Risk management**

Strong reinsurance companies that face a limited risk of bankruptcy due to their size and international diversification can assist in the management of systemic risk in the insurance sector. Insurers are able to transfer part of their risks to reinsurers who have large capital bases and international expertise. This then allows for the primary insurance sector to manage and control the risk it faces. This was the general response from the countries surveyed.

Capital requirements for reinsurers also led to a decrease in the risk faced by the insurance industry in general, as this offers another form of protection. Currency risk was dealt with by reinsurers through matching and hedging strategies, which would then reduce the risk of adverse currency movements causing losses to the insurance industry. The Swiss Solvency Test (SST), which is a compulsory capital adequacy test for insurers in Switzerland, contains a section devoted to foreign exchange risk. This was the only mention out of all of the respondents of a specific currency risk provision in the capital requirements, and perhaps should be investigated further in the South African context.

If the reinsurance company were to set up subsidiaries in foreign countries (as opposed to branches), intra-group retrocessions were used in 60% of countries surveyed. These were used as a method of improving capital efficiency (as suggested by the UK). Intra-group retrocessions were said to be a common occurrence, suggesting that the use of these for South African reinsurance subsidiaries should be investigated and potentially promoted if they do indeed lead to greater capital efficiency. For those reinsurers that did not have an intra-group retrocession structure, the respondents said that the regulations that applied to insurers (with respect to capital requirements) were used to improve the credit worthiness of the local subsidiary.
**Strategic management**

The management of composite insurers was discussed in the survey, with 20% of respondents saying that they are managed as one organisation, with the others saying that there was a separation of the operations, management and risk management of the organisation. The reason for this was given as being the differences in operational structures of the components making up the composite insurer, and the difficulty in managing these differences in one organisation.

The success of the reinsurance market in the individual countries was ascribed to factors such as reputation and credit worthiness, quality underwriting and risk based capital requirements. These factors are not surprising given the nature of insurance business.

**Operations**

The questions in this section related to data, with the data received by reinsurers from direct writers being a concern in terms of quality. Respondents identified legacy data as being more of an issue than more recent data, as the quality of data has improved recently. The incentive for direct writers to provide better quality data comes through more accurate reinsurance pricing, and thus more affordable reinsurance. The FSA in the UK has record-keeping requirements which have aided in improving the quality of data kept by insurers. Attempts to manage the data risk varied between respondents, with the options given in the responses being data reserves, assumptions based on external data and experience monitoring, all of which are sensible and expected.

Data quality needs to be considered at two levels. What is captured (whether there is enough detail) and how it is captured (in terms of systems), both could lead to substandard outcomes. The data quality of South African insurers would need to be scrutinised to see whether regulation would be required to address any explicit allowances by reinsurers for data risk.

**Skills and development**

This section of the survey dealt with the assistance provided by reinsurers to insurance companies, and the potential impact of this assistance. The assistance provided by reinsurers was largely dependent on the development of the insurance industry, with highly developed insurance markets obviously requiring less in the way of reinsurer assistance than those markets that are less developed. This assistance was not thought by any respondents to be a barrier to access for new insurers, and there was no influence on the levels of competition between reinsurers due to the assistance offered by reinsurers in the market. The table below gives examples of the assistance that reinsurers offer to their clients.
Country Assistance provided
---
Canada Policy wording
Switzerland Underwriting, pricing, reserving, claims prevention consulting, claims handling in complex cases, legal consulting.
UK Technical underwriting, claims underwriting and management, pricing and product design and expense support.
Ireland Support for pricing

**Tax**

The company tax rate in the countries surveyed varied between a value of 0% for Bermuda and 40% for Japan. The majority of respondents had fixed, single company tax rates, but the USA and Switzerland had different rates according to a graduated marginal tax rate system (for the former) and according to cantons or provinces for the latter. There were no separate tax regimes for reinsurers, with the only slight exception being in Switzerland where an additional tax is placed on companies earning the majority of their revenues from countries outside of Switzerland (which may apply to global reinsurers).

The table below shows the company tax rates per respondent, as applicable over the 2013 calendar year.

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax rate</th>
<th>Country</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>17%</td>
<td>Canada</td>
<td>26.5%</td>
</tr>
<tr>
<td>USA</td>
<td>15-40%</td>
<td>Bermuda</td>
<td>0%</td>
</tr>
<tr>
<td>UK</td>
<td>23%</td>
<td>Ireland</td>
<td>12.5%</td>
</tr>
<tr>
<td>Germany</td>
<td>29.55%</td>
<td>Australia</td>
<td>30%</td>
</tr>
<tr>
<td>Japan</td>
<td>38.01%</td>
<td>Switzerland</td>
<td>11.32 – 24.43%</td>
</tr>
</tbody>
</table>

The majority of respondents indicated that there were double taxation agreements in place, with a large variety of countries and of varying forms. These agreements generally allow for improved tax efficiency of reinsurers, and may make offering reinsurance business more attractive in these countries. We were not provided with a complete listing of DTAs from each respondent; however we were able to obtain the information provided in the table below. Please note that the below table does not represent an official listing of all applicable DTAs.

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Countries with a double taxation agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>70 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>Australia</td>
<td>42 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>Canada</td>
<td>90 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>Japan</td>
<td>64 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Over 70 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>Ireland</td>
<td>60 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>Respondent</td>
<td>Countries with a double taxation agreement</td>
</tr>
<tr>
<td>------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>South Africa</td>
<td>71 countries, including all other respondents except for Bermuda</td>
</tr>
<tr>
<td>UK</td>
<td>Over 100 countries, including South Africa and all other respondents except for Bermuda</td>
</tr>
<tr>
<td>USA</td>
<td>Over 70 countries, including South Africa and all other respondents</td>
</tr>
<tr>
<td>Germany</td>
<td>89 countries, including South Africa and all other respondents except Bermuda</td>
</tr>
<tr>
<td>Bermuda</td>
<td>Since there are no direct taxes in Bermuda, there are no double taxation agreements</td>
</tr>
</tbody>
</table>

### 5.4 Insurers’ reinsurance needs

**Risks and reinsurers**

The risks that reinsurers were stated as reluctant to reinsure were mainly risks relating to catastrophes, and in the case of Germany, market risk and longevity risk. These risks would be expected as they represent highly uncertain losses, with the potential for significant claims that would possibly damage the reinsurer’s capital position. The suggested solutions for this problem were government support programmes and securitisation, but there was a lack of consistent responses, which could indicate that there is not yet a consistent school of thought on how this problem could be solved.

### 5.5 Factors driving reinsurance brokers’ placements

Internationally, the majority of reinsurance was placed through the use of brokers (though direct placement was used). There did not seem to be differences in the intermediation of reinsurance for life and non-life reinsurance, with only the UK saying that non-life reinsurance made far greater use of brokers as compared to life reinsurance. 30% of respondents said that there were no differences in intermediation between facultative and treaty placement, while the other responses were not consistent. Examples of the responses are:

- Singapore said that treaty reinsurance was placed through brokers
- Switzerland said that intermediation was generally used for facultative business

This inconsistency means that the role of brokers seems to vary significantly across the world, and their role in South African reinsurance will need to be assessed.

The role of regulatory arbitrage will be diminished through the introduction of Solvency 2 as there will be consistency in the regulations applicable to reinsurers. However, tax differences (such as the 0% company tax rate in Bermuda) would present chances for arbitrage opportunities beyond those related to Solvency 2.
6 South African reinsurance from insurers’ perspectives

This section provides the results of the local survey and interviews conducted by PwC for life and non-life insurance companies. There were 34 life and 68 non-life insurers surveyed. Where possible, summary statistics of distinct answers are provided below. In some cases, not all of the respondents felt that they could give a response. This may cause the totals in the tables or discussions below to not sum to the figures above. Insurers in run-off were not required to respond to the questionnaire.

For the life insurers, we have split the market into 4 ‘large’, 3 ‘niche’ and 25 ‘medium/small’ insurers. For the non-life insurers, we have categorised 8 as ‘large’, 3 as ‘niche’ and 57 as ‘medium/small’ insurers. The responses of the large and niche insurers have been highlighted on occasion.

The opinions and results provided are those of the respondents.
6.1 Insurers’ strategies and challenges with regard to reinsurance

Professional reinsurers – Life insurers

There were 16 life insurers who said they prefer to deal with a professional reinsurer with others being indifferent or providing no comment. Two large insurers classified were included in those that did make use of professional reinsurers, with the other two stating that they did not make use of professional reinsurers only.

All three niche insurers said that they made use of professional reinsurers, with the particular emphasis being on the use of these reinsurers for the placement of catastrophe reinsurance programmes.

The reasons given for requiring a professional reinsurer were:

- The expertise provided and technical support available
  - Specifically underwriting and claims expertise of professional reinsurers.
- Professional reinsurers introduce less risk to the insurance company
- Potential for economies of scale through dealing with larger, professional reinsurers resulting in better rates.

Local reinsurance capacity – Life insurers

For facultative reinsurance contracts, 23 of the 34 life insurance companies surveyed felt that the local capacity was sufficient. All four of the large life insurers were included in these 23 as well as two niche insurers. The other niche insurer did not offer any comment. There were similar responses for treaty reinsurance contracts, with 23 respondents feeling that there was sufficient capacity. The split between large, niche and other insurers remained the same as for facultative reinsurance.

For catastrophe reinsurance (CAT) specifically, there was a slight majority of 15 life insurers (some life insurers did not comment on capacity requirements for CAT cover) who felt that there was insufficient capacity and that international markets needed to be accessed for local companies to get the required protection. Included in these 15 were three of the large insurers. The other felt there was sufficient capacity, but gave the proviso that there was a need for using offshore CAT cover in order to avoid concentration in the South African market. Only one of the niche insurers felt that there was insufficient capacity in the CAT market.

The South African Insurance Association (SAIA) SAM Reinsurance Technical Forum expressed the view that the discussions surrounding capacity in the South African market required a caveat, in that the feelings of a lack of capacity being offered by local reinsurers may in fact be issues of risk appetite, risk management and pricing. These three factors are instead the determinants of whether certain risks are taken on by local reinsurers, rather than a ‘lack of capacity’ offered by the local reinsurers. The Forum felt that there are potentially only two to three large catastrophe programmes that cannot be sufficiently accommodated by the local reinsurance market.
This comment should also be considered in other areas of discussion around reinsurance capacity.

**Professional reinsurers – Non-life insurers**

The majority of non-life respondents stated that they made use of professional reinsurers. Only 22 of the 68 non-life insurers indicated that they did not have a preference for using professional reinsurers. 7 of the 8 large non-life insurers did place their business with professional insurers, and two of the niche insurers had a preference for professional reinsurers.

The reason for this preference was the need for specific skills and knowledge in developing their reinsurance needs as well as, for more complex agreements, in structuring the legal contract. Those who did not say that professional reinsurers were used generally stated that it was not an explicit requirement of their procurement policy.

**Local reinsurance capacity – Non-life insurers**

32 of the 68 non-life insurers that felt there was insufficient capacity for facultative arrangements. Some of the respondents thought that there was enough capacity for the smaller to medium sized risks, but for some of the larger or more complex risks, the foreign markets needed to be accessed. 4 of the large insurers felt that there was not enough capacity, and one said that there was only sufficient capacity for the smaller and medium risks. Another large non-life insurer stated that the approved/non-approved structure is ignored by their company if there are markets that offer better value or security than here. 2 of the niche insurers did not feel there was enough facultative capacity, with the other not offering any comment.

37 non-life respondents felt that there was sufficient capacity and 21 felt that there was limited capacity for treaty business. 4 of the large insurers and 2 of the niche insurers felt there was insufficient treaty capacity. There were justifications that some of the larger risks/insurers may require capital beyond what is available in the South African market. There were also comments made that although there was sufficient capacity, there may be an argument that there is not sufficient price competition in our market.

20 non-life respondents thought that there was sufficient capacity and 38 felt that South Africa’s catastrophe market did not have enough capacity. Again there were 4 large insurers that felt there was enough capacity, and 2 niche insurers who felt there was insufficient capacity. One comment was made that local prices are expensive compared the relative risk that applies in South Africa. Another large insurer said that they feel that local reinsurers do utilise the full extent of their underwriting capacities when it comes to issuing CAT cover, which is encouraging.
Types of reinsurance used and the market for reinsurance

Types of reinsurance used

<table>
<thead>
<tr>
<th>Type</th>
<th>Life insurers</th>
<th>Non-life insurers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facultative only</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>Treaty only</td>
<td>14</td>
<td>20</td>
</tr>
<tr>
<td>Both facultative and treaty</td>
<td>14</td>
<td>24</td>
</tr>
<tr>
<td>Proportional only</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Non-proportional only</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>Both proportional and non-proportional</td>
<td>15</td>
<td>31</td>
</tr>
</tbody>
</table>

Competition in the market

<table>
<thead>
<tr>
<th>Competition</th>
<th>Life insurers</th>
<th>Non-life insurers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes, the reinsurance market is competitive</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>No, the reinsurance market is not competitive</td>
<td>1</td>
<td>7</td>
</tr>
</tbody>
</table>

The portion of the survey that dealt with competition in the reinsurance sector was not intended for life and non-life insurers. As such, the majority did not provide answers (as shown by the low numbers in the above table).

Life Insurer Comments

The reasons for the market being competitive were given as the sufficient number of reinsurers that offer reinsurance to these insurers, and the market competitive rates offered locally. The one insurer who felt that it was not competitive thought that there were not enough reinsurers in our market, which may lead to there being insufficient competitive pressures on the prices charged locally.

The number of reinsurers and the ease of access to the reinsurers were the main contributors to the high level of competition. Regulation and barriers to entry were mentioned as possibly limiting competition, as was capacity by one respondent, but there was no further detail provided in the responses on this theme.

8 life insurers felt that the constraints caused by the levels of competition locally were not a problem and 2 said that they were. It was said that the regulatory capital adequacy requirements (CAR) impacted on alternative risk transfer arrangements, leading to restrictions on the reinsurers or alternative risk transfer structures that were available. None of the large or niche insurers provided a response to the question of whether the reinsurance market was competitive.

There was also a concern with the capacity that was available in the alternative risk transfer space.
One solution that an insurer used was to look at overseas markets for capacity, while another insurer proposed that access to capacity was made easier using better parameters that would make the credit charge applied more accurate and appropriate.

Non-Life Insurer Comments

The insurers that thought the market was not competitive said that there were better prices to be found in offshore markets. The low number of local reinsurers was also given as a reason why the market was uncompetitive. Of the eight large non-life insurers, one felt that the market was competitive, and two did not think the market was competitive. The remainder did not give an answer. None of the niche insurers gave an answer to this question.

For the few companies that gave responses regarding contributors to competition, the number of reinsurers and ease of access were the two most common reasons. There were too few comments made to give any further detail on the possible market sentiment regarding competition in the market.

5 non-life companies felt that there was a problem with the level of competition in the reinsurance industry, while 9 did not feel that there were any problems.

The risks not dealt with adequately by reinsurers, and how to cure this problem – Life insurers

The vast majority of the life insurance respondents either did not give any opinions or felt that the question was not applicable to their position in the market. Of the 34 respondents, only 5 gave notable responses (these responses were from medium/small insurers). The risks mentioned were long-tail risks, aggregate group risk (stop loss), longevity risk (which was mentioned by other categories of respondents), high levels/low retentions on catastrophe risk cover, investment risk and retrenchment benefits. These do offer some insight into the sentiment of the insurance industry as to the shortcomings of the reinsurance industry; however, the limited number of responses from this sector may indicate that the life market is well-catered for by South Africa’s reinsurance market (and probably by the offshore market as well, given the input of the interviews, with a particular focus on CAT cover). What was interesting to note was that most life insurers regarded this question as the territory of reinsurers, which may indicate that they did not experience much difficulty in reinsuring their particular risks.

Only one of the respondents felt that reinsurers’ reluctance to reinsure stop loss risks was a problem, with the rest indicating that there were no problems caused by this reluctance. This may show that there is adequate capacity available to the life sector from the reinsurance market.

The Actuarial Society of South Africa (ASSA) noted that some reinsurers do offer these types of cover, such as stop loss and retrenchment. It may be that not all offer it which is why they are classed as “not adequately covered” by the respondents of the questionnaire. The issue around longevity risk also relates to the practical
complication of reinsuring an annuity without reinsuring the investment risk (as a swap would be required) and the fact that international reinsurers are more likely to have more conservative mortality improvement assumptions.

There were two suggestions given as to how to solve the lack of reinsurer willingness to reinsure certain risks. These were that the market should be left to decide the prices of the reinsurance, based on the risks faced, and to look towards overseas markets where there is insufficient capacity here in South Africa. This latter suggestion was made despite the presence of approved/non-approved structures.

For the most part, direct writers did not feel that there were significant risks that were not covered by reinsurers, but where these risks had been identified, it was a problem that the reinsurers were not comfortable with taking them on.

**The risks not dealt with adequately by reinsurers, and how to cure this problem – Non-Life insurers**

18 non-life respondents gave an opinion, with 4 of these being that there had been no risks seen in recent years the reinsurers did not want to reinsure. Comments were made that very high-risk business was not accepted, such as open-cast mining and high fire risks. Crop insurance was mentioned by a large non-life insurer as being avoided by local reinsurers. Again stop-loss contracts were mentioned as having limited offerings from local reinsurers, which corresponds with what was mentioned by life insurers. There was also an answer from one of the large insurers that reinsurers avoided those risks that they felt should not have been written in the first place. Two of the other large insurers stated that crop business and aggregate stop loss business may be examples of risks that are not reinsured. Niche areas were given as a general space that reinsurers possibly avoided, with examples such as motor insurance for transport contractors and passenger carrying for reward.

It was clear from the responses that those non-life insurers who indicated that there were risks that reinsurers did not want to take on felt that this was a problem for their business. 9 companies said that the lack of reinsurance cover for these types of risk was an issue for them, with a lack of capacity being given as the major reason for it being an issue; however, it is noted that the lack of cover could be more the result of strategic decisions made by reinsurers rather than an inability to provide capacity.

Allowing reinsurers to charge higher rates to cover these risks was mentioned multiple times as a means of to allow the market to accept these risks. Government intervention was also suggested as a means of ensuring that crop risks are adequately accepted. The pooling of risks and tapping into the local insurance market through inwards reinsurance were unique suggestions made. Better risk management and improved local knowledge sharing could also be used to create a more effective and knowledgeable reinsurance market, and this then tied in with the suggestion of improved relationships with reinsurers, and the ability to improve rates/acceptance of risks through these relationships.
6.2 Regulatory framework, current short-comings and desired change

Strategic and operational concerns with the implementation of SAM

The local questionnaire provided respondents with the opportunity to raise any strategic and/or operational concerns with the management and reporting of reinsurance under the SAM regime.

In general, life insurers highlighted the following concerns related to SAM.

Strategic concerns – Life insurers

- Use of simplifications should be allowed when calculating the risk mitigation effects of reinsurance.
- Reinsurers’ capital requirements may be significantly higher which could lead to higher reinsurance rates.
- SAM will result in a review of the use of catastrophe and other forms of reinsurance and therefore affect the demand and price of reinsurance at an industry level in order to optimise capital.
- The decision-making process associated with placement of new reinsurance treaties will require some changes as service and price alone will no longer be sufficient to reach a decision on placement.
- Reinsurance structures and renewal dates may be chosen to possibly artificially optimise capital requirements.
- Financial reinsurance is likely to be more seriously used to help manage capital and liquidity.
- One insurer stated that the allowance for counterparty risk should be reflected in the SCR and not in technical provisions at all.

Operational concerns – Life insurers

- Additional complexity and the increased number of calculations required to determine the technical provisions and the SCR.
- Availability and integrity of data required for SAM modelling.
- Stretch reinsurer and insurer resources; which may have a secondary impact through support to direct writers.

Strategic concerns – Non-life insurers

Similarly, non-life insurers raised the below SAM concerns.

- Allowance in capital requirements for the economic benefit of non-proportional reinsurance.
- Many non-life insurers feel that the current non-life underwriting workbook is restrictive with regards to segmentation of lines of business leading to incorrect recognition of reinsurance arrangements within the model.

- Approved and non-approved reinsurance should not be required in a risk-based solvency regime.

- The ability to compare all reinsurers on a consistent basis for purposes of the counterparty default risk module.

- The ability to access global reinsurance markets particularly in territories where there is no third-country equivalence to Solvency 2.

- The ability to aggregate and report at the level of detail required by the reinsurance sections of the quantitative report templates (QRT) that will be required by SAM.

- The effect that the SAM standard formula approach to quantifying the SCR will have on reinsurance pricing, and in particular, the reinsurer’s charge for using their balance sheet capital.

- The manner of application of appropriate risk management systems within reinsurers and the impact these systems could have on administration, pricing, flexibility and the operational efficiencies of the reinsurance market in South Africa.

- Reliance on credit rating agencies to ensure that the credit risk exposure is managed.

- SAM approach to liability catastrophe risk seems too severe.

- Selection between proportional and non-proportional reinsurance structures are biased toward proportional, as under the current SAM framework, relatively greater capital relief is achieved.

**Approved versus non-approved reinsurance**

Overall life and non-life insurers preferred removing the non-approved reinsurance restriction and encouraged a free market approach to reinsurance. This suggestion stems, in part, from the fact that a risk-based capital regime will allow for the reinsurer’s default risk. In addition, many insurers indicated that the collateralisation requirements for non-approved reinsurance often provided little financial security when compared to claim exposures.

The results of life and non-life insurer preferences regarding approved reinsurance are summarised in the table below. In general, where insurers commented that the concept of approved reinsurance should be ‘modified’ they referred to the amount of relief taken in technical provisions and/or the additional capital requirements being risk-based referring to various measures of reinsurer security (most regularly credit ratings).
Solvency Assessment and Management - Reinsurance regulatory framework review

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Maintain approved reinsurance</th>
<th>Modify/remove approved reinsurance</th>
<th>Indifferent/No comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life Insurers</td>
<td>6</td>
<td>11</td>
<td>17</td>
</tr>
<tr>
<td>Large Life Insurers</td>
<td>2</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Medium/Small Life Insurers</td>
<td>3</td>
<td>8</td>
<td>16</td>
</tr>
<tr>
<td>Niche Life Insurers</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Non-Life Insurers</td>
<td>13</td>
<td>36</td>
<td>19</td>
</tr>
<tr>
<td>Large Non-life Insurers</td>
<td>2</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td>Medium/Small Non-life Insurers</td>
<td>11</td>
<td>29</td>
<td>17</td>
</tr>
<tr>
<td>Niche Non-life Insurers</td>
<td>0</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

Total Life and Non-life Insurers | 19 | 47 | 36 |

Approved versus non-approved reinsurance - Advantages and disadvantages

The main advantages raised by insurers regarding approved reinsurance are as follows:

- Provides a degree of comfort to insurers regarding reinsurer credit risk.
- Financial system security.
  - The FSB has the right to call on the letter or credit/irrevocable letter of guarantee in the event of a default, for reinsurers that the FSB does not have regulatory control over. With the alignment of the international standards of regulators, this should be less of a risk for the FSB.
- Positive exchange control measure.
- Improves regulatory oversight in market.
- Encourages dealing with locally domiciled reinsurers.
- More secure debtors/creditors and quicker settlement of accounts.

The main disadvantages raised by insurers regarding approved reinsurance are as follows:

- Barrier to entry - the collateral requirements, for reinsurers with non-approved status, lead to certain international reinsurers being reluctant to do business in South Africa.
- Anti-competitive and increases the regulatory burden.
- Disallowing non-approved reinsurance (including non-proportional reinsurance) means that the regulatory position is not a realistic representation of the financial position of the insurer (especially in a self-insurance environment where operational ring-fencing applies).
• Administratively more onerous to use an unapproved reinsurer which may result in sub-optimal decisions.
• Cost disadvantage due to the extra implied capital cost to the reinsurer, resulting in additional costs being passed onto policyholders.
• Many insurers see approved reinsurance as a limitation on availability and choice of reinsurer.
• Some insurers felt that they are able to reinsure with far more secure markets overseas than within South Africa. They have noted the following concerns with the current limitations on the use of foreign reinsurance:
  o Comparatively secure foreign reinsurers may require deposits or guarantees to be approved. These rules place the policyholder at a disadvantage in terms of price paid for the additional (possibly negligible) security achieved.
  o The rules could potentially make the South African insurance market weaker due to concentration risk.
• The concept represents a non-economic view on the value of foreign reinsurance treaties and could lead to non-economic reinsurance decisions where reinsurance may be placed with lower quality reinsurers.
• Approved reinsurance requirements do not recognise the advantages brought by foreign reinsurance placements though additional capacity and diversification benefits.

Approved versus non-approved reinsurance – Capital requirements & governance

Life and non-life insurers highlighted the below points regarding capital and governance implications of approved/non-approved reinsurance.

• Governance structures at the moment may not be fully equipped to assess the risks attached to non-approved reinsurers.
  o Over half the respondents stated that their current governance frameworks would simply not consider non-approved reinsurance as a viable option. The majority of life insurers stated that they do not consider non-approved reinsurance.
  o For other companies the approved/non-approved criteria were stated to have no impact on the governance approach (often attributed to robust ‘look through’ governance processes).
• It makes sense to have a reduced credit risk capital requirement for counterparties who provide collateral. It is not clear that a local counterparty that does not provide collateral should attract a lower capital charge.
• Current regime is too simplistic in providing full offset for approved reinsurance, and no offset for unapproved reinsurance.
  o The concept should rather consider financial strength, rating by approved rating agencies (or by the regulator) and the regulatory environment in which the reinsurer operates.
• Legislative measures may favour traditional European and North American markets thus inhibiting growth and development of African and other developing markets.
Companies may consider each reinsurer individually and foster individual relationships meaning that governance is performed on a case by case basis.
The international credit rating and standing of the company often drives governance for reinsurance arrangements, according to board-approved policies.

**Branches versus subsidiaries - Life Insurers**

The general comments provided by life insurers on subsidiary and branch reinsurers are provided below.

**Branches versus subsidiaries – Advantages & disadvantages**

The primary concern regarding branch structures was about how the operational structure might affect service levels, knowledge, capacity, expertise and counterparty risk. Life insurers were emphatic about the need for local skills and face-to-face interaction for the purposes of their reinsurance business.

If branch reinsurers tend to have fewer local skilled resources (underwriters and actuaries in particular) available to meet face to face as well as fewer resources to provide speedy services (e.g. underwriting decisions based on up to date local industry issues), then life insurers view having a branch as a significant disadvantage.

Insurers expect the reaction in the life reinsurance market to be that reinsurers would tend to maintain local skills and operational efficiency to prevent losing life insurance business in South Africa.

In addition, most life insurers noted concerns relating to reinsurers having a vested interest in South Africa. This included discussions around:

- South African employment
- Capital invested & economic development in South Africa
- Tax collections

The following benefits associated with branch offices were also discussed:

- Cheaper to operate branches
- Companies generally preferred either parental guarantees or branches to mitigate counterparty credit risk
- The branch would provide direct access to the capital of the foreign domiciled reinsurer. In a period of local "stress", this could increase the probability of securing the benefits reinsured

Similarly, the following risks associated with branch offices were discussed:
• Local capitalisation means capital can be accessed more easily by local authorities in the event of dispute.
• South African economic development.
• Legal entity exists in South Africa and is regulated by the FSB.
• Easier to unwind branch businesses, which was understood to be a disadvantage as it could mean that branches find it easier to leave the South African market (and not fulfil their obligations) than subsidiaries could.
• Foreign domiciled reinsurers might not be regulated on the same basis as local subsidiaries and hence the level of understanding of the security provided by regulation might be different.
• Reinsurer branches would not be protected from contagion from parent companies or other subsidiaries whilst subsidiaries may be partially protected via ring-fenced capital.

Branches versus subsidiaries – Capital requirements & governance

Insurers were asked how capital requirements and governance should change for both their businesses as well as for reinsurers. The main themes raised by life insurers are provided below.

• Capital should be sufficient to meet the branch/subsidiary risks without relying on parent companies, as a result capital requirements should be the same for branches and subsidiaries.
• Capital requirements can change if parent companies provide guarantees.
• Branches may have lower capital requirements depending on:
  o location of the parent company
  o ability to diversify the business
  o lower default risk from parent support
• Branches regulated by foreign legislation with a different standard require higher capital.
• Subsidiaries should be regulated on local legislation.
• Insurers will perform more detailed due diligence (effectively adapt their processes) when reinsuring with branch reinsurers.
• Branches should meet governance and reporting standards.
• Governance requirements would depend on the credit rating of the international parent company.
• For branch reinsurance, insurers need to understand a parent company’s risk position and balance sheet.
• The use of branch reinsurance should be approved by the regulator.
• Branch governance structures need to allow for different regulations and requirements.
• Governance requirements impact the reinsurance strategy.
• Risks may be spread over more reinsurers.
Branches versus subsidiaries – Encouragement to operate as a branch or subsidiary

As long as capital security and the availability of skilled resources is not impacted, the majority of life insurers (including most of the largest life insurers) stated that they would be indifferent to which structure is chosen (non-life insurer responses are discussed in the section below).

However based on their expectations of inevitable changes as a result of introducing branches (such as potentially improved security with branches, fewer skilled resources locally etc.), some life insurers indicated specific preferences as per the table below.

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Preferred Subsidiaries</th>
<th>Preferred allowing both branches and subsidiaries</th>
<th>Indifferent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Life Insurers</td>
<td>0</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>Medium/Small Life Insurers</td>
<td>6</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>Niche Life Insurers</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>7</strong></td>
<td><strong>3</strong></td>
<td><strong>14</strong></td>
</tr>
</tbody>
</table>

*Note: Insurers that did not answer the question are not included in the above statistics.*

In addition, it is worth noting the following comments from Life insurers:

- The current approval process via the FSB works well; there is no need to change that for Life business. The FSB should prescribe the level of security required.
- From a business point of view, fewer requirements are preferred. However, it will be unfortunate if foreign insurers are allowed to write direct business without local prudential supervision.
- Subsidiary structure is arguably better from a country point of view; requires capital and people investment into South Africa.
- Subsidiaries with letters of comfort from parent companies are preferred in order to better ensure local governance requirements are met.
- Subsidiaries are preferred as the FSB regulates the entities locally, subsidiaries have to comply with the Companies Act and a legal entity exists in South Africa for legal procedures.
- If regulation is constructed appropriately to protect policyholders from an economic perspective; taking into consideration legal certainty, liquidity and credit quality of the reinsurer then some life insurers felt that the branch structure should be encouraged. This would result in reduced barriers to entry for foreign reinsurers, increased competition and capacity in the market and lower reinsurance costs for the ultimate benefit of policyholders.
Branches versus subsidiaries – Non-Life Insurers

The comments provided by non-life insurers on subsidiary and branch reinsurers are summarised below.

Branches versus subsidiaries – Advantages & disadvantages

The main advantage of using branches is that non-life insurers can gain access to the global market through the wider range of reinsurance contracts available. In addition, reinsurance recovery (risk and operational process) through a branch is considered as good as via a subsidiary therefore reducing the risk of counterparty default. Branches may incur lower administration and overhead costs which can translate into reduced reinsurance prices.

Insurers expressed concern that branches operating in South Africa would tend to repatriate capital to the holding companies. This could have negative impacts such as:

- Decreased investment in the country
- Less development in the insurance industry through education, training and job creation

To counteract these potential problems, regulation needs to create an incentive for reinsurers to operate with local capital and to invest in developing skills in the local insurance/reinsurance industry. This may not be possible if there are not enough people with the correct level of technical competence, knowledge of local market conditions, or local risks. Local skills and understanding is a particular problem for lead reinsurers on a programme or treaty. Some insurers stated that they would be more comfortable if branches, that did not demonstrate the requisite local capabilities, provided following line capacity only.

Other key themes raised by non-life insurers regarding the use of branches include:

- Branches may refer to head office for underwriting guidance. This could be time consuming and increase turnaround time to the insurer
- Branch reinsurance should be automatically approved and not require special additional security for a branch registration
- When selecting a reinsurer, the insurer will consider the reinsurer’s financial strength, credit rating and the relevant skill and experience
- There is concern around the entrance of smaller and/or unknown branch reinsurers
- The parental rating and the ability to claim directly on the parent company provides more financial security
- Easier to unwind branch operations
Other insurers stated that a locally capitalised subsidiary and the fact that a subsidiary has more decision making power than a branch provides them with more comfort on a reinsurance arrangement with a subsidiary than with a branch.

The following themes were raised with regard to using subsidiaries:

- There may be capital fungibility risk during periods of financial stress.
- There is concern regarding the extent of parental guarantee with its local subsidiaries.
- Subsidiaries are required to comply with all the laws of the land including all solvency requirements and might not enjoy the same levels of dispensation as branches.
- Using branches or subsidiaries makes no difference to companies who use internal reinsurance programmes.
- Insurers would still want strong regulation by the FSB within both a branch and subsidiary environment.

Branches versus subsidiaries – Capital requirements & governance

Insurers were asked how capital requirements and governance should change for both their businesses as well as for reinsurers. The main themes raised by non-life insurers are provided below.

- Risk-based capital requirements, independent of operational structure
- Solvency requirements identical to full representation (subsidiary) in country
- Capital requirements reflect risk exposure
- The need for branches to be individually capitalised
- Branches offer security through larger and more diversified capital pools
- Limited liability of subsidiaries without parental guarantees to the market
- Subsidiaries can ring fence any losses; branch structures would not restrict losses
- Branches can rely on offshore parent’s capital
- Subsidiaries can use a retrocession programme and keep low capital locally
- Subsidiaries can transfer risk to the parent company
- Enhance insurers’ internal governance approaches for branches and smaller reinsurers.
- Monitoring whether a branch will remain in the country
- Some insurers will use their normal risk appetite and governance considerations:
  - International credit ratings
  - Exposure concentrations
  - Default risk exposure thresholds
- Restrict branches from leading programmes if there were concerns about the quality of support provided by branches
Branches versus subsidiaries – Reporting requirements

Similarly insurers were asked how reporting requirements should change for both their businesses as well as for reinsurers. The main themes raised by non-life insurers aimed to:

- Reduce cost of reporting
- Prevent tax arbitrage
- Create a level playing field requiring similar reporting requirements for subsidiaries and branches
- Create further reporting efficiencies via mutual recognition
- Ensure that the regulator and the local industry are able to track reinsurance flows in South Africa and understand the breadth of reinsurance business conducted in South Africa.

Branches versus subsidiaries – Encouragement to operate as a branch or subsidiary

The view of non-life insurers was split into the following two groups:

1) Market forces should be allowed to prevail and the local market should have more participation from foreign reinsurers - in either the form of a branch or local subsidiary.
2) A large proportion of non-life risk is reinsured with offshore reinsurers due to unequal requirements for local and offshore reinsurance. Local reinsurers should be encouraged to compete better on price via a less costly regulatory regime.

Respondents with an indifferent view between branches and subsidiaries stated that regulations should not be used to create hurdles regarding the choice of operational structure.

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Preferred Subsidiaries</th>
<th>Preferred Branches</th>
<th>Indifferent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Non-Life Insurers</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Medium/Small Non-Life Insurers</td>
<td>20</td>
<td>9</td>
<td>14</td>
</tr>
<tr>
<td>Niche Non-Life Insurers</td>
<td>0</td>
<td>0</td>
<td>22</td>
</tr>
<tr>
<td>Total</td>
<td>23</td>
<td>9</td>
<td>19</td>
</tr>
</tbody>
</table>

*Note: Insurers that did not answer the question are not included in the above statistics.*

The preferences shown in the above table suggest a subsidiary basis be adopted.

Some companies stated that they prefer subsidiaries to lead their local reinsurance programmes. This increases the level of reinsurance interaction and support to the insurer as well as encourages skills development in the local market, creates the opportunities for training and jobs and supports the local economy.
In addition, it is worth noting the following comments from non-life insurers:

- Insurers should be allowed the flexibility without undue penalty to enter into agreement with a foreign reinsurer. This will eliminate the scenario where reinsurers open either subsidiaries or branch offices in South Africa for the purpose of becoming approved reinsurers.
- Some insurers have stated that they would prefer local structures (branch or subsidiary) because they would have a better understanding of the local risks and dynamics. This is conditional on both structures having similar capital requirements and parental guarantees.
- It is important not to ‘encourage’ either option but to create a system that allows for both. The current ‘subsidiary only’ approach is too restrictive. Many insurers stated that the number of jobs that will be lost if reinsurers convert from subsidiaries to branches is not significant to the economy or industry.
- From an ease of doing business perspective, insurers prefer subsidiaries due the administrative time lag if branches need to refer to head office. Insurers also find the own capitalisation of a subsidiary attractive as decisions relating to deployment of that capital could be taken at a local level. This model would also be fair to existing subsidiaries in the local market and subsidiaries would be forced to capitalise locally. On the other hand branches offer greater counterparty security because group capital is available and liability is not ring-fenced.

**Mutual recognition – Life Insurers**

Mutual recognition was an important topic for all types of respondents, as the achievement of mutual recognition by South Africa would be an important step for the local regulatory regime, and would allow for advantages due to a possible removal of regulatory duplication by local companies. The summary of perspectives of life insurers is given below.

**Mutual Recognition – Benefits & risks**

Mutual recognition would allow for a direct and quick comparison between the local regulatory regime and that of an “equivalent” regime elsewhere in the world. This could improve the investor confidence in South Africa, and could lead to growth in foreign investment locally. However the converse also applies, and if there were not to be an achievement of mutual recognition, it is possible that foreign investors would not feel as safe in investing or doing business in South Africa.

There may be concerns that the power of the local regulator to amend the local regime may be constricted due to recognition requirements and a need to remain consistent with international regimes. South Africa’s regime may also be forced to move in-line with European changes to Solvency 2, which may not be wholly appropriate to the local economy.
The most significant advantage however may be the removal of regulatory reporting duplication, in that those companies that operate locally but have parents located in countries with mutual recognition arrangements could avoid the costs and effort required to meet both South African and local (to the parent) regulatory requirements.

**Mutual Recognition – Barriers to entry**

As mentioned above, the lack of mutual recognition would lead to increased compliance costs, which would serve as a barrier to entry for foreign companies. Having mutual recognition agreements in place may facilitate easier access between markets, and could thus reduce the current barriers to entry that exist.

**Mutual recognition – Non-Life Insurers**

The general comments provided by non-life insurers on regulatory mutual recognition are summarised below.

**Mutual Recognition – Benefits & Risks**

Non-life insurers had similar comments to those offered by life insurers above. It was felt that the administrative burden that results from not having mutual recognition was onerous, and that achieving mutual recognition would allow for lower regulatory effort and costs. There may then be additional attraction for international companies to conduct business locally as the ease of doing business locally is improved.

A risk that was considered was inconsistent application of regulation between countries, as well as the local implementation of a mutually recognised regime that may not be entirely suitable to the South African environment.

**Mutual Recognition – Barriers to entry**

In a similar vein to life insurers, there was a feeling that achieving mutual recognition would lead to lower barriers to entry due to lower costs and administrative burdens resulting from complying with multiple regulatory regimes.

**Insurers taking on inwards reinsurance – Life insurers**

For inward reinsurance (insurers accepting insurance risk from other insurers in the group or from other independent insurers) there was a particular emphasis on quota share (mostly 100% quota share). There were 2 respondents who provided additional detail, possibly because they were the only insurers who had a more developed reinsurance programme (in terms of reinsurance sold); these insurers also listed surplus and excess of loss products being sold.
Below is a summary of the non-overlapping comments from life insurers. Most insurers were in favour of inward reinsurance for the following reasons:

- It provides an opportunity for insurers to acquire a book of business
- It is an alternative when local reinsurers cannot write the business due to competitive sensitivities
- Insurers will be able to diversify their portfolios amongst themselves
- It will provide flexibility in the insurer's business and capital structuring
- Insurers can affect joint ventures between themselves
- Insurers operating a number of licenses will be able to maximise capital efficiency and streamline risk management
- Insurers may be able to offer more cost-effective reinsurance options
- Insurers may be in a better position to offer reinsurance to small insurers or cells within a cell captive
- Insurers have experience in managing risks that are being reinsured

The above benefits will only be recognised if the insurer was properly authorised for the class of business to be reinsured. The insurer will also need to have sufficient knowledge and expertise to properly manage the risks. Insurers should meet separate reporting requirements for inward reinsurance business.

**Insurers taking on inwards reinsurance – Non-life insurers**

For the non-life insurance companies that did have inwards reinsurance, the main types of arrangements were quota share followed by surplus reinsurance. The majority of respondents stated 100% quota share.

Below is a summary of the non-overlapping comments from non-life insurers. As for life insurers, most non-life insurers were in favour of inward reinsurance for the following reasons:

- It will increase capacity in the local reinsurance market
- It is a method of retaining premiums and risks in the South African market
- It will improve diversification of the insurer’s existing business portfolio
- Insurers will be able to deploy capital in the same manner as for direct business
- It will improve market competition and encourage the growth of reinsurance skills locally
- Inwards facultative reinsurance is no different to writing an individual policy
- It facilitates group risk and capital management within group undertakings

In order to conduct inward reinsurance appropriately, insurers need to ensure that the business is given enough attention and is conducted by qualified reinsurance professionals. Inward reinsurance would need to follow a separate set of reporting requirements and be conducted as a separate line of business.

Some insurers felt that there should be a higher capital charge for inward treaty business due to the lack of transparency.
One insurer stated that inward reinsurance could be considered a breach of the Competition Act. This could be seen to occur if a non-life insurer, for example, were to reinsure with another independent non-life insurer competing in the same market. The reinsurance arrangement would result in the sharing of company specific policy/claims data and underwriting practices, creating the opportunity for insurers to collude (either intentionally or unintentionally) with regard to price setting.

The counter-argument is that inwards reinsurance of this nature (between insurers in the same market) often does not occur due to insurers being unwilling to reveal confidential information to competitors. In addition where reinsurance is performed in the same market, access to information is restricted meaning that confidential price information is not shared and the reinsurer provides capacity with less underwriting information and hence greater risk.

**International developments**

**Impact of Solvency 2 and SAM developments on current reinsurance business – Life & Non-Life insurers**

The impact of Solvency 2 and/or SAM on insurers could be classified in one of the following categories:

1) Sophisticated internal governance and economic capital requirements mean that respondents expect minimal reinsurance business changes.

2) Developing internal governance and capital requirements mean that the way reinsurance business is conducted will be reviewed. The knowledge introduced via Solvency 2 and SAM has prompted overall business changes and changes in reinsurance placement are expected to occur over the short-term.

3) Reinsurance business changes have not yet occurred and may be needed. These changes will only gain priority close to or after implementation of SAM and when product pricing is reviewed.

2 of the 4 large life insurers in South Africa and 2 medium-sized life insurers indicated that they form part of group 1 above; the other large life insurer suggested that they were part of group 2.

The majority of life insurers indicated that Solvency 2 and SAM proposals have had no impact on their reinsurance placement to date suggesting that, for reinsurance placement, they form part of group 3 above.
6.3 **Key factors influencing reinsurance decisions**

**Key factors - Life insurers**

Life insurers ranked credit quality and price as the two most important factors when deciding on reinsurers to be used.

During the interviews it emerged that technical expertise and long-term relationships proved to be extremely important in the life reinsurance market and that the larger life insurers would rank these reinsurer factors more highly. Domicile and diversification did not feature prominently as highly-rated factors.

Of the large insurers, technical expertise was ranked as the most important on two occasions, with price being ranked the most important for the two other insurers. Business relationships were the other most common factor mentioned in the top three most important factors.

There were similar feelings from the niche insurers, with technical expertise being the top-ranked criteria twice out of the three insurers, and price being the second highest rated factor on two occasions. Credit quality was the top ranked factor for the third insurer, and featured highly for the other two insurers as well.

Of the other life insurers, there were 18 responses. Credit quality was ranked first 6 times, and second three times. Technical expertise was ranked first 6 times, and second 5 times as well. Price and business relationships were ranked first three times each.

An interesting point that was made was that most of the major life insurers have a reinsurance panel of preferred reinsurance providers. This panel would have been selected with credit quality as one of the main criteria, which allowed the insurer to view all the reinsurers on the panel with a similar (almost equal) standing in terms of the security and financial strength they provide. Reinsurance decisions are then based less on the credit quality of the counterparty and more on the technical skills and business relationships (and possibly price although this was not explicitly stated) between the two parties.

One respondent explained that their retention levels were very low, and as such there was a greater dependence on the technical skills provided by reinsurers. As SAM is introduced, they felt that there would be an increased reliance on credit quality and diversification as guiding factors, as these would have an impact on capital requirements.

The most important aspects when considering the placement of reinsurance were clearly:

- Credit quality
- Price
- Technical expertise
Direct writers aim to maximise the security of their reinsurance arrangements, yet minimise the cost. This explains why the reinsurance industry is reliant on the credit rating agencies for their assessments of the credit quality of reinsurers, and why this is entrenched in all direct writers minimum requirements for their reinsurance counter-parties. Given a specific credit quality, the decision process became more holistic and situation dependent, with the insurers aiming at achieving the most suitable deal for the risks being transferred.

Some respondents felt that a more rounded approach was more appropriate, and that taking into account other factors such as capital position and market position of the reinsurer may lead to more valuable and secure decisions being made.

Section 9 below further analyses the current process of reinsurance business placement.

**Key factors - Non-life insurers**

When placing reinsurance, the following factors were ranked as most important:

- Credit quality
- Price
- Technical expertise

7 of the large insurers described credit quality as the most important factor, with technical expertise being the other highest ranked factor. All three of the niche insurers ranked credit quality as the most important factor, with price being the second most important factor. When considering the other non-life insurers, there were 39 other responses. Of these, 24 ranked credit quality as the most important factor, 5 ranked business relationships as the most important, and 3 felt that technical expertise was the most important factor. 4 insurers said that price and credit quality were the joint most important factors. Reputation was regarded as the second most important factor by 13 non-life insurers, followed by price and technical expertise which were rated second most important on 8 occasions each.

There was a large variety of answers from the non-life insurers, as shown above. The major concerns for most non-life insurers were the need for security and the confidence that the reinsurer would not default on their payments. Often the reinsurance placement criteria had a minimum required credit rating, and emphasised the importance of a strong credit rating. In addition, non-life insurers indicated that they were placed significant reliance on the brokers’ vetting process for different reinsurance programmes.

Other results that appeared include:

- Strong relationships between insurer and reinsurer were important.
- Due to the range of non-life reinsurance options relationships with preferred brokers are key.
• Domicile was not considered important since the need for reinsurance capacity (from whichever country it was available) outweighed the need to obtain this capacity from any particular region.
• The importance of reputation varied, however insurers prefer strong credit ratings.
• Diversification did not feature strongly in respondents’ rankings.

Some insurers stated that they preferred to use locally registered reinsurers but maintained some form of a “prudent risk mitigation” policy, which allowed for spreading of reinsurance risk.

Section 9 below further analyses the current process of reinsurance business placement.

**Credit rating requirements and their influence on the placement of reinsurance - Life insurers**

The results of the survey showed that:

• 13 of the 34 life insurers did not have a minimum credit requirement, sometimes due to the reinsurance programmes being intragroup and not requiring a credit rating.
• The majority of life insurers had a minimum required credit rating. This was usually a minimum rating of A-.

All of the large and niche insurers have minimum credit rating requirements. They did not all give the explicit requirements, but the responses showed that A and A+ were the most common. One respondent described their ranking system where they set restrictions on the amount and type of reinsurance that can be placed with a reinsurer. These limits were based on the reinsurer’s credit rating where the less secure entities had lower exposures.

The results showed that often, any downgrade of a reinsurer’s credit rating would result in a review of the arrangement in order to assess whether the reinsurer remains appropriate. Reinsurers can also be assessed using their capital positions instead of only reviewing the credit rating. Some insurers only considered a specific selection of the major international reinsurers. This reduced the need to analyse credit ratings or other measures of risk.

In summary, credit ratings are an important factor (and in many cases, the most important factor) considered when selecting a reinsurer (within A-rated reinsurers, respondents have indicated that they will consider the financial strength of the reinsurer, and the level of any parental guarantees). In the South African market, insurers often require a minimum level of credit rating for a reinsurer. As a result, a poor credit rating is likely to present a significant barrier to entry. Some respondents suggested a more holistic approach, which applies more weight to other factors (such as capital position and the market position of the reinsurer), may lead to more valuable and secure decisions.
Credit rating requirements and their influence on the placement of reinsurance - Non-life insurers

The results of the survey showed that:

- 52 of the 68 non-life respondents have explicit minimum credit rating requirements for reinsurers.
- The main requirement was a minimum of A-. Some insurers required only BBB. The Board would need to specifically evaluate reinsurers with credit ratings below these levels.
- Insurers sometimes conducted internal evaluations of the reinsurance counterparties. This showed that insurers did not rely solely on credit ratings a measure of security and they valued discretion over concrete rules.
- The reinsurer’s capital position could be used together with credit ratings.
- Some types of reinsurance (for example nuclear) are placed with unrated mutuals and intercompany risk pools.

As for the life insurers, all of the large and niche non-life insurers did have a minimum credit rating when it came to placing reinsurance. One respondent commented that they would not place business with companies domiciled in countries that were deemed, by the applicable reinsurance/risk committee, to present unacceptable risks. This would occur for countries where the standards of regulatory supervision were inappropriately low but could be due to other reasons such as financial distress, political instability or conflict in the country.

There were some discussions regarding other potential metrics for measuring the suitability of reinsurers and respondents discussed whether credit ratings alone are appropriate, or whether more direct measures related to capital position and risk framework maturity could be more appropriate.

Using the credit rating of a subsidiary in South Africa was difficult because this rating is limited to the country’s sovereign rating. South Africa’s recent downgrades may impact the continued suitability of local reinsurers (due to the strict requirements brokers/insurers have when placing their reinsurance business). The introduction of branches can lessen this problem because local branches will be able to use their parents’ credit rating. Parent companies could be required to produce letters of guarantees; industry would need to consider the cost of this requirement.

One non-life company monitors the overall financial condition of the reinsurer over the duration of the reinsurance contract. This monitoring includes:

- Credit rating.
- Ownership of the reinsurer.
- Claims service received.
- Advice received from intermediaries with regard to that reinsurer.
- Market intelligence on the reinsurer’s position.

**Regulatory arbitrage – Life insurers**

The results of the survey showed that:

- 23 of the life insurance respondents did not consider regulatory arbitrage to influence reinsurance placement.
- Price was a greater concern.
- Some insurers only considered South African regulation in their business; therefore there was no scope for arbitrage.

The three insurers that indicated that regulatory arbitrage was a concern explained that it may impact the price of available reinsurance. One of these comments came from a large insurer who stated that, although regulatory arbitrage did not play a role currently, it may in the future for financial reinsurance placements. Reinsuring to their offshore subsidiaries meant that economic capital was more reflective of the risks, and was able to give “more flexibility with regard to assets that can be held to manage the insured/reinsured risks”.

The influence of regulatory arbitrage on the reinsurance decisions of local direct writers was not significant. This may be due to a great dependence on approved reinsurance, which would remove the opportunity for arbitrage. The local reinsurance market may also be considered as suitably priced hence direct writers do not search for better rates created through some form of arbitrage.

**Regulatory arbitrage – Non-life insurers**

- 7 non-life insurers said that they do consider regulatory arbitrage when placing their reinsurance contracts.
- Credit ratings, price and other factors are more important than arbitrage, but this may change in the future if there is an advent of more reinsurance havens that may make arbitrage easier.

One respondent described how they use reinsuring to their offshore subsidiaries where the “economic capital is more reflective of the risk assumed” as a means of arbitrage. Only one of the large non-life insurers felt that there may be some influence from regulatory arbitrage, and stated that it may be possible to reinsure with an entity based in a territory that has lower regulatory capital requirements. Some of the respondents who did not use regulatory arbitrage at the moment did say that as Solvency 2 and SAM came into force, so they may look towards regulatory arbitrage as a meaningful factor when deciding on reinsurance placement. A comment was made that the capital requirements placed on foreign reinsurance by the current SAM specifications, specifically relating to capital relief due to mutual recognition, may have an effect on future placements.
Local or foreign placement – Life insurers

- Local expertise would be important in terms of knowledge of local market conditions. Beyond this, the proximity of local reinsurers is important, as it allows the insurer to access the knowledge of the reinsurer more easily.
- The fact that local reinsurance more readily qualifies as approved reinsurance also encourages the placement of reinsurance in South Africa.
- Capacity is considered, as some insurers may feel that the local market is unable to meet their needs.
- Life insurers placed a greater reliance on the relationships developed with reinsurers, as well as the technical expertise of the reinsurer when it came to the placement of reinsurance.

Any conflicts of interest that arose in the process of placing reinsurance were said to be handled using group policies or control frameworks.

The close proximity of locally based reinsurers was attractive to the direct writers, who gained comfort from the easier availability and contact with the people at reinsurers who made decisions relating to the cost and structure of reinsurance contracts. Dealing with overseas reinsurers was not considered overly burdensome, but there was a distinct advantage from having the opportunity for face-to-face dealings with a local contact.

Local or foreign placement – Non-life insurers

Insurers would consider local reinsurers first and turn to offshore markets if the capacity or expertise was not available locally.

A major advantage of local reinsurers is the proximity to the direct insurers. One respondent stated that the lead reinsurer should be local in order to facilitate easy access to their functions, and have supporting lines which are a diversification of local and offshore reinsurers. Another reinsurer emphasised the diversification benefits of having global reinsurance protection since any local catastrophe would not necessarily affect all of their existing reinsurance arrangements.

Some insurers said that, provided the price is reasonable and the expertise offered is sufficient, there is not much difference between reinsuring locally or abroad. However, local reinsurers have the knowledge to develop a more relevant reinsurance programme that is tailored to the specific needs of the insurer.

One insurer stated that, for cross-border reinsurance, deposits or guarantees paid are often not sufficient to cover the losses in the event of default of a foreign reinsurer.

The following factors were considered important when assessing a reinsurer:

- Brand
Many non-life insurers stated that they have not experienced conflicts of interest; this could be due to the intermediated nature of non-life reinsurance business. One respondent stated that they had a “compliance committee” that oversaw the purchasing of reinsurance and acted as a body to deal with any conflicts.

### 6.4 Intermediated versus non-intermediated reinsurance placements

#### Life reinsurance

Life insurers predominantly placed reinsurance directly. 2 insurers used consultants, but there was no detail on what cases these were used for. 13 life insurers used brokers but these were mainly in addition to direct placement, for catastrophe cover or when insurers were looking to place reinsurance overseas.

7 life insurers said that there were differences in intermediation between life and non-life reinsurance business, and 5 thought that there weren’t. Insurers sometimes used intermediaries when there is insufficient cover in the local market, and insurers need to access overseas reinsurance. 10 life insurers said that there are no differences in intermediation between different types of reinsurance (facultative and treaty), and seven felt that there were differences. The same split of answers applied to the differences between insurers/reinsurers.

During the research process, the following other points were raised by insurers:

- There are no differences in the intermediation of different contract types
- Brokers are mainly used for catastrophe cover
- Direct placement deals with both treaty and facultative
- Brokers are used more for treaty contracts (and catastrophe reinsurance in particular)
- Brokers are used in the placement of non-proportional business
- Brokers are useful when looking at or entering new/unknown markets

Brokers are the most popular method of reinsurance intermediation in non-life reinsurance and direct placement is more common for the life sector.

#### Non-life reinsurance

- The principal form of intermediation is brokers
- 30 respondents use direct placement (alone or in addition to brokers)
The group structures of a company are used for inward reinsurance, hence neither direct placement nor brokerage is applicable in that case. One insurer stated that brokers are used for non-proportional business, and direct placement used for treaty proportional and facultative business.

Other issues that were raised include:

- 12 insurers said brokers are used only for treaty contracts
- 4 insurers said brokers used for facultative arrangements
- 7 insurers said brokers are used for both treaty and facultative
- 7 insurers said they use direct placement for facultative arrangements
- 1 insurer said they use direct placement for treaty placement
- 8 insurers said they use direct placement for both types of arrangement
- 1 insurer that smaller facultative contracts are usually done through direct placement, rather than through a broker

6.5 Costs and value of reinsurance brokers to insurers

Life insurers

Those who responded stated that there were no concerns with the cost of brokers for the services that they received. The value offered by brokers reflects the service received. The broker market, like all service industries, bases its charges on what the market is willing to pay and equilibrium is reached when the price charged by the brokers equals the price that direct writers are willing (and able) to pay.

Non-life insurers

4 non-life insurers stated that the costs of brokers are unreasonable or a matter of concern. One respondent suggested a split of the charge between servicing, placing and technical assistance. This would clarify the services offered for the prices charged.

The remaining insurers considered brokers' charges as reasonable, or they could often negotiate charges down to reasonable levels otherwise. Market forces are often responsible for keeping brokers' charges at an acceptable level.
6.6 Risk transfer and financial reinsurance

Risk protection from reinsurance – Life insurers

This section of the questionnaire dealt with the following issues:

- Use of reinsurance to protect against concentration risk
- The extent to which reinsurance is considered as a form of diversification in product design and reinsurance placement decisions

Concentration risk

The use of reinsurance to protect against concentration risk is split between:

- Management of risks faced by the insurer
- Risks faced by having a concentration of reinsurance with any particular counterparty

Management of concentration of risks written by the insurer was mainly achieved through using catastrophe reinsurance followed by surplus reinsurance arrangements.

Reinsurer concentration risk was allowed for by using multiple reinsurers with multiple lines in order to diversify the risk of reinsurer failure. In addition, insurers selected reinsurers with specific credit ratings. This concentration risk occurs for both individual life and group business, and in the case of the latter, quota share reinsurance is also used to mitigate this risk.

22 life insurers stated that reinsurance provided sufficient protection against concentration risk.

Only 2 life insurers disagreed with the sufficiency of reinsurance protection against concentration risk. One of these respondents said that they used reinsurance as a means of sharing risk, rather than targeting concentration risk specifically.

One insurer stated that it was difficult to judge whether the catastrophe reinsurance offered sufficient protection because there have not been significant catastrophic events in the life space for the reinsurance to be truly tested.

Use of reinsurance as a form of diversification

There were few opinions on whether reinsurance was considered in product design. The responding life insurers highlighted that the presence of reinsurance may allow for higher levels of cover, and that this was used in to design products that meet the needs of the consumers.
**Risk protection from reinsurance – Non-life insurers**

As for life insurers, this section of the questionnaire dealt with the use of reinsurance to manage concentration risk and the extent to which reinsurance is considered as a means of diversification.

**Concentration risk**

The use of reinsurance to protect against concentration risk is split between:

- Management of risks faced by the insurer.
- Risks faced by having a concentration of reinsurance with any particular counterparty.

For non-life insurers, the majority of insurers managed catastrophe and concentration risk together.

One respondent said that the purpose of their reinsurance was to increase capacity as opposed to protect from geographical concentration risk. Another respondent investigated Geo Coding, which identifies concentration of risks by allowing an accurate geographic placement of risks.

To manage concentration of reinsurance, most insurers monitor the amount of reinsurance placed with any one reinsurer and manage this to ensure that there was no undue concentration of risk with one reinsurer. One insurer uses a panel of reinsurers with specific credit quality and they could spread their risk among a number of reinsurers. Some reinsurers apply caps on a “per risk” or “per event” basis to protect from concentration. Non-proportional reinsurance is used to decrease the risk faced by a single event, and proportional reinsurance could decrease the risk faced by a particular industry.

Only 3 non-life insurers were not satisfied with the protection from concentration risk that reinsurance provided. There may be a risk that the total concentration risk was unknown (reinsurance cannot help with risks that companies are not aware of), but there was not a suggestion made as to how this could be addressed. Another stated that there could be greater utilisation than what happens currently.

Non-life insurers that used reinsurance for protection against concentration risk also stated that this protection needed to be based on accurate calculations of the risk faced by insurers. If concentration in any one area is not modelled correctly, there may be a problem with the reinsurer cover.

One insurer said that the local insurer may have South Africa-wide risks, and reinsurance cover may not provide enough protection against this concentration risk. The cost of purchasing a sufficiently extensive reinsurance programme may be prohibitive and this reduces the cost-effectiveness of the protection.
Insurers will purchase sufficient reinsurance based on their risk appetite, and ensure that they have their required level of protection. This introduces a risk that the modelling of the risks they face could be incorrect, leading to an inadequate reinsurance purchase.

**Use of reinsurance as a form of diversification**

Insurers expressed different opinions on whether the diversification benefits of reinsurance were considered in the product design process. This is expected given the diverse nature of the non-life insurance space. Some companies stated that their product design was not influenced by reinsurers and others would only sell a product if an appropriate reinsurance regime/contract/structure was available.

One company argued that diversification was only applicable if the presence of reinsurance allowed the insurer to write a line of business that they would have otherwise been unable to write. Another insurer responded that reinsurance can be used to offer products beyond the insurer’s original risk appetite. Insurers used “carve outs” to protect themselves from risk while still being able to offer full cover to the consumer. If the reinsurance programme could decrease the cost of capital, products could be sold at a reduced price, which may lead to improved competitiveness.

Another response was that diversification was achieved through the sales of a variety of products, rather than through reinsurance. One insurer used reinsurance as a measure of protection of the net account and capital position, but it was not a major driver of product design.

The smaller insurers were more likely to make use of reinsurance, especially when starting their business, because reinsurance would provide capital relief and technical expertise.

Overall, more insurers use reinsurance to improve diversification and reduce the capital cost of selling products.
Financial reinsurance – Life insurers

Types of financial reinsurance

Less than a quarter of the life insurers provided descriptions of the types of financial reinsurance utilised.

Only the below two types of financial reinsurance were described to be actively used by life insurers. This means that these are the most common types and other types of financial reinsurance were not currently in use or that those insurers that declined to comment on financial reinsurance make use of other reinsurance variants. Local reinsurers have however provided an overview of the variations of financial reinsurance sold in South Africa; please see Section 7 below for further details.

Descriptions of the primary financial reinsurance policies used by life insurers are stated below. Note that finite reinsurance is also discussed here as many, although not all, respondents classified finite reinsurance as part of financial reinsurance or more broadly as alternative risk transfer.

Type 1: Asset enhancing – ‘Transfer’ of future profits

Reinsurer provides upfront financing determined as a percentage of the value in force (VIF) of a book of life insurance policies. As the value in force emerges as statutory profits, the specified percentage of the transfer from VIF to profits is paid to the reinsurer in return for the upfront financing received.

Repayment on these and other variants of financial reinsurance are subject to the actual experience of the book; if the profits do not arise from realisation of the VIF the reinsurer does not receive compensation for the financing provided.

These arrangements are mostly embedded into or combined with quota share treaties.

Type 2: Reinsurance commission

These are reinsurance arrangements under which an upfront commission/rebate is provided by the reinsurer to the insurer to fund the cost of entering into new business in return for the insurer’s reinsurance business (often a significant quota share arrangement).

The ‘liability reducing’ type or finite reinsurance used for life insurance was not directly commented on by life insurers.
IFRS recognition & disclosure requirements

Most life insurers stated that they did not make use of financial reinsurance and were hence comfortable with or indifferent to the IFRS recognition and disclosure requirements for financial reinsurance. These insurers did however comment that any potential deficiencies in IFRS recognition and disclosure requirements should be remedied in statutory recognition and disclosure to prevent inappropriate use of financial reinsurance.

For those insurers that did make use of financial reinsurance, the issues stated with regard to financial recognition and disclosure are summarised below.

For IFRS recognition, the key issues raised by life insurers were as follows:

- Financial reinsurance arrangements were stated to be appropriate and non-problematic if the contract exhibited significant risk transfer and could be classified as an insurance contract under IFRS.
  - Insurers classify these contracts as insurance contracts if the repayment of the financing is dependent on the experience of the book of business to which it is attached (i.e. there is risk transfer) or if the financing is part of the standard reinsurance contract and hence classified as insurance.
  - Few insurers discussed issues relating to the materiality of risk transfer required for these contracts to be correctly classified as insurance contracts. Governance processes and independent auditors were cited as being responsible for ensuring appropriate recognition.
  - The idea of ‘unbundling’ the financing portion of the reinsurance contract, for recognition purposes, was not discussed in the written responses. When prompted, insurers found this to be inappropriate for contracts where the financing portion was not a significant portion of the arrangement.
- If these instruments could not be classified as insurance contracts (but rather as investment contracts) then the arrangement seen as inappropriate or should provide no solvency relief.

For statutory recognition, the key issues raised by life insurers were as follows:

- Statutory recognition should be consistent with the economic principles underlying SAM.
  - Insurers found that the assessment of technical provisions should be based on probability weighted best estimate cashflows of the reinsurance arrangement.
  - The assessment of the risk transfer was found to be less relevant for SAM and the impact of the contract on the risk to the organisation should be reflected through the technical provisions and solvency capital requirement.
- Adopting reserving methodologies which are inconsistent with the principles used for the rest of the SAM balance sheet could create the possibility of financial structures which may artificially improve a firm’s solvency position.
Advantages, disadvantages and concerns

Life insurers noted the following advantages of financial reinsurance:

- Improved capital position.
- Assist with cashflow management.
- Provides an option for financing the new business strain of a young business or of new products. Since few potential shareholders understand the business of life insurance like a reinsurer, the absence of financial reinsurance options could significantly reduce the pool of potential investors and inhibit growth in the life insurance industry.

Life insurers noted the following disadvantages of and concerns with financial reinsurance:

- Transfer of future profits.
- Some insurers’ assessment of the cost of this funding option makes it prohibitive.
- Abuse may lead to artificial solvency relief.

Many life insurers stated that appropriate use of financial reinsurance means that there are no significant disadvantages with the arrangement.

*Financial reinsurance – Non-life insurers*

Types of financial reinsurance

Less than a quarter of the non-life insurers provided descriptions of the types of financial reinsurance utilised.

Of the large non-life insurers, none used any financial reinsurance, and only one said that their ART contracts may be seen as financial reinsurance but that all of their contracts were structured with a significant risk element. None of the niche non-insurers had financial reinsurance in place. Only the below three types of financial reinsurance were described to be actively used by non-life insurers. As for life insurers, other variants of financial reinsurance may be in use by non-life insurers that declined to comment. Local reinsurers have however provided an overview of the variations of financial reinsurance sold in South Africa.

The types of financial reinsurance policies used primarily by non-life insurers are as follows:

- Finite reinsurance arrangements
  - Standard finite reinsurance programmes
  - Multi-year finite arrangements such as spread loss programs
- Solvency relief reinsurance with a significant loss corridor
- Ultimate net loss protection
IFRS recognition & disclosure requirements

For IFRS and statutory recognition and disclosure, non-life insurers raised primarily the same issues as life insurers.

Advantages, disadvantages and concerns

Non-life insurers noted the following advantages of financial reinsurance:

- Generally priced lower than capital markets.
- Assists insurers to overcome possible solvency concerns by enabling them to utilise the balance sheet of reinsurers.
- An internationally acceptable form of solvency/capital provided it is underwritten by major global markets.
- One insurer noted that after three years they were able to fund the reinsurance deductible entirely as opposed to paying the premium.
- Reduces new business strain and capital requirements.
- More stable financial results.
- Coverage may be better suited to the insurer. Allows for coverage of non-traditional risks. The cover is also low risk and enables insurers to leverage additional income from investment spreads.
- Optimise efficiency in terms of regulatory and tax requirements.
- Upfront financing provides the insurer with the opportunity to learn about the risk and the industry and can, over time, assess their appetite for sharing in such risks.

Non-life insurers noted the following disadvantages of and concerns with financial reinsurance:

- Potentially of not being able to recognise the reinsurance (if there is no risk transfer), and not achieving your objective.
- Abuse may lead to artificial solvency relief.
- More disclosure to prove significant risk transfer.
- More disclosure to ensure appropriate tax and financial condition analysis.
- Transfer of future profits.
- If incorrectly structured, the severity of the losses can substantially impact an insurer's balance sheet in the first year of a finite reinsurance programme.
- Finite risk programmes often have complex tax and accounting implications.

A few non-life insurers stated that they may be forced to consider use of financial reinsurance agreements should SAM be implemented in its current form.
In addition a large non-life insurer stated that a market exists for such products and allowing these to be written within the insurance industry framework keeps these products in a regulated market. If insurers were not allowed to write such products it was argued that these products would simply go off balance sheet and operate in an unregulated market.

6.7 Trends and issues

Structure of the local reinsurance market – Life insurers

Life and non-life insurers agreed with brokers and reinsurers by saying that diversification and the sharing of risk with parent companies was the main reason why reinsurers would use offshore retrocessions. Life insurers were not able to provide substantial information on the extent of retrocessions used by reinsurers.

18 life insurers felt that local reinsurers would not have sufficient available capacity if foreign reinsurers withdraw from the South African market. Only one respondent (one of the niche insurers) felt that the local reinsurers could manage the capacity. There were also concerns raised about the subsequent lack of geographical diversification without foreign reinsurers available.

There was some confusion in the wording of the questions in the questionnaire that related to this section, as the respondents were unsure whether the term “foreign reinsurers” referred to those who operated offshore or those who had foreign parents. This made interpretation of the answers slightly more difficult. The local market would not be able to offer sufficient (if any) capacity if the reinsurers with foreign parents were to leave the market. It was difficult to conclude whether the market would cope if the offshore players were not allowed to conduct their operations here, but direct writers felt that the current local reinsurance market would have enough capacity to meet the majority of the local reinsurance.

Some respondents were concerned about the extent of retrocessions, although the reasons for these opinions were not clear. Perhaps they were based on a feeling that this meant that there was insufficient capital held locally to meet claims as they fall due, and there was thus a lower level of security.

Structure of the local reinsurance market – Non-life insurers

6 non-life insurers offered opinions on the amount of reinsurance that is retroceded offshore, with the answers being that the majority of reinsurance is retroceded, and the other answer being that an exercise which had been carried out into local reinsurance showed that 30\% to 40\% of non-life reinsurance was written locally (proportions in this range were repeated by different insurers), and a large proportion of that was then retroceded.

57 non-life insurers did not believe that local reinsurers would be able to carry the risks of the insurance market should foreign reinsurers leave. Only 4 thought that the local market would cope, with one being a niche
insurer. None of the large insurers felt that the local reinsurers could cope. Again there was ambiguity in the exact definition of “foreign reinsurers”. One respondent made the comment that there was a need for more foreign reinsurers in order to promote more competition in the reinsurance sector.

**Global trends and the impact of branches on South Africa’s skill levels – Life and Non-life insurers**

The majority of respondents said that trends towards centralisation and better risk management are seen globally.

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Positive impact from branches</th>
<th>Negative impact from branches</th>
<th>Neutral Impact/No comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Brokers</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>25</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>Large</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Medium</td>
<td>21</td>
<td>20</td>
<td>19</td>
</tr>
<tr>
<td>Niche</td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Life insurers</td>
<td>3</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Large</td>
<td>1</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Medium</td>
<td>2</td>
<td>7</td>
<td>17</td>
</tr>
<tr>
<td>Niche</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
</tbody>
</table>

Branches may operate on a more lenient basis and could lead to less demand for local skills.

It is uncertain how subsidiaries that are currently capitalised would react to the change. If they remained in South Africa, the structure of their operation would not change significantly and there would be a positive impact due to branches opening locally. One comment suggested that the possible lower capital requirements for branches would make subsidiaries uncompetitive and this would drive skills out of South Africa. There could be a move to centralise functions within the parent company/country and this would decrease the number of people and level of skills employed locally.

Life insurers noticed the following trends:

- Greater centralisation
- Increased focus on risk-adjusted return on capital

The neutral impact was due to:

- An insignificant impact from the change to branches
• An offset between jobs lost by subsidiaries and jobs gained through the influx of branches

The negative impact was as a result of centralisation of reinsurer functions offshore. This would lead to:

• Job losses
• Skill drainage
• Capital flight

The possible positive impact of change would be an improvement in skills and an increase in jobs due to branches coming into South Africa.

The impact would be influenced by the governance and capital requirements of branches. Branches may still want to maintain some form of physical presence in South Africa and hence would need local employees.

There was not a consistent answer to whether branches operating in South Africa would have a positive or negative impact. The responses above highlight insurer concerns around:

• The impact on the level of reinsurer assets backing reinsurance liabilities held in South Africa
• The impact on the level of reinsurer capital held in South Africa
  o This refers to amount of total capital (excess of assets over liabilities) held by South African reinsurers.
• Job losses in the reinsurance sector as subsidiaries convert to branches.

These impacts would be assessed by considering changes in the above factors depending on the regulatory framework adopted and any mitigation measures introduced.

**Africa – Life insurers**

• 5 life insurers said that their African subsidiaries would make their own reinsurance decisions, with four of the large insurers stating that the African subsidiary would make the decisions. One of the niche insurers stated that there was a combination of the subsidiary placing some of the risks, and a line of business being reinsured via their South African business.
• 3 life insurers said that there was a central policy that was instituted across all companies in the group. This was done to ensure consistency in terms of basing decisions on the same capital or security requirements, and limiting risk in the reinsurance contracts taken out.

For the 8 life insurers who said that they had African business, two said that both options (local reinsurance purchases and purchases through South African entities) were used. The other 6 all had their reinsurance business locally placed, with some respondents saying that the South African business offered oversight or advice but was not involved in the placing of the business.
Compulsory cessions to local reinsurers imposed by African regulations were the most common disadvantage listed.

These cessions were felt to distort the placement of reinsurance, as companies are forced to reinsure with reinsurers that may not have the credit rating, security or expertise that the insurer is comfortable with. Forcing cessions with African reinsurers may mean that profitable operations are jeopardised, which could then lead to higher costs for consumers.

Only 3 life insurers felt there was a move to using African reinsurers to a greater extent. One of the respondents did point out that this was due more to local regulations forcing placement with African reinsurers, rather than a choice made by the company itself. This makes conducting insurance business in these countries more complex, as there are now risks related to the reinsurance of these risks that would not be apparent if there was free choice of reinsurers.

The 13 respondents who did not think that there was a movement towards using African reinsurers justified their answer by saying that these reinsurers did not offer the required security, capital, expertise, or reputational strength for them to be attractive reinsurance options.

The regulatory nature of African countries made conducting reinsurance business there troublesome for the direct writers. Compulsory cessions, whilst potentially beneficial for the local economy, did not assist the South African direct writer in achieving the necessary security and capital backing that is usually required when buying reinsurance. The experience of the South African direct writers in selling business in Africa, and thus having first-hand experience of the situation on the continent, was limited to a few companies, so it was difficult to obtain significant comments or perspectives.

_Africa – Non-life insurers_

16 of the non-life insurers had African operations on which to base their opinions on the placement of reinsurance locally in Africa.

For the large insurers, there was a mix of independence on the part of the African subsidiary, and some oversight from the South African parent company. One of these insurers said that the reinsurance placements of the African subsidiary are handled from South Africa, and another said that although the African operations directly reinsure their risks, the management of the placement and negotiations would take place on South Africa.

There was a mix between independence and group-based decisions, with some respondents saying that the African subsidiary was able to make their own decisions when it came to placing reinsurance, and others saying that it was decided on centrally in South Africa.
Africa-based decisions are favoured by some companies as they are made with a more detailed knowledge of the insurance/reinsurance conditions of that country. Most of the answers contained information on the need to be within the legal requirements of whichever country they are operating (with a particular emphasis on compulsory cessions). One respondent said that there was a group programme in place, and the African subsidiaries were named as the reinsured party, which was a unique response.

The non-life insurers gave similar answers to the decisions made when placing the reinsurance in Africa, with one comment being made that the reinsurance placed with some of the African-based reinsurers will be retroceded back into South Africa, and again there was a comment of a group reinsurance contract structure where both South African and African risks are reinsured through the same contract.

23 non-life insurers gave some perspective on the advantages and disadvantages of African regulations, although it seemed that for some the comments made were based on perceptions of the market rather than actual experience in Africa.

Compulsory cessions were raised as a disadvantage due to the inability to reinsure all of the risk outside of the country in which the risk is based. Inconsistency of regulation between African states was another disadvantage mentioned, which may lead to regulatory compliance duplication, and thus increased costs.

The fact that the cessions are compulsory means that there is a disregard for any credit rating or solvency requirements, which may make the placement of reinsurance slightly more risky than may otherwise be the case.

49 of the non-life insurers surveyed did not think that there was a move towards using African reinsurers. Only 6 insurers thought that there was a move towards a greater use of these companies. The main reason given for not making greater use of African reinsurers was a lack of security in terms of credit ratings and capital requirements. One comment was made was that there was an increased use of African reinsurers for non-South African insurers/subsidiaries, but this was not extended to South African companies.

The regulatory nature of African countries made conducting reinsurance business there troublesome for the direct writers. Compulsory cessions, whilst potentially beneficial for the local economy, did not assist the South African direct writer in achieving the necessary security and capital backing that is usually required when buying reinsurance.

**Parental guarantees, retrocessions and the requirements of counterparties - Life insurers**

A life insurer gave a response on the issue of parental guarantees and retrocessions, and they explained that there were no explicit guarantees from their holding company, nor was there any reinsurance between the
holding company and this insurer. It was explained that there were some retrocessions placed from the insurer to the holding company where cell captives had reinsured with the insurer. The only answer given on the type of company used for retrocessions was that local subsidiaries of foreign reinsurers were used for retrocessions. No answers were given by any of the large or niche insurers.

**Parental guarantees, retrocessions and the requirements of counterparties – Non-life insurers**

Only 2 non-life insurers gave perspectives on the presence of parental guarantees and intra-group retrocessions. These were from two of the large insurers. One described how there was a requirement from an insurer for there to be adequate protection for the reinsurer in the form of either a group retrocession arrangement or a parental guarantee. The other answer gave a brief description of the structure of retrocessions, and how insurers provide reinsurance capacity to group insurers using formal reinsurance arrangements.

Only one comment was offered on whether there were differences between the retrocession arrangements between South Africa and elsewhere, and this described that retrocessions should be treated in the same way as reinsurance, and subject to the same regulations. This may be an important point when it comes to evaluating the impacts of reinsurance regulation, as retrocessions may not be at the forefront of our considerations.

**Skills and development, and the expertise provided by reinsurers – Life insurers**

The answers given by life insurers were common to the other groups of stakeholders, and display a level of consistency among the market in terms of the perception of the skills offered by a reinsurer.

15 life insurers felt that there was some level of technical assistance offered, with nine feeling that there was significant assistance given by reinsurers. One mentioned that they sought assistance on the non-traditional products that they sell, highlighting health policies as a particular example. Allied to this were the comments that there was more assistance required for those products/lines of business for which the insurers did not have significant experience. This assistance was also then said to extend to the establishment of appropriate underwriting guidelines.

Smaller life insurers also placed greater dependence on the expertise of reinsurers, which is expected given their more limited resources.

**Barriers to entry and competition**

There were 15 life insurers saying that there was some impact on barriers to entry due to technical assistance offered by reinsurers whilst 8 life insurers said there was a significant impact, and only one said that there was no impact.
A large life insurer also stated that they believed that a reinsurer was in the position to provide all the technical expertise that would be required to start an insurer. The presence of technical assistance may also allow for some insurers to price more competitively, which may allow these insurers to undercut other new-entrants, thus acting as a barrier to entry.

The knowledge gained through the assistance of the reinsurer may give the direct writer an indication of future trends and industry direction, which could prove to be helpful in designing new products and establishing a larger foothold in the market.

There was also mention made of the impact that reinsurance would have on new entrants’ capital requirements, and that it may make the cost of entering a market lower. The general consensus was that using a reinsurer would allow for easier entry into the insurance market, due to the ability to leverage off the skills base of the reinsurer, and to decrease the capital requirements of the new company. These would then reduce the barriers to entry and improve the ability of the new insurer to compete in the market.

There were 20 life insurers who thought there was only some impact on the level of competition in the market as a result of barriers to entry, with four feeling there was a significant impact, and again only one who thought there was no impact. There was a comment made that the reinsurance industry may be more differentiated by the levels of technical assistance provided by each reinsurer, as a reinsurer offering more significant levels of assistance may distinguish themselves from others.

Again the point was raised that the ability of the direct writer to access technical assistance could lead to better priced premiums, which then leads to more business through being more competitive.

The general feeling was that there was some assistance offered through the presence of technical expertise as a part of the reinsurance transaction. Certain respondents felt that this assistance was sufficient to allow for a new entrant to the insurance industry to develop their skills sufficiently to become independent soon after entering the market. This could lead to access to the insurance market being easier, and could promote a more competitive environment.

**Skills and development, and the expertise provided by reinsurers – Non-life insurers**

The most common services offered by reinsurers are:

- Underwriting
- Pricing
- Product development
The opinions of non-life insurers tended to gravitate to there being some assistance from the technical assistance offered by reinsurers, with the majority of respondents saying that this was the case. There were equal numbers saying that there was no impact and a significant impact from the assistance provided, but it seemed that these views were determined by the individual experience of these companies. The technical expertise that was most sought after was that in the specialised or niche areas of insurance, especially where there may not be significant local expertise. This may also apply to more globally prevalent risks, such as terrorism risk. Training given by reinsurers was also said to be a useful form of technical assistance.

**Barriers to entry and competition**

The impact on barriers to entry comes through where smaller players are not able to enter the market because they do not have the time or resources to develop the necessary technical expertise, and thus would rely on the expertise of reinsurers.

One non-life company said that it was not convinced that reinsurers should be providing assistance to new entrants, as this could be a breach of confidentiality with existing insurers.

The views of the non-life insurers were mixed, but the most common opinion on the impact on competition was that there was “Some impact” on the levels of competition in the market. The comment was made that there would be an impact if the lack of technical assistance led to there being fewer new entrants into the market (due to difficulties in developing the required knowledge/pricing for the market), and then lower levels of competition. This may then also have a detrimental impact on improving the levels of capacity in the local market.

An interesting point made was that the levels of competition could also be influenced by the improved pricing that technical assistance might create – if an insurer were to have a more accurate pricing strategy due to reinsurer assistance, and then there may be a competitive advantage resulting from this assistance. On the other hand, as one non-life insurer pointed out, if there was to be the same level of assistance provided to all insurers, then there would be a market with little price differentiation, and perhaps a decrease in the levels of competitiveness.
7 South African reinsurance from reinsurers’ perspectives

This section provides the results of the local survey and interviews conducted by PwC for all reinsurers in South Africa. There were 9 reinsurers surveyed.

Where possible, summary statistics of distinct answers are provided below.

7.1 Reinsurers’ strategies and challenges

Reinsurers and their local capacity

The table below provides a representation of the numbers of each respondent who gave an opinion on the use of professional reinsurers.

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Prefer professional reinsurers</th>
<th>Indifferent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Brokers</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>46</td>
<td>22</td>
</tr>
<tr>
<td>Life insurers</td>
<td>16</td>
<td>18</td>
</tr>
</tbody>
</table>

Reinsurers had no comments on the preference of placing reinsurance with professional reinsurers. The following two issues were noted:

- There is sufficient capacity for facultative reinsurance contracts (in general) however the local reinsurance industry may not have the expertise, skills or capacity to reinsure some of the larger or more complicated risks.
- The small size of the local reinsurance market (in terms of number of operators) was said to be a limitation on the capacity offered by this market.

Reinsurers may not want more than a specific exposure to one risk which reduces the capacity offered in the market. Reinsurers may be able, but not willing to provide for the risk. One reinsurer stated that the capacity provided by South African markets was “immaterial” because the purpose of reinsurance is to spread risk globally, and there will always be sufficient capital on a global scale. This view was given for all types of reinsurance contract.
7 of the 9 reinsurers said that there is sufficient capacity in the local market for treaty contracts. One reinsurer said that foreign reinsurers contributed to some of this capacity because local companies may not always have the skills and capacity to meet some of the bigger or more complex risks.

Some reinsurers stated that there was sufficient capacity for small to medium companies. The larger companies looking for catastrophe protection need to supplement their reinsurance programmes with foreign reinsurance.

The table below summarises the responses on the local capacity for catastrophe risk:

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Sufficient capacity in the local CAT market</th>
<th>Insufficient capacity in the local CAT market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Brokers</td>
<td>-</td>
<td>5</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>20</td>
<td>38</td>
</tr>
<tr>
<td>Life insurers</td>
<td>14</td>
<td>15</td>
</tr>
</tbody>
</table>

The reinsurers said that only the CAT market amongst other reinsurance arrangements may need assistance through offshore capacity. Offshore reinsurers may have taken some of the local treaty and facultative market and local reinsurers believe that they are able to cater for the remaining requirements of the local direct writers.
Types of reinsurance used and the market for reinsurance

Split of reinsurers between lines of business

<table>
<thead>
<tr>
<th>Life versus Non-life</th>
<th>Primarily Life Reinsurer</th>
<th>Primarily Non-life Reinsurer</th>
<th>Large Life and Non-Life Reinsurer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of reinsurers</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Treaty versus facultative</td>
<td>Primarily treaty business</td>
<td>Primarily facultative business</td>
<td>Both</td>
</tr>
<tr>
<td>Number of reinsurers</td>
<td>1</td>
<td>-</td>
<td>8</td>
</tr>
<tr>
<td>Proportional versus non-proportional</td>
<td>Primarily proportional business</td>
<td>Primarily non-proportional business</td>
<td>Both</td>
</tr>
<tr>
<td>Number of reinsurers</td>
<td>1</td>
<td>-</td>
<td>8</td>
</tr>
</tbody>
</table>

There were no easily identifiable trends in terms of whether quota share or surplus structures were preferred or more popular, and it is thus difficult to draw any significant conclusions from this theme.

The following characteristics all added to the competitive nature of the reinsurance industry:

- The number of reinsurers available
- Ease of access to reinsurers
- Availability of capacity

All reinsurers felt that the reinsurance sector was competitive. One reinsurer said that this was because there is a limited local market for reinsurance, and so there is significant pressure to keep prices reasonable in order to maintain a sufficient level of business. Another reinsurer said that the fact that locally registered reinsurers were able to keep prices in line with those offered by international, non-registered reinsurers showed that the local market is competitive. In addition it was stated that the large range of products and personnel available meant that the levels of competition would be significant.

Interestingly, the views on the impact of regulation and barriers to entry on levels of competition were not so clear cut. Some felt that the lack of reinsurer-specific regulation contributed to competition by allowing foreign reinsurers to enter our market and compete. Others felt that South African regulation had a limiting effect on competition. 5 respondents were of the view that barriers to entry limited competition, due to the need to register a local company in order to sell approved reinsurance in South Africa.

5 reinsurers felt that the level of competition was not a problem, and that we have healthy rates of competition currently.
The 3 reinsurers who felt that the level of competition was a problem said that the problem was caused by a lack of a level playing field between local and foreign reinsurers. In addition, these reinsurers felt that the cost of local registration was too high.

There were no significant suggestions given by reinsurers as a method of levelling the playing fields. A comment was made that any decisions on the future structure of reinsurance businesses was important, and needed to be assessed as they could either improve or worsen the current levels of competition. The reinsurers were all of the opinion that their market was adequately competitive, and explained that the number of reinsurers allowed for sufficient options for those direct writers looking to place reinsurance. The types of contracts offered show that South Africa has a diverse reinsurance market, with the majority of the needs of the direct writers being catered for locally.

**The risks not dealt with sufficiently by reinsurers, and how to cure this problem**

The risks that may be under-catered for were not considered a problem by eight reinsurers (with the reason often being given as there being sufficiently accessible external reinsurance markets for these risks).

Risks mentioned as being possibly under-catered included risks such as:

- Aviation
- Pandemics
- Gradual pollution risks
- Financial/market risk
- Longevity risk

Hedging of market risk was regularly referred to as the primary solution whilst one reinsurer stated that market risk would be a marketable risk if reinsurers were to offer it. It was also stated that there is a need to avoid government/regulator intervention when considering the risks that might not be covered by reinsurers, as the distortions caused by this intervention may lead to the market behaving irregularly, and reinsurers being unable to take on other important risks that cedants want to transfer.
7.2 Regulatory framework, current short-comings and desired change

Strategic and operational concerns with the implementation of SAM

The local questionnaire provided respondents with the opportunity to raise any strategic and/or operational concerns with the management and reporting of reinsurance under the SAM regime.

A summary of the SAM issues mentioned by reinsurers is provided below.

Strategic concerns – Reinsurers

- Reinsurers were impacted by the change in capital requirements to a greater extent than the impact these changes had on most insurers.
  - This potentially has an impact on business in South Africa. It could potentially lead to less capacity locally with more business having to be retroceded offshore.
- Duplication of effort for a subsidiary of a global group for little perceived benefit to the group or insurer clients.
- Group diversification strategies are not taken into consideration in determining capital requirements for reinsurers under SAM.
- Issues regarding capital charges credit for reinsurance are still unclear; will capital charges be based on local domicile or reinsurer security strength or combination of both?
- Will security for liabilities held (letter of credit, bank guarantee or cash reserve deposits) enhance security rating / reduce capital charge?
- Offshore reinsurers operating in this market do not need to comply with SAM or Solvency 2.
  - Compliance adds significant additional operating expenses resulting in a competitive disadvantage.
- Wording of reinsurance contracts
  - Under SAM the clients are forced to take account of clauses such as "if the experience is poor the reinsurer has a right to increase rates" in contracts and set up reserves if applicable. Reinsurers are therefore forced to remove some of these clauses from their contracts which provided protection in the past.
- Skills availability to meet SAM requirements across Pillars I and II.

Operational concerns – Reinsurers

- Cost of implementing SAM
- Granularity of available data
**Composite reinsurers**

All reinsurers preferred allowing composite reinsurers with the primary reasons being:

- More efficient corporate governance requiring only one board, audit committee, financial statements, and etcetera; especially if there is only one shareholder.
- Diversification within a single legal entity as well as easier capital allocation between different segments.
- Reduction in administration and associated expenses.
- Economies of scale.
- More complete package to present to clients.
- Operate as a single tax entity.

No disadvantages of composites were noted from reinsurers.

**Approved versus non-approved reinsurance**

6 of the 9 reinsurers preferred removal of the requirement for reinsurance to be approved.

Reinsurers who viewed approved reinsurance as valuable and relevant in the South African market listed the following reasons:

- Non-approved reinsurance increases the risks for insurers (and for the local market) as the foreign reinsurers are not supervised and regulated by the FSB.
- Foreign reinsurers can enter/exit the local market as they see fit - there is a risk that reinsurance capacity provided by foreign reinsurers might shrink in South Africa if a foreign market is offering better terms and conditions.
- There is also the risk that innocent/passive capacity provided by foreign reinsurers will add to competitive pressure in the local market and make the local insurers vulnerable to failure.

Some respondents felt that charges to insurers for the use of a non-approved reinsurer who is not locally registered should generally be more stringent.

Reinsurers who viewed approved reinsurance as no longer relevant to the South African industry listed the following reasons:

- Non-approved reinsurance introduces additional cost from a capital and an administrative point of view.
• Credit for reinsurance should be based on the quality of the security provided rather than domicile of security. Specific enhancements of creditworthiness (such as LOC bank guarantee or cash reserve deposits) should reduce capital charges relating to reinsurance.
• Reinsurers are required to make provisions for counterparty default risk in their capital requirements; provided that SAM calibrations and the rating agency assessments are reliable.
• Local cedants should be encouraged to monitor their concentration risk and adequately manage their reinsurance programmes as opposed to requiring reinsurers to post collateral.

Branches versus subsidiaries

Branches versus subsidiaries – Encouragement to operate as a branch or subsidiary

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Preferred Subsidiaries</th>
<th>Preferred allowing both branches and subsidiaries</th>
<th>No Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurer</td>
<td>2</td>
<td>6</td>
<td>1</td>
</tr>
</tbody>
</table>

Reinsurers who viewed not allowing branch structures as valuable and relevant in the South African market listed the following reasons:

• Develop local expertise
• Maintain capital in the country - capitalisation in South Africa ensures that funds are maintained in SA to meet local liabilities.
• Local employment
• Development of the local economy
• Foreign reinsurers operating as a subsidiary would be subject to oversight by the local regulator. Foreign reinsurers operating as a branch might be subject to less stringent oversight by a foreign regulator and the small size of the South African operation is unlikely to attract much attention.
• If South Africa wants to remain the leading (re)insurance market on the continent, it is essential to maintain a strong skills base in South Africa. A strong local reinsurance market provides the skills for a gateway to Africa approach.

Reinsurers who viewed allowing branch structures as valuable and relevant in the South African market listed the following reasons:

• The additional regulatory oversight that comes from the subsidiary structure does not add significant value to the insurers.
• The argument for branches is stronger where local governance requirements to protect subsidiary shareholders are not required due to many local reinsurers being fully owned by the parent company (some subsidiaries also hold with parental guarantees).
• Branches will allow for a levelling of the playing field with cross-border reinsurers.
• Branches will be more cost-effective.
• Local ceding companies would gain access to the higher security of the parent companies.
• Reinsurers should be able to choose the structure they believe to be most appropriate to ensure fairness and market efficiency.
• It would seem inconsistent with the goal of third country equivalence under SAM not to allow branches of at least Solvency 2 regulated reinsurers to write business in South Africa. Therefore to the extent that the goal of third country equivalence is being pursued the branch question for reinsurers arises.

**Mutual recognition**

The reinsurers would most likely be the most affected by the achievement of mutual recognition due to their international nature and the existence of parents located in countries that South Africa may seek to enter into mutual recognition arrangements with.

**Mutual recognition – Risks and Benefits**

The reinsurers felt that mutual recognition may lead to lower levels of regulatory duplication, and could therefore lead to lower costs in conducting business in South Africa. There was a concern raised with the potential for inconsistency in the application of regulation across different regimes, and this may make regulation less applicable to the local environment. There was also a risk of there being differences in the details between different regimes, leading to the mutual recognition being less effective.

The benefits of allowing for mutual recognition would be an increase in the fluidity of the international reinsurance markets, as companies find it easier to conduct business in a variety of markets. There is also a potential advantage of South Africa becoming a more trusted territory in terms of regulatory strength, which may lead to improved confidence in placing business locally.

**Capital requirements**

**Capital requirements – Non-proportional reinsurance**

The reinsurers were mainly of the opinion that the recognition of non-proportional reinsurance in the SAM capital requirements calculations was inadequate. There were also concerns relating to the complexity of the calculation regarding non-proportional reinsurance. The detailed responses will be considered by the regulator.

**Insurers taking on inwards reinsurance**

The reinsurers were asked to consider whether direct writers should be able to take on inwards reinsurance. The majority of respondents did feel that there were no reasons why this should not be allowed, as it would
enable the direct writers to diversify their business. However, some of the reinsurers were of the view that direct writers would need to display sufficient skills such that they did not expose themselves to increased risks that could threaten their policyholder’s interests.

A distinction was made between facultative and treaty reinsurance, with reinsurers feeling that the skills required for treaty reinsurance may be beyond those possessed by direct writers, and that facultative reinsurance may therefore be more appropriate for inwards reinsurance business. Reinsurers also felt that they would need to adopt some form of “ring-fencing” between the direct reinsurance and reinsurance business that is written by direct writers. Reinsurers also felt that separate reporting for these two types of reinsurance was required.

7.3 **Key factors influencing reinsurance decisions**

Only 3 reinsurers gave their perspective on the factors that are considered when placing reinsurance. The following factors were ranked by reinsurers as most important:

- Credit quality
- Price (most important for non-life business)
- Reputation
- Business relationship (mainly for life business)

The answers of these 3 varied, with 2 being consistent in saying that credit quality was the most important aspect that was considered, and domicile the least important. Reputation and price were the next most important qualities. The third respondent split their response by life and non-life business. Non-life had price as its most important factor, although this was only ranked as third most important in the life sphere.

Technical skills and expertise were judged to be most important for life insurers, with diversification and domicile being the least important. And although the business relationship was judged as the second most important factor for life business, this was second least important for the non-life insurers. The distinction between the two spheres of reinsurance were further emphasised by insurers and by reinsurers during interviews.

**Regulatory arbitrage**

The 4 reinsurers who gave an opinion on regulatory arbitrage said that regulatory arbitrage did not influence the placing of reinsurance and that other factors such as skills, price and capacity were more crucial factors that influenced the choice of placement of reinsurance.
Credit rating requirements

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Yes to credit rating restrictions</th>
<th>No to credit rating restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Brokers</td>
<td>5</td>
<td>-</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>52</td>
<td>16</td>
</tr>
<tr>
<td>Life insurers</td>
<td>21</td>
<td>13</td>
</tr>
</tbody>
</table>

The ratings given in this section refer to the Local Currency Scale Ratings, which are then mapped to South African National Scale Ratings by the various ratings agencies. The National Scale Ratings express the relative creditworthiness of the entity with that rating. These scales then offer a finer distinction in credit quality between various issuers. As an example to be used for reference, the table below demonstrates the mapping between the two scales from Standard and Poor’s, dated 15 October 2012.

<table>
<thead>
<tr>
<th>Global Scale Rating (Local Currency)</th>
<th>National Scale Long-Term Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBB+ and above</td>
<td>zaAAA and zaAA+</td>
</tr>
<tr>
<td>BBB</td>
<td>zaAA+ and zaAA</td>
</tr>
<tr>
<td>BBB-</td>
<td>zaAA and zaAA-</td>
</tr>
<tr>
<td>BB+</td>
<td>zaA+, zaA and zaA-</td>
</tr>
<tr>
<td>BB</td>
<td>zaA-, zaBBB+ and zaBBB</td>
</tr>
<tr>
<td>BB-</td>
<td>zaBBB, zaBBB- and zaBBB+</td>
</tr>
<tr>
<td>B+</td>
<td>zaBB+, zaBB and zaBB+</td>
</tr>
<tr>
<td>B</td>
<td>zaBB-, zaB+ and zaB</td>
</tr>
<tr>
<td>B-</td>
<td>zaB and zaB-</td>
</tr>
<tr>
<td>CCC+</td>
<td>zaB- and zaCCC+</td>
</tr>
<tr>
<td>CCC</td>
<td>zaCCC+ and zaCCC</td>
</tr>
<tr>
<td>CCC-</td>
<td>zaCCC and zaCCC-</td>
</tr>
<tr>
<td>CC</td>
<td>zaCC</td>
</tr>
<tr>
<td>SD</td>
<td>SD</td>
</tr>
<tr>
<td>D</td>
<td>D</td>
</tr>
</tbody>
</table>

One reinsurer did not have any restriction, and explained that this was because they are only allowed to retrocede to their parent, and thus this type of restriction was not necessary. The other reinsurer that did not have any explicit credit rating requirements explained that although there was no definitive minimum requirement for credit ratings, the nature of their assessment of reinsurers meant that 95% of their business is placed with businesses whose rating is A- or higher.

The 2 reinsurers which gave credit rating restrictions said that they would not place business with companies who had ratings below A and A-, while the others had more general answers describing that the reinsurance...
policies of the parent group decided whether or not they could place business with an external company. One reinsurer stated that the requirement was that no business could be placed with any company who had a lower credit rating than themselves.

7.4 **Considerations of group structure, parent supervision and involvement and retrocession**

- 5 reinsurers used only intra-group retrocessions
- 4 reinsurers used both parental guarantees and retrocessions. There were no cases of reinsurers having only parental guarantees.

One reinsurer said that the fact that they didn’t have a parental guarantee was due to “deposit back practice”.

All forms of reinsurance (proportional and non-proportional) were said to be used to retrocede risk back to parent companies or within the group. There did seem to be some differences in which contracts were used for life and non-life retrocessions, although there was not any consistency between the respondents in this regard. Some reinsurers said that a retrocession contract with a parent company did allow for a reduction in TCAR. Quota share was said to be the preferred structure for retroceding group business as there is a decreased administrative burden.

External retrocessions are only considered in very specialised cases. One example would be catastrophe cover above a certain limit. The credit rating requirements discussed above would also apply to retrocession arrangements – one respondent said that although they only retrocede to their parent, the technical requirement for retrocession is a credit rating of A- or above.

4 respondents felt that there were differences in the way that South Africa treats retrocessions, as compared to the rest of the world. The comments that were made in this regard were that some countries have restrictions on the extent of retrocessions, collateralisation of reinsurance arrangements is not a global requirement, and some African countries enforce a system of compulsory cessions to local reinsurers whereas in South Africa there is no such compulsory requirement.

Retrocessions are a significant part of local reinsurance operations, and the extent of retrocessions in South Africa indicates that there is already a significant movement of capital out of South Africa. It must then be questioned how much more of this capital will be sent offshore in the case of branches being introduced. The use of intra-group retrocessions means that capital is consolidated at a group level and should be re-directed to the subsidiary as necessary.
7.5 Risk transfer and financial reinsurance

Risk protection from reinsurance

Concentration risk

Catastrophe reinsurance was given by three reinsurers as a means of limiting concentration risk. The use of retrocessions was said to mean that concentration risks were then dealt with at a group/parent level. One company said that their retrocession agreements were not intended to reduce concentration risk, and the others described the way that their reinsurance contracts provide protection through their excess of loss structure.

Use of reinsurance as a form of diversification

Reinsurers were not required to describe the extent that reinsurance is used as a form of diversification, and as such only one reinsurer offered a response. This reinsurer said that diversification was a consideration in the reinsurance purchasing decision, but from a reinsurer’s perspective, was not part of the product design.

It was also stated that reinsurance does provide sufficient protection from concentration risk, and suggested that the provisions under the SAM regulatory framework should take into account the highly diversified nature of reinsurance portfolios in the risk capital calculation.

Financial reinsurance

Types of financial reinsurance

All reinsurers provided descriptions of the types of financial reinsurance utilised. 4 of the 9 local reinsurers stated that they did not sell financial reinsurance.

The types of financial reinsurance policies typically sold by locally registered reinsurers are as follows:

- Standard risk treaties with modified cashflow arrangements (primarily life insurance).
- Asset enhancing transfer of future profits (primarily life insurance).
- Reinsurance commission on a quota share basis.
- Cash financial reinsurance with or without deficit account structures; on a new-business financing basis or in-force portfolio basis (with material risk transfer on different classes of business).
- Non-cash financial reinsurance (with material risk transfer on different classes of business).

Note ‘cash’ financial reinsurance refers to an arrangement where cash is transferred between the parties, often to provide an asset to the insurer. ‘Non-cash’ financial reinsurance occurs where an obligation is transferred, often an asset is provided to an insurer by means of a ‘reinsurance receivable’ being accounted for by the insurer.
One reinsurer offered the following opinion on financial and finite reinsurance:

- Financial reinsurance, or structured reinsurance, involves reinsuring selected risks (e.g. reinsure the risk of extreme (if remote) event losses whilst the cedant retains the risk of smaller but more probable losses). This enables the ceding insurance company to control the level and nature of risk retained on their balance sheet according to its own risk appetite. As such financial reinsurance is a legitimate capital management tool offering genuine risk transfer.
- Finite reinsurance is a term often used in the context of solutions which limit the reinsurer’s downside compared to traditional reinsurance, leaving more if not most of that risk with the insured. Such reinsurance may have a legitimate purpose, e.g. cash flow management. However, if not accounted for correctly, these can distort financial statements if true economic value is not transparent.

For non-life insurance one reinsurer stated that each financial reinsurance arrangement is different and the reinsurer has a risk management structure in place to ensure that the contracts are sound and pass the risk transfer test. In addition, the reinsurer employs a board-level compliance committee to approve these deals.

**IFRS recognition & disclosure requirements**

For IFRS and statutory recognition and disclosure, reinsurers raised primarily the same issues as life insurers.

All reinsurers were comfortable with the IFRS recognition requirements for financial reinsurance, however one reinsurer raised the concern that interpretation of the IFRS recognition and disclosure requirements varied significantly between insurance companies and audit firms.

No additional comments (beyond the points raised by life insurers, stated in Section 6) were made on where the statutory basis could be improved for financial and finite reinsurance.

**Advantages, disadvantages and concerns**

Reinsurers noted the following advantages of financial reinsurance:

- The benefit for the insurer is that it reduces the financial strain of writing new business.
- For a reinsurer the advantage is that this business can be written profitably.
- Reinsurance arrangements tailored to specific risk transfer needs facilitate cost effective protection of the insurer’s capital base and claims paying ability, by implication securing affordable protection to policy holders.
- As with other catastrophe reinsurance, financial reinsurance provides companies with protection against hard-to-predict risks, and with appropriate disclosure can suitably reinforce the insurer's reputation with investors for having effective risk management and credible disclosure.
- It facilitates the spread of risk exposure over a larger (global) capital base and as such is an important tool for the global insurance industry.
- Encourages longer term partnership.

Reinsurers noted the following disadvantages of and concerns with financial reinsurance:

- The credit risk arising from both the insurer and reinsurers perspectives.
- For the reinsurer there is a capital risk arising from the provision of the arrangement.
- Finite reinsurance has been abused elsewhere in the world. Reinsurers need to have stringent criteria for assessing potential transactions. There should always be adequate risk transfer and transparent economic reasons for entering into the transaction; or, where contracts have insufficient technical risk transfer, they should be clearly disclosed as such and deposit accounted. From a solvency perspective, the standard formula doesn’t allow appropriately for such contracts.
- Finite reinsurance may not exhibit sufficient risk transfer.
- Deficit account financing should be prohibited.
- Different interpretations of requirements by different audit firms.
- Current treatment of financial reinsurance as unapproved on a statutory basis is being reviewed under SAM and may further encourage financial reinsurance.
- Tax treatment of financial reinsurance under SAM has perhaps not received sufficient attention.
- World-wide, financial reinsurance arrangements are increasingly being recognised as a type of reinsurance business and therefore reinsurers require clarity in their treatment as soon as possible.

### 7.6 Factors driving reinsurance brokers’ placements

8 reinsurers said that brokers and direct placement were used in their interactions with direct writers. One of these reinsurers said that consultants were also used. One respondent said that only direct placement was used.

5 of the reinsurers felt there were differences in intermediation for both non-life/life business and types of business. Only four felt that there were differences between different insurers/reinsurers. One of the comments made in this regard was that there is very little broker intermediation in the life insurance industry, and that broker intermediation is more concentrated in the non-life insurance sphere. One of the life insurance professional reinsurers commented that only catastrophe reinsurance was placed using brokers and the rest of their reinsurance agreements were facilitated through direct placement.

There were no definitive trends in the answers from reinsurers regarding whether there are differences between the placements of facultative and treaty business and most reinsurers said that there were no differences. One of the reinsurers commented that brokers were used to a greater extent in facilitating the more complicated contracts.
Local or foreign placement

Only 2 reinsurers gave opinions on the placement of reinsurance. The first explained that, for the most part, no business would be placed with local reinsurers as they are direct competitors. So unless there were co-insurance arrangements or strategic alliances, they would avoid placing business with local reinsurers. The second stated said that the locale of a reinsurer was not an important part of the reinsurance decision as it was more important to ensure adequate security and diversification of risk, rather than placing reinsurance in a specific market. The second reinsurer was of the opinion that being able to access reinsurance from all sources freely is a means of improving overall security and diversification.

The influence of credit ratings on the placement of reinsurance

- Credit ratings were of clear importance to reinsurers.
- Most reinsurers said that credit ratings should not be used as the only proxy in an assessment by management or in guidance provided by the regulator.
- 2 reinsurers said that minimum credit ratings of A- and AA were required for retrocessions but not for reinsuring an insurers’ risk (one reinsurer stated that this was equal to the credit rating of their parent).

From the interviews we found that international reinsurers felt that their international pedigree (rather than the credit rating of their local subsidiary) should be a more influential factor when insurers are deciding on the placement of reinsurance. One reinsurer said that the credit rating should be a part of the overall decision process, but that this factor should not be the only consideration when deciding on the suitability of a reinsurance contract.

The reinsurers were only able to give the perspectives that they had gained from their own experience, which is limited to the selling rather than purchasing of reinsurance. The restrictions on the local subsidiaries’ credit ratings from the South African sovereign credit rating did prove to be a potential problem, as the strict minimum requirements of brokers and reinsurers may not be met by local reinsurers. This may then add to an argument for allowing the credit rating of the parent company to be accessed, whether this is as an amendment to the current structure of regulations pertaining to the treatment of subsidiaries or through the allowance of branches locally.

7.7 Costs and value of reinsurance brokers to reinsurers

7 of the 9 reinsurers said that there was not a problem with the costs of reinsurance broking, that this was determined by market forces and that it is a cost borne by insurers.

One reinsurer raised a concern and based this statement on a consideration that the cost relative to the services provided could be considered to be too high. No details were provided on any cost structure or other issues.
7.8 Trends and issues

The structure of the local reinsurance market

The amount of reinsurance that was retroceded offshore varied between life and non-life lines of business. A range of 60% - 75% retroceded was most common.

The most common reasons given by reinsurers for retroceding offshore were:

- Diversification
- The efficient allocation of capital between the subsidiary and the parent company
- Access to the capital of the parent company or group
- A means of decreasing volatility
- Access to international expertise

There may have been some ambiguity in the question that aimed to gauge whether local subsidiaries would be able to cope if the offshore reinsurers stopped selling business locally. This may have then caused the quality of answers to this section of the questionnaire to be slightly degraded. 6 reinsurers felt that local reinsurers would not have the capacity to meet the reinsurance needs of the market. One respondent made the comment that, should a branch structure be allowed, then if the foreign reinsurers were to leave, there would be sufficient support for the local market. One other felt that it would not have an impact in the long-run as the access to international reinsurance markets meant that South African insurers would still be able to access the required capacity.

2 reinsurers felt that the local market would be able to meet local reinsurance needs, except for the catastrophe reinsurance sector. These may have been the reinsurers who interpreted foreign reinsurers as those located offshore. Reliance on only local reinsurers was raised as a concern regarding concentration risk.

There is a large proportion of the total reinsurance premium received locally that is then retroceded offshore, in an attempt to improve the diversification of the local reinsurers. This could be considered as either a positive or negative aspect of the local market, as it is either improving the security through a greater state of diversification, or means that capital is not held locally which itself could be problematic due to issues around exchange control, capital fungibility and local investment.

Global trends and the impact of branches on South Africa’s skill levels

The trends that have been noticed most predominantly by reinsurers are:

- The movement towards branches (although regional differences prevail, with note of a move to branch structures under EU regulation)
The centralisation of activities
The implementation of better governance structures, due to new legislation and increased awareness of the need for better management techniques and risk management
Two reinsurers said that there had been some movement towards an increased use of brokers

There were two views from reinsurers on the possible impact on skills resulting from branches being allowed to operate in South Africa. The first view is that there would be an increase in jobs and skills due to an influx of reinsurers branches and the second view is that there would be a move to centralise processes and remove skills from the branches and keep a central skill base at the parent company. The split is almost exactly equal, with four reinsurers saying that there would be a decrease in skills/jobs and three saying that there would be an improvement.

In addition, we note that there will be further economic impacts in the form of:

- Indirect job losses
- Loss of tax revenues
- Decline in capital investment and savings within South Africa

However, there may be offsets in the form of increased demand and general economic activity related to the reinsurance market.

One comment was that any job losses would be absorbed by the local insurance industry, which suffers from a lack of skills. The sentiment was that there is more likely to be a neutral impact on the South African economy, and without further details on the exact definition of branches, it is difficult to offer an accurate assessment of the possible results of moving to a branch structure.

One interesting perspective given by a reinsurer was that the change from a subsidiary to branch structure would not lead to major changes for those companies that are already registered here as subsidiaries. These subsidiaries would continue the status quo, and there would be an increase in jobs as branches are allowed to enter into the South African market. This sentiment was often echoed in the interview process, with some reinsurers saying that they would continue to operate as a subsidiary as they had developed a strong foothold in the market as a result of being able to provide significant services to clients as a subsidiary.

Many reinsurers gave the response that their experience had shown that there would be less local skills development as reinsurers would prefer to use their skills abroad, and thus save money on local training and talent recruitment. They made mention of the pooling of skills at a parent level, which would then over time lead to a loss of skills in South Africa.

The reinsurers were undecided whether there would be a positive or negative impact from changing to branches, which shows a similar pattern to the insurers.
Africa

Only one reinsurer gave a detailed perspective on how reinsurance placement decisions were made for African subsidiaries of South African companies. They gave the response that usually there is a global reinsurance programme written, but if there are specific African risks, these may be written on a facultative basis.

- Compulsory cessions were given as the major disadvantage (given by half of the respondents) of African reinsurance regulations. This then limits the business available to South African-based reinsurers and puts the local reinsurers at a distinct competitive advantage.
- 2 respondents stated advantages to reinsurance regulations in Africa, with the lower regulatory requirements making access to markets easier, and the need for domestication effectively making all external reinsurance non-approved, yet at a lower cost.

One reinsurer explained that compulsory cessions may be harmful to the local reinsurers as they force the reinsurers to take on risks that they may not have the expertise to deal with or risks that local African reinsurers do not have the capacity to reinsure, resulting in that risk simply being retroceded (introducing additional cost) to a foreign reinsurer. This could lead to improper risk-based underwriting. Monopolies were also given as a potential problem in African markets.

2 reinsurers brought up the point that it appeared that in some African countries, direct foreign reinsurance was not allowed, which then prevented them from conducting business remotely in these countries. It was also stated that a lack of control over reinsurance arrangements had led to some reinsurer failures in these markets.

There was an even split between those reinsurers that had and had not seen any movements towards using African reinsurers instead of the more traditional European reinsurers. Those who said there had been trends thought that this may have been due to the compulsory cessions enforced in Africa, or through companies having a long-term perspective and deciding to develop relationships with local reinsurers with a view of future business that would be conducted with these reinsurers. An example given was the establishment of state-owned reinsurers, which could see a move towards using these by companies in those countries. These local reinsurers may also then have a better perspective on the local insurance markets, and could add more value than foreign reinsurers.

One of the reasons given for there not being a trend of increased placement with African reinsurers was that there is not sufficient capital security, and that credit ratings may not be strong enough.

Africa’s reinsurance market may not be considered sophisticated enough yet for there to be major shift in the placement of reinsurance with African reinsurers as opposed to the traditional European and American reinsurers. The restrictive regulations of some major African economies also meant that there were undue difficulties in accessing these markets, and it seemed that opening up these markets more could allow for further penetration of the African reinsurance market by more foreign reinsurers.
Skills and development, and the expertise provided by reinsurers

The assistance that was most commonly offered by reinsurers was:

- Underwriting
- Pricing
- Product development

Some of the other services offered were given as training and knowledge development. There was a comment made that start-up insurers would require more intensive and extensive assistance than that required by bigger, more established insurance companies. There was also the blanket answer given by one reinsurer who said that all functions were provided to some extent.

Barriers to entry and competition

Three of the reinsurers felt that there was ‘some assistance’ offered in the way of technical assistance by reinsurers. One of the reinsurers was of the view that the failure to provide technical assistance to new insurers would create a barrier to entry for new insurers. The assistance given was said to allow the insurer to develop its skills whilst being present in the market, and thus maximising its sales ability while still developing its own skills.

5 reinsurers felt that there was a significant impact on the levels of competition in the market due to the level of technical assistance offered by reinsurers. 2 felt that there was some impact. The explanations given were both with regard to competition in the insurance industry and in the reinsurance market. For the former, the comment was that technical assistance would make entry into the market easier, and thus could promote competition among insurers. For competition among reinsurers, the presence of technical assistance was described as an important ‘value add’, which went beyond just the price of the reinsurance offered. If significant technical expertise is offered, then this may elicit a premium above the pure risk rate to be paid by new entrants to the reinsurer in consideration for the technical expertise received.

The level of technical assistance offered by reinsurers was seen to be a possibly distinguishing feature between the various reinsurers, which may then lead to competition between them. Direct writers will become aware of the differences in the services they receive from different counterparties, and in this way move away from having price being the most significant determinant of who to place reinsurance with (after credit rating). Reinsurers are also able to provide sufficient assistance to the direct writers such that these insurers can develop their own skills whilst still writing business, and in this way build-up sufficient expertise over time so that they can operate independently of the advice and assistance offered by reinsurers.
Risk management

Reinsurers were asked if branch reinsurers should be required to appoint a local statutory actuary as well as maintain some local governance functions.

The response from all but 2 reinsurers was that a local statutory actuary and local governance processes should not be a mandatory requirement.
8 South African reinsurance from reinsurance brokers’ perspectives

There were 5 brokers surveyed, and it was felt that their positions as intermediaries may offer a different slant on the perspectives given by the reinsurers and insurers.

8.1 Reinsurance broker strategies and challenges

Reinsurers and their local capacity

4 of a total of 5 brokers indicated they prefer dealing with professional reinsurers as they offer better expertise and security due to their knowledge of the market. The other said that they will refer to professional reinsurers only in the case of very specialised risks; otherwise they will look at capacity and security as their primary guides with whom to place the reinsurance business.

3 of the brokers felt there was insufficient local capacity for facultative insurance in South Africa. 2 others felt that there was enough capacity for the majority of risks. Only one broker felt that there was sufficient capacity in local markets when considering treaty contracts. The rest of the respondents felt there was insufficient capacity, especially for specialised lines.

All of the brokers who responded did not feel there was capacity in South Africa to provide for all catastrophe risks that required reinsurance.

The fact that most of the brokers did not feel that there was sufficient capacity in certain lines of business may indicate that brokers will not hesitate to suggest to their clients that offshore capacity is accessed as a part of their reinsurance programmes. The needs of the client will determine whether the administrative burden of obtaining non-approved reinsurance is felt to be too onerous, or whether the need for additional capacity outweighs the difficulties in obtaining this capacity.

Types of reinsurance used and the market for reinsurance

There was an even spread between brokers who placed non-life business only, and brokers who placed both life and non-life reinsurance. 4 out of the 5 brokers placed both facultative and treaty contracts and the same number placed both proportional and non-proportional contracts. The other respondent placed treaty and non-proportional contracts respectively. There was only one broker who described themselves as being mono-line and specialist, and so they had very particular requirements for their reinsurance-placement needs.
There was no standard answer on the types of business that brokers most commonly placed, with quota share, surplus and catastrophe all being listed as the primary focus of their business. This shows that there are specialists within this market who have a particular focus in the placement of their business.

4 of the 5 brokers felt their sector of the reinsurance market was competitive, with an explanation that although there was not a multitude of reinsurance brokers, there was still competition in terms of the skills and services being offered. The one respondent who felt that the sector was uncompetitive felt that as a specialist buyer, there were not enough options in the market.

There was a sentiment from the majority of brokers that the number of reinsurers, the ease of access, and the availability of capacity all contributed to competition. One respondent felt that there was slightly too much regulation which may have some limiting effect on the level of competition. There was also a sense that there were barriers to entry in terms of reputation and size of the brokerages that may have a limiting effect on the extent of competition in the market.

4 of the 5 brokers did not feel that the extent of competition was a problem and one said that it was a problem only in that there were always hurdles to overcome in the conducting of their business, but intimated that these hurdles were limited to those regularly found in entering a new market. The only suggestion offered to rectify the problem was a strengthening of relationships, which may then allow for that respondent to gain a stronger foothold in the market and become more competitive.

The sentiment of the reinsurance brokers is encouraging, as the broker market feels that the reinsurance market locally is largely competitive and thus offers sufficient value for premiums paid. The comments made regarding reinsurer regulation proving to be a barrier to entry indicates that brokers expect more reinsurers to enter the local market should there be lighter regulation. The SAIA SAM Reinsurance Technical Forum noted their agreement with the current state and these potential impacts on the reinsurance market.

**The risks not dealt with sufficiently by reinsurers, and how to cure this problem**

Respondents were asked to comment on any general concerns around any risks that are not adequately provided for in the South African market. 4 reinsurance brokers felt that reinsurers not providing cover for certain risks is a problem.

Examples of risks that may be problematic were:

- Specialised risks, such as cyber risks and financial guarantee
- New products that do not have a ‘track record’
Catastrophe risk was not seen as a strategic problem as many brokers view catastrophe risk as one which requires global diversification; the fact that the local reinsurance market is unlikely to have capacity to write all catastrophe business was not relevant due to the need for diversification.

The results of reinsurers not taking on these types of risks were said to be a hindrance to innovation, and also meant that brokers had difficulties in placing the risks of all their clients with reinsurers. It could be seen to limit the growth of the market (if the fears of a lack of innovation hold true) as insurers may not have the confidence to develop new products if they feel that they may not be able to reinsure these new risks.

There was a lack of any significant suggestions as to how these problems could be resolved. One suggestion was the opening of access to international markets, as well an allowance for the market to meet these needs by matching prices to the risk faced. Allowing reinsurers to price according to the level of risk faced (and thus allow for their risk appetite) was given by two brokers as a possible means to fix the problem of reinsurers not taking on certain risks.

The comments provided by the brokers show that the reluctance on the side of the reinsurers to take on certain risks may be detrimental to the local market by stifling the innovation of the direct writers as they cannot get the desired security that would allow them to sell new and unique products. The solutions to this problem are, however, not obvious, and may require further unpacking in order to discover a method to encourage the reinsurers to take on further risks that they might not currently.

As discussed in previous sections regarding reinsurance capacity in South Africa, the SAIA SAM Reinsurance Technical Forum noted that the drivers behind reduced capacity offered to the market for particular risks relate more to risk appetite and pricing than a pure lack of capacity.

**Strategies and goals**

The interview process with the brokers gave interesting insights into the strategies that some of the brokers intend to implement in the future. One encouraging strategy described was the movement towards developing the African and BRICS reinsurance market, as well as looking to place an increased amount of business with emerging markets in the hope of developing their economies and assisting the goals of improved wealth-sharing and economic development. This was felt to be appropriate given the significant capital held worldwide by insurers and reinsurers, and by placing business (through the brokerage) in these emerging markets, there may be new benefits obtained from investing this capital into smaller and possibly less-developed economies. The BRICS area was identified as being an important focus point, and the development that could occur in this space was thought to be significant and could be of great importance to South Africa. Africa and Asia were also given as important new territories that could be targeted, and could complement the current developed insurance/reinsurance markets of the West.
8.2 **Regulatory framework, current short-comings and desired change**

**Approved versus non-approved reinsurance**

Overall reinsurance brokers preferred removing the non-approved reinsurance restriction and encouraged a free market approach to reinsurance.

In addition, many brokers noted that the collateralisation requirements for non-approved reinsurance often provided little financial security for non-proportional reinsurance.

**Approved versus non-approved reinsurance - Advantages and disadvantages**

The main advantages raised by reinsurance brokers regarding approved reinsurance are as follows:

- Local approved markets have a significant cost of doing business and employ many people; as a result local approved reinsurers should be provided with this advantage to maintain their local operations.
- Allows for closer oversight of reinsurer reserves and management of risk of default
- Assists the country in persuading international insurers to locally capitalise and license, thereby producing jobs, tax and local investment for the economy.
- Non-approved reinsurance is exposed to claims complications (slower settlement of claims) as well as cashflow complications.

The main disadvantages raised by reinsurance brokers regarding approved reinsurance are as follows:

- Loss reserves place a significant burden on non-approved reinsurers as they end up with a credit risk on South African non-rated entities.
- Creates a barrier to entry for overseas reinsurers thus limiting the choices available.
- Additional costs
- Limited access to counterparty security

**Approved versus non-approved reinsurance – Capital requirements & governance**

Reinsurance brokers highlighted the below points regarding capital and governance implications of approved/non-approved reinsurance.

- All reinsurers should be treated based on their local and international credit worthiness.
- Reinsurance by its nature is international and it should be able to operate internationally in an unfettered manner.
• Mutual recognition should allow for relief from local capital and governance requirements if the parent company meets mutual recognition criteria.

**Branches versus subsidiaries – Reinsurance brokers**

Reinsurance brokers generally commented that reinsurance is an international business and reinsurers should have the freedom to choose their operational structure in South Africa.

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Preferred Subsidiaries</th>
<th>Preferred allowing Branches &amp; Subsidiaries</th>
<th>Indifferent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurance Broker</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

The 2 respondents that stated a preference for branches did so stating that this would encourage operation of foreign reinsurers in South Africa. The broker that preferred subsidiaries stated that subsidiaries are required to maintain investment in South Africa.

**Regulations other than SAM that could have an impact on your business**

60% of brokers said there were no regulations other than SAM that were directly affecting them. The other two both gave FAIS as an answer. They also both indicated that they felt that reinsurance brokers did not warrant being targeted by FAIS, and instead FAIS should be aimed at insurance brokers. One respondent also felt that binder regulations would have an adverse impact on their business.

In the interview process some of the brokers felt that FAIS should also be applied to reinsurers, as they may also be involved in the giving of advice to the insurers.

**8.3 Key factors influencing reinsurance placement**

**Credit rating requirements and their influence on the placement of reinsurance**

All of the brokers did have credit rating requirements for the reinsurers with which they placed business, with the comment made that most direct writers have some form of vetting process or minimum credit rating. Thus the full broker market surveyed ostensibly operates at a minimum rating level of A-.

The options for an “alternative” rating metric (instead of purely using credit ratings as an assessment of reinsurer strength and suitability) were posed to the brokers, and there were no definitive answers produced. There was a comment made that the international reinsurance market was based on the credit rating strength of the reinsurers, and that this was a difficult thing to change.
**Regulatory arbitrage**

3 of the brokers said that regulatory arbitrage was used as a deciding factor when placing reinsurance, and 2 felt that it did not rank highly as a factor. Of those who said that it was a factor, it was said by one respondent that they would seek the easiest way to access good security. One other said that there was a big role played by approved versus non-approved reinsurance, but did not elaborate on the arbitrage opportunities that were present.

**8.4 Factors driving reinsurance brokers’ placements**

The responses from brokers showed that credit quality of reinsurers received a high ranking in all of the responses, with four of the five brokers rating it as the most important factor. Price was felt to be important by most respondents, as was technical expertise. Domicile, diversification and reputation were the most common lower-ranked factors.

**Local or foreign placement**

On the brokers’ side (i.e. relating to non-life reinsurance), price and security of the reinsurer were stated to be the priority. Some brokers mentioned that they would prefer to go with local reinsurers in order to access approved reinsurance, but would look offshore if there were issues regarding capacity and a perceived lack of innovation locally. There is also the advantage of being in close proximity to key decision makers within the reinsurance companies being used, if these companies are local. This would facilitate an easier working relationship, and was given by the respondents during the interview process as an important positive when considering placing reinsurance locally as opposed to with a foreign-based reinsurer. This proximity won’t be available from international players. One respondent said that, if all else is equal, they would go with local reinsurers, which is encouraging for the local market.

**Risk protection from reinsurance**

**Concentration risk**

3 brokers gave opinions on the use of reinsurance as a means of protecting against concentration risk. One said that reinsurance was used to spread the risks faced by insurers, which then decreased risk; another said that catastrophe excess of loss cover could be used; and the last said that the syndicates through which it operates must have sufficient quality (in terms of security) of reinsurance contracts, which then provided the security needed to have sufficient diversification. Group-wide standards are used as a means of assessing the risk faced by the individual companies, and to ensure that none is faced with too much risk.
Use of reinsurance as a form of diversification

Reinsurance was said to assist in some regard with solvency by one broker, and that diversification was “definitely” considered in product design and diversification strategies of direct writers. 2 brokers thought that there was enough utilisation of reinsurance for protection against concentration risk. One of them gave the comment that the purpose of reinsurance is to diversify the risks faced, and if the reinsurance market is allowed to function without external hindrance, then it will achieve this purpose more easily and efficiently. The one broker who thought that there was not enough protection offered by reinsurance said that there should be a greater use of catastrophe cover to protect from significant risks.

8.5 Costs and value of reinsurance brokers to insurers, reinsurers and the insurance industry as a whole

The majority of brokers said that they were the chief method by which reinsurance business was placed, with some direct placement and one respondent saying that consultants play some role.

Brokers indicated that they were used more in complicated business, and not in the life insurance side of the market. 4 brokers said there were differences between the life/non-life sectors, three said there were differences between the types of reinsurance, and four said there were differences between insurers and reinsurers.

There were not any concrete conclusions on the question of what differences were apparent in the placement of treaty and facultative reinsurance. Most brokers indicated that they are involved in a lot of treaty business, and direct placement is used more for facultative placements. Larger facultative contracts may attract the attention of a broker; otherwise they will most likely be placed directly.

4 of the brokers did not feel that broker prices were a concern, with particular mention made of the fact that many have now moved to a fee-based (rather than commission) structure, which is fairer to the purchaser. There is also substantial competition which has the effect of reducing prices. The one broker who said that there was a concern said that the costs were increasing due to increased work on capital management and advice. This is a slightly different perspective as it shows that there is a concern regarding the cost, rather than the price, of broker work. The respondent went on to say that this increase in cost was not matched by an increase in remuneration from cedants, which was an issue.

The last comment made by the brokers that the cost of brokering is increasing due to a wider scope of services being offered may indicate that there is a possible future increase in broker prices. This could lead to higher costs of placing reinsurance, and could also lead to direct writers using brokers only for the more complicated contracts and thus limit their total expenditure on brokers.
### 8.6 Trends and issues

#### The structure of the local reinsurance market

Brokers gave views on the levels of retrocession by locally-based reinsurers that seemed to be based more on perception than on actual experience, with estimates of 60%, 20% and “way too much” being given as responses. It is noted that retrocession is an internal strategy employed by reinsurers based on a number of issues, which will vary significantly by reinsurer, and that without retrocessions concentration risk will increase. Reinsurance brokers’ concerns were however focussed on potentially large scale flight of capital from South Africa via retrocessions.

The need for capacity was given as a main reason by four of the brokers for retroceding offshore. Other reasons included accessing the expertise of the reinsurer’s parent company, diversification, and retrocession treaties.

None of the brokers felt that South African reinsurance companies could meet the capacity needs of the market should foreign reinsurers leave. The SAIA SAM Reinsurance Technical Forum noted that, if the business is priced right capacity would not be a problem, except for the large catastrophe reinsurance programmes in South Africa (possibly the 2 or 3 largest programmes).

#### Global trends and the impact of branches on South Africa’s skill levels

The brokers surveyed gave similar answers to the reinsurers on the trends that they had witnessed in international reinsurance trends, and added that the Australian model that has been adopted for branches may be a good guide for the structure of branches (should they be considered for South Africa).

2 brokers thought there would be a definite negative influence from the allowance of branches here in South Africa, and one felt that there would be a definite positive influence. The impact would depend on how subsidiaries already registered in South Africa would react, and whether they would seek to decrease the extent of their operations here in order to establish a branch structure instead. Also, if there was any special dispensation given to existing subsidiaries in terms of supporting their operations, this could help mitigate any job losses. There was no further description given for what this special dispensation may involve, but we may assume that it could be some form of capital or reporting relief or something similar to reduce the cost of operations.

#### Africa

One broker based its responses on the questions regarding Africa on the experience gained through their clients. This response said that South African insurers buy global protection, which would then apply to their subsidiaries in Africa. One of the brokers went on to say that facultative contracts may be used to reinsure specific risks that arise from their clients’ African operations.
Only one broker gave a perspective on whether reinsurance for African subsidiaries is purchased through South African reinsurers, and said that most South African companies will purchase their reinsurance for their African subsidiaries from South African reinsurers.

2 of the brokers indicated that compulsory cessions posed a disadvantage in reinsurance regulatory requirements for African subsidiaries. Interestingly, the compulsory cessions were also described by one broker as an advantage to the African countries employing this regulation, because they maintain premiums in the country and also force the development of local skills. So while this may not be an advantage to foreign reinsurers aiming to do business in Africa, it can be seen as an advantage for the development of local reinsurance markets.

2 respondents said that they saw a movement towards increased capital requirements and minimum security levels, which would help develop the security of the African reinsurance market. This could make the idea of compulsory cessions less dangerous as the companies that receive these forced cessions may then be in a stronger and more stable financial position.

4 brokers said that there had not been a move towards using African reinsurers by South African insurers. The reason given was a lack of security or lower than the minimum required ratings. The other respondent said that there was a slight movement towards African reinsurers, but if there were worries about credit ratings/security, then the insurers would revert to using the traditional reinsurance companies. One respondent did mention that African insurers may be looking towards African reinsurers for their reinsurance needs, rather than traditional reinsurance companies.

**Parental guarantees, retrocessions and the requirements of counterparties**

Two brokers offered some form of comments on the theme of parental guarantees. These comments were limited to acknowledging that parental guarantees were used and had cost implications for the reinsurer, and that quota share arrangements with parents were the most common structures for retrocessions.

There was only one broker who offered a comment on the type of company retroceded to, and confirmed that parents were the recipients of retrocessions from South African reinsurance companies.

Four brokers gave responses on the issue of differences between the retrocession regulations of South Africa and the rest of the world, with two stating that there were no differences, and one stating that there were differences with no further comments. The remaining broker stated that South Africa had no regulations pertaining to retrocessions, and therefore it was difficult to compare its position to other countries.
Skills and development, and the expertise provided by reinsurers

Due to there being only five brokers who participated in the survey, and only two who gave responses to the question of what technical assistance was provided by reinsurers, it was difficult to disseminate any common themes. Both of the respondents did mention that pricing and product design and development were provided, with data, underwriting, capital modelling and accounting treatment all being mentioned once.

3 brokers felt that there was some technical assistance provided by reinsurers, one felt that there was significant assistance, and the other two did not offer a response. There was one broker who differentiated their answer by saying that significant assistance was offered to smaller insurers, and the larger insurers only required some assistance.

Barriers to entry and competition

One broker felt that there was only some impact on barriers to entry from the presence of technical assistance, and one other thought that there was a significant impact.

2 brokers thought that there was some impact on the level of competition from the provision of technical skills, and the same number thought that there was a significant impact on competition. One explained that the provision of technical skills meant that the reinsurer can differentiate itself from the market, and in this way be more competitive.

4 of the brokers did say that there had been a negative impact from there being a shortage of skills in South Africa, with a potential problem being highlighted that there is a risk of incorrect pricing and a possibility for ‘naïve’ capacity to be offered to insurers.
9 Analysis of reinsurance regulations and policy issues

9.1 Registration and authorisation of reinsurers

Registration of reinsurers

For the issue of composite reinsurers, reinsurers emphasised that regulation should allow for level playing fields. Importantly they also stated that regulation should create equal requirements between local reinsurers and should aim to align the requirements of offshore reinsurers, to prevent offshore or local reinsurers from having an unintended advantage in the South African reinsurance market.

The current regulatory environment allows for composite reinsurers to remain operating as composites and provides the opportunity for other reinsurers/new entrants to adopt a composite structure.

Some reinsurers are, however, holding life and non-life licences in separate legal entities (rather than via a composite entity). Three primary concerns which have been raised by these reinsurers are:

1) Capital diversification benefits

Concern that composite reinsurers will benefit from capital diversification benefits across the life and non-life businesses that would not be afforded to reinsurers with separate legal entities.

Reinsurers felt that the allowance for capital diversification across life and non-life businesses is appropriate but that this allowance should be provided to all reinsurers.

If all applicable reinsurers are provided with life and non-life diversification benefits there is a question around whether an industry standard correlation assumption (as would be the case in the Standard Formula under SAM) would be appropriate or if life and non-life risk correlation should be assessed per individual reinsurer.

These benefits would need to be judged according to whether they are fair or dangerous in terms of reducing the overall levels of the capital held. The regulation of these entities may also become more complicated, as there may be offsetting effects within their businesses and difficulties in identifying the individual/indirect components of the reinsurance sold.
2) Product sales/reinsurance risk placement

Single licence reinsurers were concerned that overlaps of risks allowed under the long-term and short-term insurance licences (e.g. life insurance is allowed under both licences) were not allowed for appropriately for reinsurance. The primary concern is that life insurers are currently unable to reinsure life insurance risks from a non-life cedant (due to the mis-alignment of licences). The FSB interpretation of existing legislation is that reinsuring across long term and short term licences is not allowed, except for the cases of credit life and health insurance business.

This restriction could fall away under SAM due to life and non-life insurance reserving and capital requirements being risk-based and hence being aligned. However certain areas of difference in the SAM technical provision and solvency capital requirements between life and non-life business, such as specification of contract boundaries, may mean that treatment of risk may not be aligned within different licences. Reinsuring across licences (e.g. a life reinsurer reinsuring a life risk from a non-life insurer) could result in inconsistent reserving and capital treatment between the insurer and the reinsurer. This would need to be addressed if reinsuring across licences were to be allowed under SAM.

3) Cost efficiencies

Composite reinsurers are able to generate cost efficiencies by having combined administrative and governance functions.

Cost efficiencies of this nature were seen as akin to development of economies of scale over time and reinsurers felt that this should be allowed for all reinsurers operating both life and non-life reinsurance businesses.

For a regulator, the concerns with composite licensing are:

- Immediate potential decrease in capital for composites due to diversification of life and non-life lines of business and whether this decrease in capital should occur for all composites (assuming the same life and non-life risk correlation assumption) or if the capital diversification benefit should be assessed in further detail.
- Lack of clarity/regulatory oversight of life and non-life businesses due to financials being merged; difficulties in specifying and supervising reporting requirements which are otherwise licence-specific.
- Separate authorising of life and non-life business would still need to be maintained under the composite structure.
- Potential complexity of company operations making attribution of revenue, expense and capital items to different lines of business more difficult or more subjective.
From a strategic perspective, the writing of life risks ceded by a non-life insurer to a life reinsurer may not be problematic for the regulator under SAM; this is based mainly on the fact that that SAM allows for a consistent economic valuation basis between life and non-life risks, irrespective of the insurance licence used. The valuation of life and non-life risks would feed into the life and non-life underwriting risk modules, respectively. However as mentioned above, issues such as contract boundaries may make reinsuring across licences more difficult to implement and supervise. Furthermore, there is substantial concern around the operational supervision of cross-licence reinsurance.

There may be attraction of more external reinsurers if the composite structure is allowed, as the cost of operating both life and non-life businesses is expected to be materially less. The interplay of licensing and branch structures will be an important consideration; as this will also affect the efficiency of branch reinsurers and the new entrants to the South African market.

**Authorisation of reinsurers**

The primary concern for classes of business, relating to reinsurance, is the detail of information required from insurers about the risks that are ceded via reinsurance treaties for reporting purposes.

Often multiple classes of business are covered in one reinsurance contract. If the regulator requires a level of detail from local reinsurers (which is provided by insurers) that is not required of foreign reinsurers by their regulators then this could potentially skew the flow of reinsurance business in South Africa.

**9.2 Mutual recognition agreements**

Mutual recognition between South African and international regulatory regimes was important when discussing the reinsurance environment with local respondents. Mutual recognition would need to be undertaken only with recognised and respected regulators to avoid any security issues, and the ability to recognise the supervisory requirements of the home-country regulator may remove any duplication of supervisory compliance efforts.

A difficult topic to deal with was the potential for mutual recognition with African countries (both when considering this from a South African and international perspective). If South Africa were to become a hub for reinsurers to conduct their continental operations, mutual recognition or consistent regulatory requirements between South Africa and other major African economies (such as Nigeria and Kenya) may be necessary. The difficulty with this is the different standards of regulation currently imposed in these countries, and the effort that would be required on the parts of all regulators involved. It may be difficult for the FSB to co-ordinate the regulations of other African countries such that reinsurers are able to operate within a consistent framework between African operations. However, this end-goal could be one which allows South Africa to become a host for reinsurers to conduct business in Africa, and could help develop economic relationships between South Africa and the rest of the continent.
9.3 Approved versus non-approved reinsurance

The principle behind the approved/non-approved structure of reinsurance is a noble one, and attempts to maintain the security of reinsurance purchased by local direct writers as they are encouraged to purchase reinsurance sold by companies that are locally regulated by the FSB. This then gives the FSB some comfort on the security of direct writers and, ultimately, the policyholders. There is also the result that the majority of primary reinsurance premiums are maintained within the South African economy, although the retrocession activities of local reinsurers do mean that a large majority of these premiums are transferred offshore in any case.

Advantages and disadvantages

The perspective on the advantages or disadvantages of the approved structure depends on the position of the respondent. The added protection provided through the fact that the approved reinsurers are situated locally and have FSB oversight is a major advantage for those who are most concerned with the security of their reinsurance programmes. However, for those who are more interested in the availability of overseas expertise feel that the restrictions on the access to overseas reinsurers to be a disadvantage. There was a general sentiment that freeing up the markets through the removal of the approved/non-approved structure may allow for easier purchasing of reinsurance from and access to international markets which could provide for more diversification of risks for local direct writers.

For the non-approved reinsurers, the collateral requirements are not material enough to act as a deterrent from selling reinsurance in the South African market, or to provide sufficient protection for the direct writers from the failure of the reinsurer to pay claims. The needs of the direct writer to access reinsurance markets will often outweigh the difficulties or repercussions of attaining non-approved reinsurance, and these insurers will thus purchase non-approved reinsurance.

An important perspective on the capital requirements related to the approved/non-approved structure is that those reinsurers who wish to have an approved status will need to be capitalised in South Africa. This will therefore increase the cost of reinsurance sold by the reinsurers, and may thus put them at a disadvantage to non-approved reinsurers, who may be able to offer more competitive reinsurance premiums even with the collateral requirements being taken into account.

The sentiment of the overall direct-writer market was that there was sufficient capacity in certain areas of the market, and that the approved/non-approved environment may be circumvented if it is felt that the capacity offered locally is not sufficient for the needs of the local insurer. Thus there may be exposures to offshore reinsurers on a regular basis as a means of accessing the required capacity.

There may be an argument to remove the approved/non-approved structure to allow for freer movements of reinsurance purchases, and to not overly penalise those direct writers who need to access international markers.
for capacity, price or expertise purposes. There is also a risk that being “forced” to place reinsurance with local, approved reinsurers may present a concentration risk. A point made by a direct writer in the interview process was that although non-approved reinsurance may have an impact on the balance sheet, there won’t be an impact on the risk appetite of the direct writer. Thus the insurer may not be worried about the probability of the non-approved reinsurer not paying its claims.

A broker gave an opinion in the interviews that opening the markets (in terms of allowing non-approved reinsurance) would be a positive thing, and if there was an allowance for the direct writers to use the parents’ credit ratings when assessing the security of the reinsurance counterparty there would be an increased use of international reinsurers. One insurer also said that the current reserve deposit practice was “chasing away” foreign reinsurers due to its cost and complexity, which proves to be a limitation on the level of competition locally. A major reinsurer said that the approved structure most likely offered additional protection to the end policyholder as the FSB was able to control to some extent the counterparties with whom reinsurance was placed, which is encouraging as it shows that there is value in the current structure.

Approved reinsurance and branches

There was a linkage between approved and non-approved reinsurance and the argument regarding branches that was provided in the interview process by one of the brokers. They intimated that under the current structures, around 70% of reinsurance purchased by local insurers goes through approved reinsurers. If there was an allowance for branches, they thought that the inflow of new reinsurers registered as branches locally would then lead to nearly 100% of reinsurance bought being approved. This is because these new branches could qualify as approved reinsurers as they are locally registered and could fall under the regulatory ambit of the FSB. This would depend on the exact structure of branches (should they be allowed locally) and whether the FSB would consider giving them approved status. However, the sentiment of this broker shows that there will be definite interactions between the various aspects of reinsurer regulation. Consideration of these interactions is vital to ensure that the optimal structure is decided upon, and to avoid any unnecessary implications from changing the current regulatory framework.

Overall there was a feeling that the structure currently being applied in terms of approved/non-approved reinsurance may be archaic and out-dated, and to promote South Africa as a market in which the trade of reinsurance is uncomplicated and free for all willing participants may require the removal of this structure. The consequences of moving away from this structure may be a decrease in the security of the local reinsurance market due to an influx of foreign (and possibly riskier) reinsurance business. The overall reaction must be quantified and assessed before implementation.

Parental guarantees

Parental guarantees were said to add an extra level of security to the reinsurance contract purchased, and gave extra comfort to the direct writer. Some of the direct writers did however rely on the reputation of the reinsurer
and not an explicit guarantee, as they felt that the parent company would not allow its local subsidiaries to fail in the event of significant claims being placed with them. These parental guarantees may therefore be considered an alternative version of assessing the security of reinsurance, as if there is a parental guarantee offered then there may not be a need for approval of a reinsurance contract (or reinsurance company, if the parental guarantee could be for all contracts written by a reinsurer) as this may provide adequate security and comfort to the insurer and regulator on the quality of the reinsurance contract.

A distinction between parental guarantees and cut-through clauses is noted.

A parental guarantee is a guarantee from the shareholders/parent companies of the reinsurer to the subsidiary reinsurer, i.e. the contractual relationship is between the parent reinsurer and the subsidiary reinsurer and protects against the risk of reinsurer default. Parental guarantees usually apply for all treaties written by the subsidiary reinsurer.

A cut through clause is an agreement between the reinsurer (usually the parent reinsurer) and the insured (usually the ceding insurer) that places an obligation on the parent reinsurer to honour reinsurance in the event of insolvency or default of the subsidiary reinsurer. Cut-through clauses usually apply only for specified treaties (where cut-through clauses are included in the agreement).

It is also noted that the enforcement of a claim payment from a guarantor in a foreign jurisdiction may present its own difficulties. If the guarantee is subject to South African jurisdiction, a South African court order could be obtained but the enforcement of a South African court order in a foreign country would be time-consuming and costly for the South African insurer. This is only an issue when enforcement of a parental guarantee is required as a result of the parent company reneging on a guarantee agreement (the guarantee agreement may have also been drafted by the parent company).
9.4 **Subsidiaries versus branch structures**

**Impact of introducing branches to South Africa’s economy**

The impact of introducing branches to the South African reinsurance landscape was posed to the respondents, who gave the following answers. Note, this question is different to the question in Section 6.2 which asked for insurer’s preferences with regard to branches and subsidiaries (or whether a specific operating model should be encouraged).

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Positive impact from branches</th>
<th>Negative impact from branches</th>
<th>Neutral Impact/No comment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reinsurers</strong></td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td><strong>Brokers</strong></td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td><strong>Non-life insurers</strong></td>
<td>24</td>
<td>23</td>
<td>21</td>
</tr>
<tr>
<td>Large</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Medium</td>
<td>20</td>
<td>20</td>
<td>17</td>
</tr>
<tr>
<td>Niche</td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td><strong>Life insurers</strong></td>
<td>3</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>Large</td>
<td>1</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Medium</td>
<td>2</td>
<td>7</td>
<td>17</td>
</tr>
<tr>
<td>Niche</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
</tbody>
</table>

**Reinsurers**

There was a separation of views on this topic, with some respondents feeling that there would be a decrease in jobs/capital investment in South Africa due to subsidiaries leaving and branches with fewer employees and capital being set up locally. Others thought that there would be an increase in economic activity and skills development as there would be a net inward movement of reinsurers, which would contribute to the capital invested locally and the tax received by SARS. A comment was made by a reinsurer that the size of capital currently attributable to reinsurers was small in the context of the South African economy as a whole, and that if there were to be some capital flight as a result of lower capital requirements for branches as opposed to subsidiaries, the overall impact of this will be small.

Reinsurer responses included the following comments:

- There would be less skills development, less capital investment and less prestige/attraction to the reinsurance industry as branches are not considered in the same light as subsidiaries. There may then be a movement to another industry such as banking or overseas.
Regardless of the direction of the impact, the size of the reinsurance market in relation to South Africa’s economy as a whole was small enough that the effects of inward/outward movement of skills and capital would not be severe on an overall basis.

There could be an increase in skills development and employment opportunities, and these could lead to an increase in South Africa’s tax base.

The decrease in costs due to operating as a branch would lower the costs of reinsurance, thus improving the affordability of insurance to the customer. We note that the cost benefit of moving from a subsidiary to a branch structure will only benefit the shareholders of the reinsurer (and not result in any downstream benefits) if this assumption is not met.

Having branches would not impact the security of the reinsurance sold, as there would still be direct access to the parent company.

The allowance of branches would cause reinsurers to re-consider their business model, which would possibly allow for increased business flowing through South Africa.

Brokers

4 brokers felt that there could be a negative impact on the jobs market, and highlighted that there needs to be some focus on the retention of skills and expertise should branches be allowed. One respondent felt that there would be an increase in the amount of competition in the reinsurance sector, which could then lead to prices being driven down. The impact on capital held in South Africa was thought to be minimal due to the relatively small size of reinsurance capital in this country.

Life insurers

3 life insurers felt there would be a positive impact through branches entering the reinsurance market and developing the competition and size of the market, which may lead to an increase in the number of jobs offered and also an improvement of local skills. Large life insurers felt that there would be an improvement in the competitive nature of the local market but were concerned about the impact on local skills. There was a view expressed that the overall impact is difficult to determine without more detailed knowledge of the exact structure that branches would take in the local market.

The 9 respondents who thought there would be a negative impact surmised that there could be a centralisation of functions and a flight of capital. Tax structures would also need to ensure that taxes on profits were earned before the profits were passed on to the offshore parent company in order to prevent any damage being done to the local fiscus. A large insurer felt that the flow of capital could have an effect on the exchange rate if the outflow is large enough. Given the feelings of other respondents on the relative size of reinsurer capital (as opposed to reinsurance liabilities and premiums) in our market, this impact may be insignificant.

The remaining respondents either felt that the impact would be very small or neutral, or did not give a response in the questionnaire. There were answers given which detailed situations where the impact could be either
negative or positive, but there was no certainty as to which direction was more likely. The overall impact was felt to be dependent on the specific branch model adopted; many views indicated that there would be initial short-term negative impacts which may be countered by longer-term positive impacts for the industry.

**Non-life insurers**

The answers provided by non-life insurers varied, with a slight leaning towards a feeling that there would be an overall positive impact. 25 respondents said there would be a positive impact. 23 respondents felt there would be a negative impact, and the remaining 23 either felt that there would be a neutral impact or did not offer a response.

The positive impacts given were mostly surrounding an increase in competition in the reinsurance market in South Africa, and the resultant pressure to decrease prices. There may also be a reduction in prices due to the decreased administrative burden of operating as a branch. It may also lead to South Africa being regarded as an attractive place to conduct reinsurance business, which could allow for more jobs/skills to be created. There was a comment made that if South Africa does not allow foreign companies to conduct business here freely, they will “set up shop elsewhere and compete with [South Africa] anyway”. One company said that there should be no undue penalty for those companies choosing to remain as a subsidiary, although the exact implications of this, and whether it would mean that branches effectively had to run as subsidiaries, were not made clear by the respondent.

From a negative side, there was a feeling that there could be a loss of jobs as subsidiaries centralise their operations and move some functions outside of South Africa. There were also fears of capital flight and the loss of tax income associated with profits of subsidiaries which are now flowing out of the country. One respondent communicated a fear of the level of long-term commitment that would be shown by branches, and if the ability to move in and out of South Africa easily and quickly might in fact be detrimental to the local insurance industry. One leading insurer in South Africa’s market gave a detailed and measured response, saying how they felt that allowing branches would impact those reinsurers with large local operations as there may be job losses as these companies move to leaner operating models. There was a suggestion that a balance is found between having a “secure line capacity in the local market, and allowing branches from Third Country Equivalent countries to do this.” There should then also be a core of locally registered professional reinsurers that either “operates as subsidiaries in SA or have SA as their primary place of registration.” These ideas could then allow for an appropriate balance between the need for local skills, capacity and employment, while still giving the necessary access to international capacity.

**9.5 Operation of foreign versus local reinsurers**

The current situation allows for offshore reinsurers to have small teams fly into South Africa and conduct business with local direct writers without needing to hold capital locally and only needing to collateralise based on a percentage of premiums, IBNR and outstanding claims. This has meant that the offshore reinsurers were
able to operate without the constraints placed on local subsidiaries, which creates a level of unfairness in the operations of the two types of entity. There is a danger that the protection afforded by the current collateralisation is not sufficient should there be a large catastrophe claim locally and the foreign reinsurer is unable to pay the claim.

Are exchange controls an issue for your business?

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Yes to SA restrictions</th>
<th>Yes to international restrictions</th>
<th>Yes to both</th>
<th>No for both</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>-</td>
<td>3</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Brokers</td>
<td>-</td>
<td>1</td>
<td>-</td>
<td>4</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>12</td>
<td>1</td>
<td>1</td>
<td>54</td>
</tr>
<tr>
<td>Life insurers</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>33</td>
</tr>
</tbody>
</table>

Reinsurers

5 reinsurers said no to both local and international exchange control restrictions, with the only comment being that although there were bureaucratic obstacles they were not insurmountable. The 3 reinsurers who said yes to international controls all said that there were difficulties getting premiums out of African countries, with Nigeria being mentioned in particular. This would be quite hard to change as African legislation is beyond the remit of the FSB/SARB.

Brokers

4 of the 5 reinsurance brokers felt there were not impacts from either South African or international exchange controls. One of the other respondents indicated that there were both international and local restrictions that were an issue, and explained that the presence of controls impedes the “effective transfer of premiums and claim payments between counterparties”. This was then said to be an increased risk to “both insurers and reinsurers”. Some African countries (with Angola, Malawi and Zimbabwe being explicitly mentioned) have controls which are very restrictive in terms of the flow of reinsurance monies.

Life insurers

Only one life insurer said that they felt that South African exchange controls were a hindrance, with no additional comment to provide any clarity on this statement. The remainder felt that there were no impacts from foreign exchange controls, although one respondent did comment that the presence of approved and non-approved reinsurance meant that they avoided buying foreign reinsurance, and thus there was no opportunity for exchange controls to have an impact.
Non-life insurers

54 non-life insurers said that they did not experience any issues dealing with international/local exchange controls. Of the remainder, one said yes to issues with both international and local controls, one said yes to only international controls, and the rest said yes to South African controls. There was not any significant commentary offered, save for one respondent saying that the placement of business in Africa necessitates a checking of exchange controls in order to identify if there are any risks in doing this business. Reserve Bank approval requirements were said by another respondent to possibly “hamper payment flows” and thus have some impact on their business.

Lloyd’s

Reinsurers

The 3 reinsurers who gave an opinion on the influence of Lloyd’s said that there was no impact of Lloyd’s affiliation, and no additional benefit from using Lloyd’s.

Brokers

4 of the brokers surveyed had some business placed with Lloyd’s. 2 of the brokers said that the security offered by Lloyd’s and its affiliates meant that it was a preferential reinsurer, and this guided the placement of business.

The benefits of using Lloyd’s were given as the security provided, the excellence in terms of expertise and skills, the ease with which approved reinsurance can be accessed and innovation in product design. There were no brokers that felt that there were no benefits to using Lloyd’s.

Life insurers

The overwhelming majority of life insurers did not feel that Lloyd’s affiliation would have an impact on the reinsurance placement decisions of their company. There were 6 respondents who did have some business with Lloyd’s, but only 2 said that there would be some influence of Lloyd’s when buying reinsurance. There were no further comments offered on what form this influence would take, or how it may change any purchasing decisions.

Only 5 life insurers gave any benefits of using Lloyd’s, and these were the ability to purchase large catastrophe cover, and the ability of Lloyd’s to provide cover and capacity that may be beyond the reach of some other reinsurers.
Non-life insurers

The majority of non-life insurers who gave opinions on the influence of Lloyd’s (31) said that they had no business with Lloyd’s, and 26 said that they had some of their reinsurance business placed with Lloyd’s. Only seven had a predominant amount of business with them, and this was justified by saying that Lloyd’s had the “largest market for the largest risks”. Some respondents would only use Lloyd’s for very specific risks that may require greater capacity or innovation in dealing with the risk.

The influence of Lloyd’s affiliation on reinsurance decisions seems to be limited, with 48 respondents saying that there was no influence, 16 saying there was some influence, and only one respondent saying there was significant influence. This was said to be due to the capacity and security offered by Lloyd’s and its syndicates, and the attraction that this offers. A respondent said that the fact that Lloyd’s is approved means that there is easy access to the reinsurance markets through one central access point, which has a major influence on their decision making processes.

The main benefits given for using Lloyd’s were the solvency levels, security and significant capacity that it offers. There were also very specific risks (the examples of cash-in-transit robberies and plantation insurance were mentioned) that only Lloyd’s would cover or had sufficient appetite to take on. The technical expertise offered was thought to be important, as was the fact that it was approved reinsurance and offered an entry to international markets.

Africa

The regulatory nature of African countries made conducting reinsurance business there troublesome for the direct writers. Compulsory cessions, whilst potentially beneficial for the local economy, did not assist the South African direct writer in achieving the necessary security and capital backing that is usually required when buying reinsurance. The experience of the South African direct writers in selling business in Africa, and thus having first-hand experience of the situation on the continent, was limited to a few companies, so it was difficult to obtain significant comments or perspectives.

Africa’s reinsurance market may not be considered sophisticated enough yet for there to be major shift in the placement of reinsurance with African reinsurers as opposed to the traditional European and American reinsurers. The restrictive regulations of some major African economies also meant that there were undue difficulties in accessing these markets, and it seemed that opening up these markets more could allow for further penetration of the African reinsurance market by more foreign reinsurers.
9.6 Capital requirements for reinsurers and capital relief for cedants

Since reinsurers are regulated by the Long and Short Term Insurance Acts their capital requirements are related to those of insurance companies. This however poses a risk to the reinsurers as their capital requirements (and thus cost of capital) are far higher than those for offshore reinsurers, who do not need to hold any capital in South Africa. There is thus a disadvantage to local reinsurers which could be removed should there be a movement towards branches with lower capital requirements in South Africa in the future.

The most important consideration regarding capital requirements is the potential difference should branches be introduced. It is likely that these branches would require lesser governance structures than subsidiaries, but the appropriate capital requirements are uncertain. If they are the same as the subsidiaries, is there any advantage to being a subsidiary in South Africa? And would there be an attraction to overseas reinsurers to set up branch operations locally as the capital requirements would still be relatively large? These points may then lead towards branches requiring lower levels of capital, which may then be construed as unfair to subsidiaries. And this goes against the discussions with all parties who felt that the most important thing to come from any regulatory changes would be the establishment of level playing fields. Arbitrage would need to be avoided when deciding on the regulation to be applied.

One comment made by the reinsurers was that the branches should be able to write business based on the capital security of their parent company – it must then be assessed whether this allows for a more or less secure reinsurer, as the majority of reinsurers locally are subsidiaries of large and very secure parents. Thus this allowance could allow for a more secure environment provided that there is some form of assurance that the parent company will be willing to meet all claims that fall due.

9.7 Alternative forms of protection for local insurers

The protection offered by reinsurance is significant and important, and gives direct writers security when writing complicated or very risky business. This security does however come at a price, and as such the potential alternative of inward reinsurance was considered in the section given below.

For the most part, direct writers did not feel that there were significant risks that were not covered by reinsurers, but where these risks had been identified, it was a problem that the reinsurers were not comfortable with taking them on.

Insurers taking on inwards reinsurance

The general feeling of the respondents was that inward reinsurance should not be a problem as long as the companies conducting this business had the required expertise and skills to offer appropriate reinsurance.
services. There was also the need for there to be potentially separate reporting requirements for the reinsurance side of an insurer’s business. The ability of an insurer to write reinsurance business was felt to be a potential risk reducing action, as there may be diversification benefits to the insurer and added protection to those smaller or cell captive insurers that would most likely make use of this locally offered reinsurance.

The reinsurers felt that the local insurer would not be able to sell international reinsurance business, but this may be a case of competitive interests coming to the fore. The continued allowance and promotion of inward reinsurance may combine to facilitate the development of a local reinsurer that could then progress into a reinsurer with operations on the African continent and in other areas of the world, although this would take time and require a significant development of local capital.

Reinsurance is seen as an important method of risk protection, and direct writers will seek the best deal available when placing their reinsurance programmes. The quality of the counterparty is largely determined by the credit quality of the reinsurer, and the price of the contract that is offered. Direct writers will maximise the value obtained from the reinsurance that they purchase, and this is influenced by the locale of the reinsurer – local reinsurers will be considered in the first place at a given level of security and price. This shows that the calibre of reinsurer present in the South Africa is, as expected, suitable for the majority of the direct writers’ needs.

### 9.8 Financial Reinsurance

The most common forms of financial reinsurance used in South Africa are stated below.

For life insurance:

- Standard risk treaties with modified cashflow arrangements.
- Asset enhancing financial reinsurance (transfer of future profits).
- Reinsurance commission on a quota share basis.

For non-life insurance:

- Cash financial reinsurance with or without deficit account structures; on a new-business financing basis or in-force portfolio basis (with material risk transfer on different classes of business).
- Non-cash financial reinsurance (with material risk transfer on different classes of business).
- Finite reinsurance arrangements
  - Standard finite reinsurance programmes
  - Multi-year finite arrangements such as spread loss programs
- Solvency relief reinsurance with a significant loss corridor
- Ultimate net loss protection
The types of financial reinsurance used in South Africa seem to be varied but also seem to be used by few life and non-life insurers. The apparent low use of financial reinsurance in the industry has been attributed to the following:

- Uncertainty around treatment of these contracts over time
- Selected market participants’ views of the cost of these arrangements
- Lack of awareness of the benefits

In addition many respondents referred to the use of other alternative risk transfer arrangements (such as catastrophe bonds and longevity swaps) as a developing market in South African insurance but that these are not widely used.

For IFRS recognition, whilst it’s clear that risk transfer is required for legitimate recognition and most respondents are comfortable with the current recognition and disclosure, the primary issues with current standards are as follows:

- Guidelines on materiality of the risk transfer are not available and the principles applied to determine risk transfer seem to be applied inconsistently across the industry.
- There is no separate disclosure around the details of financial reinsurance arrangements.
- Unbundling of the financing portion of the reinsurance contract could result in a significantly different representation of the financial reinsurance contract.
- The current recognition approach may result in artificial solvency improvement on the published basis.

For statutory recognition, the key issues are as follows:

- Statutory recognition should be consistent with the economic principles underlying SAM.
- Current SAM proposals may not adequately capture the risk retained on financial reinsurance contracts where risk transfer is minimal (some finite reinsurance contracts may fall into this category).
- Current treatment of financial reinsurance as unapproved reinsurance may be inappropriate given the legitimate uses and industry growth advantages of allowing financial reinsurance.

Financial reinsurance has a key role to play in the development of the South African insurance industry through promoting access to capital for insurers, encouraging industry growth and innovation, reducing the cost of insurance, providing tailored solutions to insurers, fostering secure insurer-reinsurer relationships and reducing industry risk by providing opportunities for risk diversification and reinsurance of non-traditional risks. Furthermore financial reinsurance is seen as a developing reinsurance product which can provide substantial industry benefit through innovative legitimate reinsurance structures.

To ensure that financial reinsurance provides the desired benefits to the industry the following mitigating actions would be required:
• Regulation on statutory recognition to prevent the risk of abuse including definitions of allowed financial reinsurance and financial reinsurance that will require approval or is prohibited.
• Strong governance requirements to ensure appropriate selection and structuring of reinsurance.
• Concentration risk monitoring or concentration limits.
• Clarity with regard on-going financial treatment.
• Clarity with regard to current tax treatment.

In addition, a best-practice guidance note to assist insurers and reinsurers in selecting, structuring and financial recognition (under IFRS and SAM) of financial reinsurance may be required.


10  IFRS 4 Phase 2 (and related) developments in accounting standards

The impact of IFRS changes

Reinsurers

4 of the reinsurers surveyed gave ideas on how the changes to IFRS would impact their business. 2 of the responses were very detailed, and described the issues that were prevalent. These included the time delays between implementing IFRS 4 and IFRS 9, and this then meaning that there would be two major accounting changes in a short space of time. This could have an anti-competitive effect for those insurers who implement IFRS versus those who don’t. There were also concerns regarding the consistency between the recognition under SAM and IFRS 4, and whether the valuation bases under these two regimes would be the same. There was also mention made of the differences in the recognition of profits under SAM and IFRS 4.

The need for improvements in technical infrastructure in order to meet the new requirements for quality and quantity of disclosures was also highlighted, and the potential negative cost impact of these improvements. A letter was issued jointly by numerous reinsurers to the IASB in July 2011 on this matter.

Brokers

Brokers did not have any significant views on this theme. The only comments made were that changes to IFRS 4 and 9 may require greater staff effort in the submission of accounting results, and that the increased effort required may lead to increased costs. Increased costs within the operations of reinsurers could then lead to increased price of reinsurance, which could be harmful to the end consumer.

Life insurers

15 of the 34 life insurers surveyed had opinions on this theme. Within this number, 8 felt that there would be no impact on their business. 2 had not done any investigation into the possible impact because of the immaterial size of their reinsurance contracts.

One life insurer gave a possible impact of volatility of earnings as a result of the treatment of reinsurance, but the other responses mostly gave an impression of there being some expected impact, but the extent and nature of this impact being unknown. This may indicate that companies have not yet done sufficient investigation into the results of these changes in IFRS 4 and IFRS 9 at this stage. There was also a response that the impact of changes to IFRS 4 and IFRS 9 could be changes to the classification of assets and liabilities, although no further detail was given. The possible impact that the recognition of profits may have on the need for current financing reinsurance was also given as a potential impact.
Non-life insurers

The majority of the non-life insurers who gave responses on this theme said that they did not expect any significant impact resulting from the changes. Part of this was the statement that the changes to IFRS would align with the changes dealing with SAM/Solvency 2, and there could be some overlap in the administrative changes that would be needed for both of these.

There were two non-life insurers who said that they felt there could be increases in costs related to the greater administrative and systemic burden resulting from the implementation of these changes. There was an answer given that the changes would lead to there being a deferment of profits, which could result in some products becoming less popular due to the impact on the income statement.

One non-life insurer felt that there would be a minor impact, but this impact would be the more “accurate measurement of insurance assets and liabilities” due to clearer guidance.

Another answer given by three respondents was that there would not be any major changes to the decision process used by insurers in placing reinsurance, which makes it seem as though they feel that there would not be a material impact on the way reinsurance is purchased in South Africa.

One respondent described the situation where inwards reinsurance could be accounted for differently in terms of the recognition of contract on their accounting statements, which would then affect all those companies who use inward reinsurance.

The responses given to the survey showed that there had not been extensive investigation into the potential impacts of IFRS 4 developments; save for the detailed response from one of the reinsurers.
11 Tax implications

The influence of tax regimes on the placement of reinsurance

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Significant impact from tax interplay</th>
<th>Some impact from tax interplay</th>
<th>No impact from tax interplay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>1</td>
<td>6</td>
<td>2</td>
</tr>
<tr>
<td>Brokers</td>
<td>-</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>-</td>
<td>14</td>
<td>54</td>
</tr>
<tr>
<td>Life insurers</td>
<td>-</td>
<td>3</td>
<td>31</td>
</tr>
</tbody>
</table>

Reinsurers

6 reinsurers felt that there was some impact on their business due to the interplay between local and international tax policies. One said there was a significant impact from this interplay, and the remaining respondent said there was no impact.

One comment was made that there was an impact on the pricing of products due to taxation. Transfer pricing was a topic brought up on three occasions, with the considerations necessary for transfer pricing for services rendered both abroad and on intra-group retrocessions resulting in an impact on the prices of the products. One reinsurer also mentioned that VAT payable on the supply of services from this reinsurer abroad resulted in additional costs, which then had an impact on the price of the services sold.

Another reinsurer noted that any profits that were repatriated would be taxed at the shareholder’s corporate rate, but added that differences in tax regimes could mean a difference in the timing of tax payments.

Brokers

Four of the five brokers that were surveyed said there was no impact from the interaction between different tax regimes, and one other broker said that there was some impact. This respondent went on to describe how registering in another African country and conducting all non-South African business through that entity provided tax benefits.

One additional comment was made that some African countries do impose tax on reinsurance for reinsurance placed outside of the country, which may prove an obstacle for South African domiciled reinsurers when attempting to conduct business in Africa.
Life insurers

Three of the 34 life insurers said that there was some impact from the way that South African and international tax regimes interact. The remainder said that there was no impact at all, which seemed to be due to these companies operating solely in South Africa. One comment that was made was that there may be some competitive advantage obtained by reinsurers who have parents in countries with more favourable tax regimes due to the effects these differences may have on prices.

Again the issue of transfer pricing was mentioned by life insurers as having some impact on the business of one of the respondents, as there was a need to ensure that transfer pricing arrangements were adequately in place. Withholding tax from foreign tax regimes was also given as a potential problem when conducting business abroad.

Non-life insurers

14 of the non-life insurers felt there was some impact, and the other 54 respondents felt that there was no impact as a result of South African and international tax regime differences. This is again due to a concentration of business being conducted in South Africa instead of overseas/international markets.

One non-life company made the comment that tax differences had the impact of being considered in the construction of any contracts with foreign companies, and there were multiple mentions of the fact that international reinsurers are often VAT exempt. One respondent mentioned that having transfer pricing policies would have some impact on their business, most likely due to the extra effort involved in setting up these policies.

**Double taxation agreements and their impacts**

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Significant assistance from DTAs</th>
<th>Some assistance from DTAs</th>
<th>No assistance from DTAs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>2</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Brokers</td>
<td>-</td>
<td>-</td>
<td>5</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>-</td>
<td>4</td>
<td>56</td>
</tr>
<tr>
<td>Life insurers</td>
<td>-</td>
<td>4</td>
<td>30</td>
</tr>
</tbody>
</table>

Reinsurers

2 reinsurers said that there was significant assistance gained from the double taxation agreements that South Africa has in place; one reinsurer said that there was some assistance, and the remainder said that there was no assistance from these arrangements. For the latter group of reinsurers, the reason why there was no impact was
said to be a lack of business conducted outside of South Africa (by the local subsidiary), and thus no real use or consideration of the agreements.

The result of double taxation agreements is a reduction in the costs of doing business with a foreign country, which then has a positive impact on the pricing of the reinsurance sold. One respondent provided detail on how the double taxation agreement between South Africa and the country that their parent company is domiciled in, meant that there were savings in the distribution of dividends to the parent company. This was, however, mitigated slightly by the administrative burden of exchange controls. They also described how the existence of double taxation agreements means that underwriting profits are protected from the taxation of the country in which the business is sold, with a particular emphasis placed on those profits derived from African countries.

One further comment made by a reinsurer was regarding the tax of overseas branches. South Africa taxes worldwide income, and it was suggested that if South Africa were to make a tax exemption for overseas branches (possibly with the exception of those based in tax havens), this could make South Africa a more attractive hub for reinsurance companies looking to expand into Africa.

Brokers

None of the brokers felt that double taxation agreements between South Africa and the rest of the world had provided any benefit. One broker did make the comment that it was felt that South Africa’s taxation regime had a limiting effect on growth in South Africa.

Life insurers

Four of the life insurers said that there was some assistance due to double taxation agreements, and the rest said that there was no assistance gained. This is again due to a lack of business being conducted overseas. Two of the life insurers felt that the impact on their business was indirect, as the double taxation agreements made South Africa a more attractive location for foreign subsidiaries.

Non-life insurers

56 of the non-life respondents felt there was no assistance offered by the presence of double taxation agreements, with the main reason being that there is not any business conducted that would benefit from these arrangements. Of the rest, four said that they had significant assistance from double taxation agreements, although the lack of any further comments from these respondents meant that deeper insight was not possible.

The only comment made by those who said there was some assistance was the statement that these agreements allow for more companies to enter the South African market, which may improve competition and pricing.
12 Conclusions

The overarching conclusion that was found through our interactions with the insurance market, both when considering the questionnaire feedback and insights gained through the interview process, was that market participants want there to be level playing fields. Reinsurers indicated that they would be comfortable with competing with local subsidiaries, branches and offshore reinsurers provided reinsurance requirements were ‘equalised’.

The details of a regulatory regime that would result in level playing fields were not consistently stated to be the same regulatory model. Often respondents deferred this answer to the regulator's review of the industry as a whole as they have not performed detailed analysis for determination of the appropriate model.

The primary issues in understanding what the regulatory model should look are:

- The need for additional requirements for cross border reinsurance.
  - Due to the collateral requirements often not providing sufficient security when compared to the exposures.
  - Whilst cross border reinsurers are identified as having too few requirements when compared to locally registered reinsurers, it is also recognised that the local reinsurers have the business benefit of being setting up full operations and employing staff in South Africa.
- If approved reinsurance is removed there should be some benefit or efficiencies afforded to subsidiaries to encourage investment in the local market.
- If the subsidiary model is not attractive and results in less ease of doing business then reinsurers should be allowed to change their operating model to a branch.
- The branch model should allow for fair competition with offshore reinsurers.
- The capital held in South Africa, by local reinsurers, is relatively small when compared to the size of net reinsurance liabilities backed by assets in South Africa.
  - If international asset transfers are to be allowed or encouraged the impact of capital leaving South Africa is expected to be relatively small. However, assets backing reinsurance liabilities are large and could or should be prevented from leaving South Africa.
- Mutual recognition would be expected to provide substantial benefits to the South African market however implementation of mutual recognition is still under development.
- Exchange control and capital fungibility during stressed periods presents significant risk, even with mutual recognition.
- The skills base of reinsurers in South Africa is also relatively small meaning that many reinsurers already operate with limited local staff.

Other common discussion threads which influenced suggestions for the regulatory environment were:
Variations of mutual recognition
Credit ratings
Africa
Nature of reinsurance arrangements
Reinsurance guidelines issued by the regulator

12.1 Results of key review items

Overall results for each of this project’s key review sections are provided below.

Approved versus non-approved reinsurance

The concept of approved and non-approved reinsurance had a variety of opinions. Most of the bigger direct writers preferred making use of approved reinsurance due to the administrative difficulty of purchasing non-approved reinsurance. Some of the smaller and more niche insurers did not feel that the local reinsurance market had sufficient technical expertise in certain areas, and so had no qualms with purchasing non-approved reinsurance. This type of sentiment was also echoed when considering catastrophe reinsurance, as the local capacity was deemed by some to be insufficient for these purposes, and thus international markets (and non-approved reinsurance) needed to be accessed. The non-life market felt that local reinsurers did not have the capacity to take on the total non-life risk in the South African market and used offshore reinsurers as a result, although price was regularly mentioned as a contributing factor.

The current approach of approved reinsurance results in:

- Significant encouragement for the use of local reinsurers.
- Reasonable exchange control over offshore reinsurance.
  - In the life insurance industry, the nature of reinsurance business means that local reinsurers are preferred regardless of approved status.
  - In the non-life insurance industry, offshore reinsurance is used regardless of the approved reinsurance hurdles. Offshore reinsurers often collateralise providing for some capital to be invested in South Africa.
- Additional costs introduced to the reinsurance market.
- Good financial security for proportional reinsurance but little security for non-proportional and catastrophe reinsurance.
- Non-economic treatment of default risk for well capitalised offshore reinsurers. In addition, default risk is explicitly addressed under SAM.

Overall we find that the concept of approved reinsurance will not be necessary under SAM.
Removal of approved reinsurance will however need to be accompanied by other regulatory changes to prevent a net negative impact on local reinsurers. The dispensation allowed to offshore reinsurers would need to be revised and local reinsurers should be provided with benefits relating to mutual recognition or to compliance with SAM.

**Branches versus subsidiaries versus offshore reinsurers**

The discussions surrounding branches and subsidiaries produced diverse opinions, which were often linked to the position of the respondent in the market. Most insurers did not have a preference for either of the two structures, with many feeling that branches being allowed would not have a significant impact on the way reinsurance is bought and sold locally. Brokers were also mixed in their opinions, but there was an underlying sentiment that the opening of the markets should be a key goal of regulators, and there was indifference as to whether this should be done through a branch or subsidiary system. Reinsurers had less disparate views, with some feeling that the introduction of branches would cause a significant loss of jobs and technical skills locally; whilst most felt that the leaner operating model that branches offer could attract a greater efficiency for local reinsurers and ultimate benefit to the insurance industry as well as the potential for new reinsurers to the South African market. Many reinsurers also expected those subsidiaries with established local footprints to maintain their current status regardless of operating structure.

Importantly some reinsurers raised the point that subsidiaries of a large reinsurance group, by nature of their more autonomous operational structure and ring-fenced capital, gain more priority within the international group than a branch. In addition, a South African branch could over time be consolidated into a broader global region of the reinsurance group and effective management of the branch could occur outside of South Africa (this would also have an impact on tax revenue received from branches). To the extent that this concept impacts economic growth, some reinsurers emphasised that this provides motivation for regulatory encouragement of operational structures that favour control and development in South Africa.

When considering the impact of moving to a branch system on the South African economy, it is pertinent to note the relative size of the entire reinsurance industry. The total reinsurance sector in South Africa does not employ more than 1000 people, and the capital held in South Africa, while significant as a monetary value, is not a large portion of the total assets invested locally. Reinsurance premiums and reinsurance liabilities are large in context of the South African insurance industry. The preference of local insurers is to conduct reinsurance activities with companies that are in close proximity, this allows easier interactions and quicker decision-making on the part of the reinsurer, however other objectives (such as price, concentration risk, reinsurance of specialised risk and capacity) results in the choice of other reinsurers. In this case, if branches are allowed, those reinsurers who decide to reduce the size of their operations locally could face losing business to those reinsurers who maintain a constant presence locally. Market forces would also be a key determinant (although this has been stated to be more significant for life reinsurance than for non-life reinsurance) of whether changes in regulation would result in loss of local skills, loss of local operational capabilities and flight
of capital, or whether the demands of the local insurers would convince reinsurers to keep their local operations strong and capable to meet the local industry’s needs.

The use of branches may also allow for local reinsurance to be sold on a cheaper basis due to a reduction in the layers of costs involved – currently the reporting and governance costs required of local subsidiaries are significant, and removing these in favour of a more streamlined operating structure could be beneficial. The cheaper cost is expected to be passed onto insurers through lower reinsurance premiums, who could in turn be able to offer lower insurance premiums to their policyholders. It is noted that the cost benefit of moving from a subsidiary to a branch structure will only benefit the shareholders of the reinsurer (and not result in any downstream benefits) if this assumption is not met.

The case for branches must take into account the incumbent subsidiaries – these companies should not be penalised for operating as a subsidiary and the possibly higher levels of employment and skill development seen from reinsurers that operate in this manner could be maintained by encouraging subsidiaries to maintain their current presence in South Africa.

**Overall we find that the option to set up a reinsurer as a branch should be offered in South Africa and the negative consequences can be mitigated by well-designed capital requirements, amended governance requirements and incentives relating to the scale of, and nature of control exhibited by, South African operations.**

**Mutual recognition**

Mutual recognition would be useful for South Africa as it would allow regulators to place reliance on the regulation conducted in other jurisdictions around the world. What must be certain when it comes to this topic is that recognition between SAM, Solvency 2 and other regulatory regimes when enacted, is practically enforceable and that regulators can ensure that the full potential of benefits and flow of required information can be realised. This issue is part of a larger international debate regarding mutual recognition.

For reinsurance regulation in South Africa, the benefits that mutual recognition can provide to locally registered reinsurers, as illustrated in the ‘end-state’ regulatory regime stated in Section 12.2 below, will be limited by the extent to which mutual recognition is practically effective.

**Credit ratings**

Insurance companies and reinsurance brokers place primary reliance on credit ratings when evaluating the financial strength of reinsurers; the reinsurance market has not developed many other metrics for evaluating reinsurer counterparty risk.

The following two concerns were identified during our investigation:
1) Concern that over-reliance, by insurers and regulators, on credit ratings is a source of systemic risk.
   a. Changes in credit ratings may occur too slowly for purposes of reinsurance regulation and insurer governance.

2) Concern that local credit ratings linked to the sovereign rating creates a business risk for well capitalised reinsurers (can result in lower sales due to a lower credit rating) as well as an artificial counterparty risk for cedants.

**Africa**

Many insurance, reinsurance and reinsurance broker companies expressed interest (and existing operations) in operating in Africa.

Overall we find that the regulatory regimes of African countries are very restrictive by requiring local capitalisation, local subsidiary structures and forced cessions. As a result, changes in the South African regulatory environment alone will not be successful in fostering an African reinsurance hub in South Africa.

National government and regulator engagement with other African countries would be required to encourage the development of an African reinsurance industry.

**Composite reinsurers**

The current situation where some reinsurers operate as composites while others operate separate life and non-life legal entities is seen as unfair (as reinsurers felt that they would not be allowed to convert to composite structures at this stage), and would be best resolved through the creation of a consistent playing field, that either results in all such reinsurers being composites, or does not allow for any composites in the South African market.

The difficulty with composites compared with individual licences may be to ensure that these entities are regulated sufficiently and do not bypass any of the necessary regulation. Conversely composites are seen to provide a more efficient operating structure for life and non-life reinsurers and encouraging composites is expected to provide further benefit to the users of insurance.

A branch structure combined with composite licences is found to be optimal for the South African market; such a structure would be expected to provide reinsurers with additional flexibility (with regard to capital, governance and administration) as well as cost and capital efficiencies. This should lead to decreases in the costs of doing business in South Africa.
**IFRS and other developments**

Developments in respect of accounting standards did not elicit much detail from the respondents, as the majority had not done any significant investigations of their own into the effects of the revised standards. Many African countries have not adopted IFRS standards to the extent that South Africa has whilst the transition is occurring slowly. South Africa is well placed to become a central hub for the continent’s reinsurance market and will provide reinsurers with an IFRS reporting environment (where required) and a statutory reporting environment that is in-line with developing international practice and regulation which provides for benefit of mutual recognition (where applicable). In order to maximise this opportunity, South Africa would need to become an attractive market for global reinsurers, either through limited barriers to entry or through the creation of more efficient market dynamics.

The dealings between reinsurers and insurers were not conducted with one party having an inherently unfair advantage in terms of knowledge or power over the other. Reinsurance arrangements were commonly referred to as business-to-business transactions; as a result respondents stated that the need for further general regulation was limited.

Conversely, it was raised that there may be an appropriate place for guidelines issued by the regulator (rather than compulsory regulation) when it comes to purchasing reinsurance. Many companies noted that treaties from different reinsurers varied vastly for the same risks and the large number of different reinsurance structures meant that individual insurers may not be aware of the appropriate criteria for selection of reinsurance business.

We found that there were significant differences in the manner in which reinsurance business is conducted when comparing the life and non-life sectors of the industry. Life insurers made far less use of brokers (brokers were only stated to be used for life catastrophe reinsurance), and instead preferred a face-to-face interactions when buying reinsurance. Non-life insurers however used the facilities of brokers to a far greater extent, and required the expertise of the brokers to source the most attractive and advantageous reinsurance contracts.
12.2 End-state regulatory regime for reinsurers

Principles of regulation

In reviewing the regulatory framework for reinsurers, the following key issues were considered:

1) Financial system security
   - The maintenance and improvement of secure reinsurance, which ultimately extends to security for policyholders; the cost of reinsurance must be considered alongside security.

2) Level playing field
   - Encouraging free-trade.

3) Open market
   - Developing an efficient and easy-to-use local reinsurance market which promotes reinsurance business and makes South Africa an attractive business environment.

4) South African economic impact
   - The development of local skills and security of employment, and the creation of a lasting legacy of reinsurers assisting South Africa’s development goals (development of capital investment).

5) Development of international reinsurance business through South Africa
   - Extension of reinsurance business into Africa and the BRICS region, with SA being the preferred hub for reinsurers looking to conduct business in these areas.

When considering these goals, regulators need to consider the perspectives with which they are evaluating the potential outcomes. It is important to set these goals with reference to the intended outcome and to create regulations that allow for the appropriate market reactions in producing the ultimate goals intended.

South Africa has a unique position as a potential gateway into Africa, and must consider how it can use its financial services sector to assist and improve the equivalent markets throughout the continent. South Africa is also a member of BRICS, which has recently announced plans to investigate the feasibility of a BRICS Bank and a BRICS Risk Pool. Regulators need to consider the methods it has available to develop contemporary and world-class regulatory structures that attract global interest and business. The impacts of local development and protection required for employment, skills development and capital investment need to be kept at the forefront of discussion. The regulations that are put into place must ensure that sufficient local development takes place, and that the human resources of South Africa are given the opportunity to thrive and progress given the influence of external expertise.

The above goals can present regulators with significant conflict and substantial industry impacts. The recommendations provided in this report are able to assist in gauging the sentiment of the local market at this
point in time, and can be used as means of developing pertinent and appropriate regulation for reinsurers and the general insurance market in South Africa.

**End-state regulatory regime for reinsurers**

Our investigation has lead us to recommend an end-state regulatory regime which is underpinned by mutual recognition, strong regulator (and exchange control) co-operation and a fair operational environment.

An example regime is outlined in the below table and explained thereafter. Deviations from this regime are required to the extent that national strategy requires promoting the interests of specific parties over others and for the practical complexities associated with insurer/reinsurer co-operation and international regulation.

<table>
<thead>
<tr>
<th>With Mutual Recognition</th>
<th>Subsidiaries</th>
<th>Branches</th>
<th>Cross-border reinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets backing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• 3rd Country liability</td>
<td>• Held in SA</td>
<td>• Held in SA</td>
<td>• 3rd Country liability</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Held in SA (collateralised)</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 3rd Country Capital</td>
<td>• 3rd Country Capital</td>
<td>• 3rd Country Capital</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Without mutual recognition</th>
<th>Subsidiaries</th>
<th>Branches</th>
<th>Cross-border reinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets backing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• SAM liability</td>
<td>• Held in SA</td>
<td>• Held in SA</td>
<td>• SAM liability</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Held in SA (collateralised)</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• SAM capital</td>
<td>• SAM capital</td>
<td>• SAM capital</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statutory Actuary</th>
<th>Local</th>
<th>Local/Offshore</th>
<th>Offshore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>Mutual recognition</td>
<td>Mutual recognition</td>
<td>Mutual recognition</td>
</tr>
<tr>
<td>Reporting</td>
<td>Mutual recognition</td>
<td>Mutual recognition</td>
<td>Mutual recognition</td>
</tr>
</tbody>
</table>

Page 155 of 163
Branches

The argument for branches is a decrease in the regulatory capital and cost requirements for conducting reinsurance business in South Africa. This could attract more reinsurance companies to South Africa, and could thus have a positive economic impact through increased jobs and investment. The danger is the sudden and detrimental movement of current subsidiaries to a branch structure causing a loss of jobs, and the potential for undermining the skills level that currently exists in the South African reinsurance market.

Given the above considerations, we propose a levelling of the current playing fields, with encouragement to maintain a capital presence locally that accurately reflects the South African risks taken on by reinsurers. We feel that branches, subsidiaries and offshore reinsurers should all be allowed to conduct business in South Africa.

Branches should be allowed to operate under lower governance and reporting structures, with these being sourced from the parent group. The branch should have to apply to the registrar to be able to operate as a branch locally to ensure that there are no unregulated entities operating under the pretence of being a branch. Similarly to subsidiaries, permission to hold capital at a group level would have to be applied for from the registrar, to determine whether the impact on financial security is appropriate. Liabilities, either via mutual recognition or directly, would be on a par with the technical provisions determined by SAM. In order to ensure that those reinsurers without mutual recognition do not have an unfair advantage or disadvantage, SAM principles which are in-line with developing international practice would be required.

In addition, to the extent that the regulator would want to encourage development of local reinsurers as well as promote access to the South African reinsurance market, short-term national dispensations and regulatory incentives should be considered.

Subsidiaries

Subsidiaries should be allowed to conduct business as they have been already, with an added facility for them to apply to the registrar to hold capital at a parent level. The registrar would then be in a position to assess the security of the parent reinsurer, based on considerations such as mutual recognition with the reinsurer’s home country, the potential level of co-operation with the foreign regulator and control of capital between South Africa and the foreign country. Should the registrar feel that these factors are favourable then the subsidiary would be able to hold capital at a central group level, and thus become more capital-efficient in running their South African operations. Reserves for their local risks will need to be maintained in South Africa, and would need to be equivalent to the SAM technical provisions so that they adequately reflect the exposure to South African risks.

We feel that market forces would work to maintain the presence of local operations in the market. Local insurers prefer working with local experts who are able to give efficient and prompt service, something which
may not be possible through small branches or offshore operations. Thus the reinsurers who wish to capitalise on these opportunities would maintain local operations.

Maintenance of local operations could however occur as a subsidiary or branch. Some reinsurers indicated that they would change to a branch structure should this be allowed locally, but the size of these operations currently did make it seem that they would maintain their current size as it would be difficult for there to be major reductions in staff levels. In the long-term, maintenance of South African subsidiaries would only occur if subsidiary structures and operational control in South Africa was required as a base for expansion in Africa or if subsidiaries were encouraged for regulatory or tax purposes.

**Offshore reinsurers**

Cross-border reinsurance should also be able to continue; however the collateralisation of reserves locally would change from the current structure (based on percentages of premiums, reserves and claims) to a structure that produces reserves equivalent to the technical provisions under SAM. As it stands, the current collateralisation requirements may be considered trivial in certain cases, especially when looking at large-exposure contracts such as catastrophe reinsurance.

With this type of structure, there is freedom for reinsurers to operate in one of three different structures, but the reserving and capital playing fields are levelled. The reserves held locally would be an accurate reflection of the liabilities incurred through the writing of local business, and thus if there were ever an event where a high-security reinsurer fails, and the capital held at group level is not forthcoming, the reserves would be able to compensate local claimants. The regulator would be able to vet foreign parents and have a decision process which provides for capital efficiency for those reinsurers that are able to prove that their business is strong enough to situate the capital at a group level, yet prohibit the removal of capital by those reinsurers who may not be considered suitably strong. This structure may then avert the envisaged capital flight from allowing branches to some extent, but would still maintain the security of the local market.

**Advantages of such a structure**

Giving reinsurers the freedom of choice with regard to operating structure would seem to be a popular choice of the entire insurance market, and could attract new reinsurers to the market. The potential for decreased duplication of effort in local regulatory compliance and governance endeavours would lead to decreased costs for local reinsurers, and could then provide for cheaper reinsurance which would only serve to benefit the end policyholder.

The regulator would also be able to get ensure appropriate oversight of the local reinsurance industry, as the application process to hold capital overseas would need to be repeated, perhaps every two years or at the request of the regulator. There would then be a deeper understanding of the security provided by the reinsurers operating locally, and the extent of local capital being held as well.
When considering the impact that this has on the approved/non-approved structure, the process involved in applying to the regulator to hold capital overseas would create a practice of having “approved companies” rather than having approved contracts. This may then provide for a lower administrative burden while still allowing for suitably secure reinsurance to be sold.

The removal of the need to approve different reinsurance contracts may promote the idea of a “business-to-business” approach to regulation, with more reliance placed on the parent company’s own security procedures and the allowance for mutual recognition.

As a means of maintaining local skills, perhaps a more innovative development could be the implementation of a premium tax or alternatively favourable tax and regulatory treatment for subsidiaries. This could be calculated on a sliding scale depending on the size of local operations and could be ring-fenced to be spent on skills development projects/scholarships. This would help local reinsurers contribute to the employment and development strategies of South Africa.

The allowance of composite reinsurers and attractive treatment under SAM would provide operational efficiencies for local reinsurers and may attract more reinsurers to South Africa. Decreased costs due to diversification of capital and no replication of activities required by both Long and Short Term Insurance Acts as is the case currently, could lead to cheaper reinsurance, and cheaper insurance for policyholders.

Overall, the purpose and intentions of the recommendations given by this report are the development of a fair and level playing field between all reinsurers operating in the South African market. This we feel can be done through the allowance of branches, the removal of the approved/non-approved system and a greater reliance on the insurance companies’ and brokers’ own decision making processes. Ensuring the long-term commitment of the reinsurers who would move into South Africa would be difficult, but regulatory incentives, the insurance market reaction, other African regulatory developments and reinsurers will determine the nature of South African reinsurance operations. The security of the local market is paramount, but at the same time there must not be a movement towards developing a regulatory regime that is overly protectionist. Opening up to foreign markets and engendering international reinsurer appetite to come into South Africa should be a key goal of any changes to regulation, and discussions should be held with African and BRICS regulators in an attempt to create an environment where business is easy to conduct and rewarding for the reinsurers.
13 Reference List

1. Discussion paper on the mutual recognitions of reinsurance of reinsurance supervision; International Association of Insurance supervisors (IAIS) Reinsurance Mutual Recognition Subgroup, 2007

2. CEIOPS’ Advice for Level 2 Implementing Measures on Solvency II: Technical criteria for assessing 3rd country equivalence in relation to articles 172., 227 and 260; Committee of European Insurance and Occupational Pensions Supervisors; March 2010


5. Reinsurance business in Korea; Ahn, Hwa Paik & Chang, Euromoney International Reinsurance Review, 2012


7. Reinsurance business in Korea; Ahn & Hwa Paik; International Reinsurance Review; 2012

8. The methodology for equivalence assessments by CEIOPS under Solvency II; CEIOPS-DOC-94-10; 2010

9. Global reinsurance market report (GRMR); International Association of Insurance Supervisors; 2010

10. Cost of capital under Solvency II: Reinsurance and capital market instruments; Zhou-Richter & Kuschel; Munich Re; 2012

11. Impact of reinsurance on risk capital – A practical example based on QIS5; Kuschel, Mamykina & Pavlis; Munich Re; 2011

12. Solvency Assessment and Management: Pillar 1 - Sub Committee – Capital Requirements Task Group, Discussion Document 75 (v 3) – Treatment of risk-mitigation techniques in the SCR; FSB

13. Solvency II - Will it Change the Purchasing of Reinsurance; Davies & Daniels; Life Conference 2011


17. Subsidiaries or Branches: Does One Size Fit All?; Fiechter, J., Ötker-robe, İ., Ilyina, A., Hsu, M., Santos, A., Surti, J., 2011; International Monetary Fund
14 Appendices

14.1 Appendix A – South African Market Trends and Issues

Lack of local skills

<table>
<thead>
<tr>
<th>Respondent type</th>
<th>Yes to negative impacts from skill shortages</th>
<th>No to negative impacts from skill shortages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinsurers</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Brokers</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Non-life insurers</td>
<td>30</td>
<td>34</td>
</tr>
<tr>
<td>Life insurers</td>
<td>18</td>
<td>17</td>
</tr>
</tbody>
</table>

Reinsurers

7 reinsurers said that there were negative impacts resulting from South Africa’s skill and personnel shortages in the insurance industry. The one who said that there were not any negative effects did concede that there was a time delay between advertising a job vacancy and this job being filled, but it would be filled eventually and thus there were no long-term negative impacts.

The comment was made that there are not sufficient specialist skills (such as actuarial and technical accounting), and that these shortages were particularly prevalent when looking to fulfil South Africa’s Black Economic Empowerment goals. Retention of skilled black employees was also highlighted as an issue.

A reinsurer made the comment that the number of people possessing high-quality skills in South Africa’s reinsurance sector was too low, and that this meant that the price for the remaining “average” skills was too high. There was also the comment made that it would be more efficient and cost-effective to centralise the support functions of the reinsurers where there are appropriate global economies of scale.

Brokers

4 brokers thought that there was a negative impact due to a lack of skills. This was down to a lack of new talent being attracted to the market, a lack of professional skills, and the risk of inappropriate pricing or service. One other broker felt that its international exposure meant that it was able to access all the expertise it required in order to conduct its business in South Africa through the transfer of expertise from other countries. This last point is important as it may go against South Africa’s planned expansion and development of local skills.
Life insurers

For the life insurers, there was an even spread between those that felt that there were and were not skills shortages in the economy. Those that said they experienced negative effects said that there were issues with retention of staff, insufficient resources of well-skilled actuarial and accounting personnel and difficulty in training junior actuarial staff due to shortages or movement of the more senior members of the actuarial teams. There may be an impact on the speed with which new strategies or projects can be implemented due to a restriction on the number of resources available. There were comments made that restrictions in the resources of reinsurers locally were noticed. Only one respondent highlighted the fact that any specific skill was limited, with medical underwriting skills noted as being limited locally.

Non-life insurers

The responses from non-life insurers were split very closely between those who felt that there were skill shortages and those who felt there weren’t. 30 respondents felt the former applied and 34 respondents felt that the latter was true. The comments made showed that this was largely down to personal experience, with some respondents not having seen any negative effects of skill shortages. The others felt that international expertise in some areas of reinsurance meant that certain reinsurers are able to offer a competitive advantage as they are better suited to providing for the needs of the direct writers.

Certain non-life insurers felt that specific sectors of the industry felt the shortages more than others, and commented that international reinsurers would then be able to offer them the services they require. One of the non-life insurers stated that the local reinsurance companies needed to incubate more skills in this sector, and that this could be done by ensuring that there is maintenance of reinsurer presence here in South Africa. An interesting point was that global markets are “freely accessible”, showing that although the skills may not be present in South Africa, they are available to South African insurers through the employees of foreign reinsurers.