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OUR REF:	Linked Business Thematic Review Report	FAX:	
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1. Purpose

This note accompanies the Linked Business Thematic Review Report (“Report”). It provides the context for the thematic review conducted during 2016 and highlights the main findings and recommendations.

2. Background and context

The risk-based Solvency Assessment and Management (“SAM”) framework for insurers is in the final stages of development, with implementation planned for 2018.

The SAM capital and reporting requirements have been field-tested through a series of quantitative impact studies and a comprehensive parallel run (“CPR”). One of the topics that required further review following the CPR in 2016 was the treatment of linked insurance obligations. Following comments received, the FSB advised industry stakeholders that it intended to undertake a comprehensive review of the operations, valuation and reporting of linked insurance obligations before finalising any longer-term policy proposals. The comprehensive review is expected to be a two to three year project, mainly under the ambit of the new Prudential Authority to be established under Twin Peaks. However, the FSB also identified some immediate concerns that it wanted to investigate as soon as possible. The FSB therefore elected to conduct a thematic review with the aim of assessing the following areas:

- (a) The use and statutory reporting of reinsurance arrangements for linked insurance obligations;
- (b) The interpretation and application of contract boundaries for linked insurance obligations; and
- (c) The allocation and reporting of operating expenses for linked insurance obligations.

3. Key findings and recommendations

The main findings of the thematic review are that:

1. The use of “reinsurance” for linked business is necessary for facilitating compliance with certain legislative requirements, specifically tax legislation and regulations under the Long-term Insurance Act. These “reinsurance” arrangements are not typical, as there is no actual risk transfer from the cedant to the reinsurer. Nonetheless, allowing such “reinsurance” arrangements is necessary in order to facilitate the purpose of linked business in the broader investment market, at least until such time as there is a broader reform of the tax and insurance regulatory frameworks.

2. Expenses are not consistently disclosed or included in the operational risk capital requirement calculation as specified in the SAM Financial Soundness Standards for Insurers (FSI) and this needs to be addressed in the SAM standards or guidance.

The main recommendations of the thematic review are:

1. Classification of business: clear guidance is needed on how to classify investment business and which product features would impact the demarcation;
2. Many of the findings of the Reinsurance Regulatory Review on linked business also extend to market related business, and this should be accommodated in the SAM Standards;
3. Nature of reinsurance: “reinsurance” arrangements should continue to be allowed for linked and market related business, even where there is no effective risk transfer, but should not be recognised as an eligible risk mitigation instrument for purposes of SAM solvency calculations. In the longer term, broader reforms to the Income Tax Act and the Regulations under the Long-term Insurance Act should be explored so as to remove the need for using the artificial reinsurance label;
4. Reporting: the cedant should report the outward reinsurance arrangements in the SAM QRT, while the reinsurer should report the inwards reinsurance in the QRT. No reinsurance recoverables should be recognised on the cedant’s balance sheet or recognised as risk mitigation in the SCR. Instead, insurers should use the look-through approach for reporting these assets;
5. Counterparty default risk: specific disclosures should be required so that the ultimate policyholder is aware of the reinsurance arrangements and that he or she is exposed not only to market risk, but also the default of an insurer(s) other than the cedant;
6. Contract boundaries: a zero contract boundary should be applied for linked business and an appropriate contract boundary for non-linked business. Where a single investment contract has both linked and non-linked investment benefits, insurers should apply the principle of proportionality to determine the most appropriate contract boundary; and
7. Expenses: more guidance will be issued on which expenses to include in the Operational Risk calculation. The main principle is that expenses disclosed on the various bases should be consistent for all the expenses and fees, other than commission and asset management fees. Commission is specifically excluded and asset management fees are specifically included for the Operational Risk calculation. Expenses for the outsourcing of functions should be included in the calculation.

Insurers are encouraged to consider the findings and recommendations of the Report and apply them to their calculations and reporting under SAM.

4. Contact information

The recommendations of the Report have been incorporated into the revised FSI to be released shortly for public comment. Because of this, the Report is not specifically published for comment, however, any questions or comments may be submitted to the FSB on SAM.LinkedReader@fsb.co.za

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