

# SAM NEWS

SAIA - (011) 726 5381

Issue 2 / 2012

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## SAM Update – Timelines, Interim Measures and More

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### SAM Timeline

By now everyone should know that the **final date** for full implementation of the SAM framework has been **changed from 1 January 2014 to 1 January 2015**. This means that all insurers and reinsurers are required to fully implement the SAM framework by 1 January 2015. The FSB indicated in their “Solvency Assessment and Management 2012 update” that the SAM framework and the existing regime should run in parallel during 2014. Final specifications on the “parallel run” has not been finalised and will be communicated at a later stage.

Although the final implementation date has been revised, insurers and reinsurers are kindly encouraged not to interpret this as an opportunity to relax their implementation efforts in anyway. The 2015 implementation deadline remains onerous, as there is still a lot of effort required in relation to the development and implementation of the framework.

### Interim Measures

Interim measures regarding the prescribed requirements for the calculation of the value of the assets, liabilities and capital adequacy requirements of short-term insurers (Board Notice 169 of 2011) have been issued by the FSB. Further interim measures pertaining to insurance groups, governance, risk management and internal controls for short-term and long-term insurers are expected **to take effect from 1 January 2013**. It should be noted that this timeline will be subject to the timing of the key stages involved in the promulgation of the Amendment Bill.

### FSB Pillar II Readiness Assessment

The FSB has indicated that they will be conducting a Pillar II readiness assessment during the course of 2012. The exact detail of the exercise is still being developed, but it is envisaged that the exercise will consist of a survey, followed up by targeted interviews at the insurers and reinsurers to understand what developments are taking place and how they are preparing themselves for Pillar II. The results of the survey will be confidential and a report on the findings of the Pillar II Readiness exercise will be released by the FSB towards the end of 2012.

SAIA also want to remind all insurers and reinsurers that the final Pillar II requirements are likely to be more challenging than the other pillars. This area will require adequate planning, preparation and review.

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❖ Pillar II consists of the following:

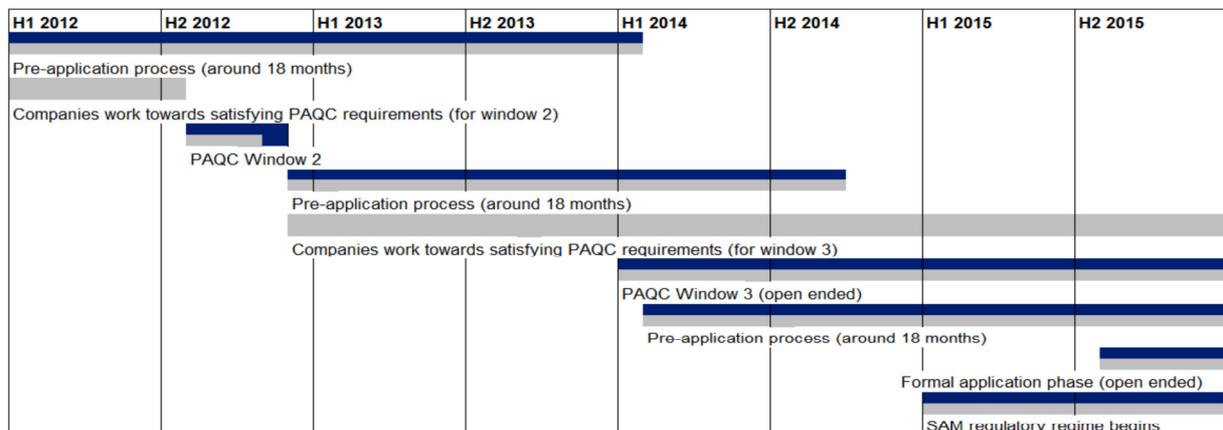
- Governance
  - Corporate Governance
  - Risk Management frameworks
  - Internal Control frameworks
  - Remuneration policies and practices
  - System of governance (the four control functions)
  - Outsourcing
  - Governance specifics for insurance and reinsurers planning to use an internal/partial model for regulatory capital purposes
- Regulatory stress-testing and scenario-analysis
- Own Risk and Solvency Assessment (on Insurance Group and licenced level)
- Internal Model use-test requirements

**The assessment will be a compulsory assessment** and will also be used to guide transitional arrangements.

## Internal Model Approval Process (IMAP)

❖ Window Two:

Due to the final SAM implementation date being revised to 1 January 2015, the timeline for the approval of internal models has also been revised. The second window where insurers and reinsurers have the opportunity to submit their Pre-Application Qualifying Criteria (PAQC) to the FSB will be open from 1 August 2012 to 31 October 2012. Once all PAQCs have been received, the FSB will communicate decisions back to the insurers and reinsurers by 30 November 2012. The open-ended PAQC window 3 will start 1 January 2014. The figure below illustrates the various changes to the SAM roll-out timeline.



 FSB Activity  
 Insurer Activity

## Quantitative Impact Studies (QIS)

The FSB indicated at a recent SAM Steering Committee meeting that the **SA QIS 2** study may be challenging to implement by insurers and reinsurers within the allocated time. Given the importance of collecting good quality data from a large number of correspondents through the SA QIS 2 study, they suggested an amendment to the timelines of the SA QIS 2 study as follows:

- Publishing of draft SA QIS 2 technical specification for comment: **31 May 2012**
- Final date for submission of comments: **22 June 2012**
- Publication of final SA QIS 2 technical specification: **13 July 2012**
- Submission of results for solo calculations: **15 October 2012**
- Submission of results for group calculations: **5 November 2012**
- SA QIS 2 report published by FSB: **31 January 2013**

It should be noted that the timeline above

- Allows 6 weeks between the publication of the draft technical specification and the final specification. This will give insurers additional time to digest the specifications and to start with preparation work.
- Reduces the time to complete the solo calculations by two weeks, but this should be offset by the additional 6 weeks that insurers have to start with preparation work.
- Gives 3 additional weeks after the solo submission date for groups to submit their calculations.
- Will result in the SA QIS 2 report being produced a month later than originally planned.

**SA QIS 3** will be conducted during 2013, and insurer and reinsurers participation in the exercise **will be compulsory**. The FSB will issue the technical specification by the end of May 2013, and all participants will be required to submit their SA QIS 3 returns in September 2013. A report on the results and findings of SA QIS 3 will be issued by the end of 2013.

## Discussion Documents and Position Papers

### ❖ Final Position Papers

At the FSB's SAM Steering Committee meeting held on 29 February 2012 the following Position Papers were adopted and considered as final Position Papers. These papers are now closed to further comment and will be considered by the FSB as part of the Subordinate Legislation.

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Final Position Paper	Task Group
<b>Position Paper 12:</b> <b>Title:</b> High-Level principles of information to be received by the supervisory authority	Reporting & Disclosure
<b>Position Paper 22:</b> <b>Title:</b> Considerations of mandating an external audit	Reporting & Disclosure
<b>Position Paper 23:</b> <b>Title:</b> Supervisory enquiries	Reporting & Disclosure
<b>Position Paper 24:</b> <b>Title:</b> Information on contracts and from external experts	Reporting & Disclosure

## ❖ Position Papers

Discussion Documents that have been in the public domain for comment will eventually take the form of a Position Paper before becoming legislation. At the FSB's SAM Steering Committee meetings held on 05 December 2011 and 29 February 2012 the following Discussion Documents were approved for adoption as Position Papers:

Position Paper	Task Group
<b>Position Paper 16:</b> <b>Title:</b> Single group-wide Regulatory Return	Reporting & Disclosure
<b>Position Paper 21:</b> <b>Title:</b> Process of Reporting and Disclosure	Reporting & Disclosure
<b>Position Paper 33:</b> <b>Title:</b> Regulatory Balance Sheet: Detailed content of SFCR and RTS	Reporting & Disclosure
<b>Position Paper 34:</b> <b>Title:</b> Own Risk and Solvency Assessment	ORSA & Use Test
<b>Position Paper 35:</b> <b>Title:</b> Use Test	ORSA & Use Test
<b>Position Paper 36:</b> <b>Title:</b> Detail Contents of SFCR and RSR: Capital Management	Reporting & Disclosure
<b>Position Paper 43:</b> <b>Title:</b> Internal Models: Validation	Internal Models
<b>Position Paper 49:</b> <b>Title:</b> SFCR and RSR: Executive Summary, Business and Performance	Reporting & Disclosure
<b>Position Paper 51:</b> <b>Title:</b> Detailed contents of SFCR and RSR: System of Governance	Reporting & Disclosure
<b>Position Paper 52:</b> <b>Title:</b> Solvency Financial Condition Report (SFCR) and Report to Supervisor (RSR) Detailed Requirements - Risk	Reporting & Disclosure

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Position Paper	Task Group
Profile	
<b>Position Paper 54:</b> Title: Internal Models: Model Governance	Internal Models
<b>Position Paper 55:</b> Title: Internal Models: Statistical Quality and Calibration	Internal Models
<b>Position Paper 56:</b> Title: Internal Models: Documentation and Data Requirements	Internal Models
<b>Position Paper 57:</b> Title: Partial Internal Models	Internal Models

❖ Discussion Documents

At the FSB's SAM Steering Committee meetings held on 05 December 2011 and 29 February 2012 the following Discussion Documents were approved for industry comments.

Discussion Document	Task Group
<b>Discussion Document 32:</b> Title: Methods and Approaches to best estimate liabilities	Technical Provisions
<b>Discussion Document 37:</b> Title: Risk Margin	Technical Provisions
<b>Discussion Document 39:</b> Title: Assets and liabilities other than technical provisions	Assets and Other Liabilities
<b>Discussion Document 41:</b> Title: Contract Boundaries	Technical Provisions
<b>Discussion Document 42:</b> Title: Calculation of technical provisions as a whole	Technical Provisions
<b>Discussion Document 47:</b> Title: Equity Risk	Capital Requirements
<b>Discussion Document 71:</b> Title: System of Governance	Governance
<b>Discussion Document 73:</b> Title: Treatment of new business in SCR	Capital Requirements
<b>Discussion Document 75:</b> Title: Treatment of risk-mitigation techniques in the SCR	Capital Requirements
<b>Discussion Document 77:</b> Title: Removal of Health SCR Module in SAM – Draft outline	Capital Requirements

For further information regarding this article please contact Nico Esterhuizen at [nico@saia.co.za](mailto:nico@saia.co.za)

## Technical Provisions

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### Introduction

Solvency Assessment and Management (SAM) is clearly revising the way insurers and regulators look at risk and capital. Less obviously though, it is also changing the measurement of technical provisions in some subtle and important ways.

In an ideal world these would be nothing more than numbers on paper; business would continue unaffected. In our world, it's likely that these changes will impact product design, matching decisions and even consolidation in the insurance industry.

### The basic technical provision measurement model

Technical Provisions will be calculated as the expected present value of future expected cash flows arising from policyholder contracts up to a determined contract boundary, plus a risk margin calculated by applying a charge to the capital requirements generated by the contracts.

The details of which cash flows, contract boundary, how the risk margin is determined as well as the notable absence of discretionary margins in the calculation will drive changes in technical provisions from current valuation approaches.

It's worth highlighting that the IFRS concepts of "insurance contracts" are not relevant here – all policyholder liabilities by regulated insurers will be captured under these technical provision principles.

### Comparisons to IFRS4

A new IFRS4 insurance accounting standard is still planned for June this year. IFRS4 and Solvency II have been influenced by many of the same players and thinking in Europe and elsewhere. It should not be surprising that there are important similarities, but it is also frustrating that there are many subtle differences. These differences can lead to important differences in reported numbers, as well as requiring flexibility of the systems used to produce, collate and present the results.

For example, IFRS4 will not permit day-one profits where Solvency II and SAM have no concern with this. For profitable contracts, it is likely that IFRS4 will calculate higher liabilities than required under SAM. The calculation of the "risk adjustment" as it is known under IFRS4 is currently less prescriptive than for SAM but potentially uses different levels of aggregation and allowance for diversification. These are just examples of differences that will need to be understood and ultimately reconciled.

**Contract boundaries**

Policies may have policy terms and premium terms and premium guarantee terms. Any discounted cash flow model must be specified in terms of how far into the future to project cash flows. The so-called “boundary” of the contract then is the point beyond which cash flows are not factored into the calculation of technical provisions.

For short term insurers, this is relatively straightforward as most contracts are monthly or annual. Construction or other project-related insurance typically also have relatively well defined policy terms with guaranteed rates. Life insurance contracts tend to include different terms within the same contract. A policy may be a whole of life contract, but only have premium rates guaranteed for ten years. An important debate for SAM, and indeed for IFRS4, has been and continues to be, what is the contract boundary for this contract? Where does the risk end?

The nature of contract boundaries means that often it is the particular characteristics of a particular product that influences the boundary determination. Life insurers in particular will have to go through a complex exercise to determine how to apply the principles and guidelines provided. The final principles and guidelines themselves will be determined using the results of the European and South African Quantitative Impact Studies and feedback from Industry.

**Discounting**

Discounting is a familiar component of valuation for life insurers and is equally unfamiliar to short term insurers. As a key principle to Solvency II and SAM, discounting of technical provisions will be required for all technical provisions, at least where arguments of materiality and proportionately don't make it irrelevant.

Discount for short term insurers removes an implicit component of prudence which is currently present. This is replaced with explicit prudence in terms of the risk margin. The risk margin also takes the place of the prudence currently introduced by many short term insurers by holding a higher percentile (frequently 75<sup>th</sup> percentile) rather than the mean liability.

The vast majority of techniques for estimating Incurred But Not Reported provisions either directly provide an estimate of the timing of cash flows or can be adjusted with little effort to produce these. This doesn't address the uncertainty around the amount and timing of the claim payments, but does provide an estimate of the timing. The uncertainty will now be captured within the risk margin rather than a combination of implicit allowances through not discounting and explicit percentile based approaches.

There is an on-going debate within Europe and South Africa around the inclusion of a liquidity premium in the discount rate, reflecting the addition yield available when backing illiquid liabilities.

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Finally, any choices around discount rate can have a significant impact on hedging decisions and the choice of hedging instruments by insurers. While not directly an issue of technical provisions, it is a result of decisions made for technical provisions.

## Conclusion

It's too early to call the result given all that must still be decided. What is clear is that insurers will need to stay on top of their games just to adjust to the changes. Forward looking insurers will be wondering where to get a competitive edge, which will only come with depth and breadth of knowledge of the people involved.

*This article was written by David Kirk, Director at PWC and Chairperson of the SAM Technical Provisions Task Group.*

## SAM Snippets

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### • FSB SAM 2012 Update

On the 12th March 2012 the Financial Services Board (FSB) issued an important document entitled SAM 2012 Update. The principal change contained within the SAM 2012 Update document, is that the final date for full implementation of the SAM framework has been changed from 1 January 2014 to 1 January 2015. This means that all insurers are required to fully implement the SAM framework by 1 January 2015, while the SAM framework and the existing regime should run in parallel during 2014.

The SAM 2012 Update document provides further guidance pertaining to important developments in respect of the following:

- Changes to the SAM Governance Structure
- Adjusted Primary and Secondary Legislation Timelines
- South African Quantitative Impact Studies (QIS)
- Internal Model Approval Process (IMAP)
- A Pillar II Readiness Exercise

The SAM 2012 Update document can be found on the SAIA webpage by accessing the SAM link. Should you require a copy of this document, please feel free to contact our office.

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- **SA QIS 2 timelines revised**

The suggested timelines for completion of the SA QIS 2 as reflected in the recently issued FSB SAM 2012 Update document has changed. Please refer to page 4 of this publication of our SAM News for the revised timelines.

- **FSB SAM Workshop**

The SAM Communication Task Group operating under the FSB SAM Governance Structure is in the process of finalising an important SAM Workshop that will be taking place on **18 May 2012 in Cape Town** and the **21 May 2012 in Pretoria**. Some of the topics proposed to be addressed at the workshops include:

- An update on SAM progress
  - An update on Interim Measures
  - Preparation for SA QIS2
  - Tax challenges
  - Progress update regarding SAM Primary Legislation
- The number of **Discussion Documents** being generated by the FSB SAM Governance Structure continues to climb and is fast approaching the 100 mark.

**For further information regarding these SAM Snippets please contact Gareth van Deventer at [gareth@saia.co.za](mailto:gareth@saia.co.za)**