



**THE PERCEIVED IMPACT OF FINANCIAL CONDITION
REPORTING ON THE STRUCTURE OF THE SHORT-
TERM INSURANCE INDUSTRY IN SOUTH AFRICA.**

by

Richard Heilig

**A research project submitted to the Gordon Institute of Business
Science, University of Pretoria, in partial fulfilment of the
requirements for the degree of Master of Business Administration**

November 2006

ABSTRACT

Financial Condition Reporting (FCR), which is set to be implemented in 2008, promises some of the most significant changes to solvency regulation in the history of the short-term insurance industry in South Africa.

The purpose of this study was to assess the perceived impact that this new regulation will have on the short-term insurance industry and to identify the main challenges for implementing FCR requirements.

The Delphi technique was used to solicit expert opinion and consensus on the key issues facing the short-term insurance industry in the transition to FCR.

The survey indicates that whilst there are several challenges in moving to a more rigorous regulatory environment, that the benefits of a principle based, internationally harmonised and risk sensitive approach to capital requirements, outweigh the efforts of implementing such a system.



DECLARATION

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University.

14 November 2006

Richard Heilig



ACKNOWLEDGEMENTS

Greg Fisher

Your guidance, insight and openness helped me immensely to get through this project. Thank you also for always been accessible.

Carla, Christie, Sophia and Nicola

My wonderful wife and children, thank you for your support, patience and encouragement over the past two years.

Hollard

To my colleagues at Hollard and my mentor, thank you for your support and encouragement.

CONTENTS

ABSTRACT	ii
DECLARATION	iii
ACKNOWLEDGEMENTS.....	iv
LIST OF TABLES.....	viii
LIST OF FIGURES	ix
LIST OF ABBREVIATIONS	x
CHAPTER 1: INTRODUCTION TO THE RESEARCH PROBLEM.....	1
1.1 BACKGROUND TO THE PROBLEM	1
1.2 MOTIVATION FOR RESEARCH.....	2
1.3 PROBLEM STATEMENT	5
1.4 RESEARCH OBJECTIVES	5
1.5 SCOPE OF RESEARCH.....	5
CHAPTER 2: LITERATURE REVIEW	6
2.1 INTRODUCTION.....	6
2.2 PORTER'S FRAMEWORK FOR INDUSTRY ANALYSIS.....	6
2.2.1 <i>Threat of Entry</i>	8
2.2.2 <i>Intensity of rivalry among existing competitors</i>	11
2.2.3 <i>Pressure from substitute products</i>	12
2.2.4 <i>Bargaining power of buyers</i>	13
2.2.5 <i>Bargaining power of suppliers</i>	14
2.3 OVERVIEW OF THE SHORT-TERM INSURANCE INDUSTRY.....	15
2.3.1 GENERAL.....	15
2.3.1.1 <i>Primary Market</i>	17
2.3.2 FINANCIAL OVERVIEW	18
2.3.2.1 <i>Underwriting performance</i>	19
2.3.2.2 <i>Investment performance</i>	20
2.3.2.3 <i>Financial Strength</i>	22
2.4 FINANCIAL CONDITION REPORTING.....	23
2.4.1 <i>Background to FCR</i>	23

2.4.2	<i>Overall Framework of FCR</i>	24
2.4.3	<i>Main components of FCR</i>	30
2.5	LITERATURE REVIEW ON RISK-BASED CAPITAL APPROACHES TO SUPERVISION	34
2.5.1	<i>Relevant theory base</i>	34
2.5.2	<i>Background and international context of risk-based capital</i>	34
2.5.3	<i>The impact of FCR on shareholder returns</i>	36
2.5.4	<i>The impact of FCR on insurance industry investment</i>	37
2.5.5	<i>The impact of FCR on operational risk management</i>	37
2.5.6	<i>The international role of regulatory bodies</i>	39
2.5.7	<i>Convergence of supervisory models across the financial services industry</i> ..	40
2.5.8	<i>South African context</i>	41
2.6	CONCLUSION TO LITERATURE REVIEW	42
CHAPTER 3:	PROPOSITIONS	43
	PROPOSITION 1:	43
	PROPOSITION 2:	43
	PROPOSITION 3:	43
	PROPOSITION 4:	44
	PROPOSITION 5:	44
CHAPTER 4:	RESEARCH METHODOLOGY	45
4.1	RESEARCH METHOD	45
4.1.1	<i>Background to the Delphi Technique</i>	45
4.1.2	<i>The Delphi Process</i>	46
4.1.3	<i>Defence of the Delphi technique for this research</i>	46
4.2	UNIT OF ANALYSIS / POPULATION OF RELEVANCE	47
4.3	SAMPLING METHOD AND SIZE	48
4.4	DATA GATHERING PROCESS AND ANALYSIS APPROACH	48
4.4.1	<i>Identification and selection of panel of experts</i>	49
4.4.2	<i>Data gathering and analysis</i>	51
4.4.3	<i>Reporting on the results</i>	53
4.5	RESEARCH LIMITATIONS	53
CHAPTER 5:	RESULTS	55
5.1	INTRODUCTION	55

5.2 RESULTS OF ROUND ONE	56
5.3 RANKING THE RESULTS	59
5.4 RESULTS OF ROUND TWO	60
5.5 RESULTS OF ROUND THREE	61
CHAPTER 6: DISCUSSION OF THE RESULTS.....	64
6.1 INTRODUCTION	64
6.2 KEY FINDINGS OF THE SURVEY	64
6.3 VALIDATION OF PROPOSITIONS	70
<i>6.3.1 Proposition 1:</i>	70
<i>6.3.2 Proposition 2:</i>	73
<i>6.3.3 Proposition 3:</i>	74
<i>6.3.4 Proposition 4:</i>	75
<i>6.3.5 Proposition 5:</i>	78
CHAPTER 7: CONCLUSION	80
REFERENCES	83
ANNEXURE A – PANEL COMMUNICATION	86
ANNEXURE B – FULL LIST OF DATA GATHERED FROM ROUND ONE.....	90

LIST OF TABLES

TABLE 1.1 - ABSA SECTORAL FINANCIAL RATIOS (2006) SHORT-TERM INSURANCE.....	2
TABLE 2.1 - PERCENTAGE SHARE OF AND AMOUNT OF GROSS PREMIUMS WRITTEN IN THE GENERAL SEGMENT	18
TABLE 2.2 - INVESTMENT SPREAD.....	21
TABLE 2.3 - SURPLUS ASSET RATIO	22
TABLE 2.4 - SURPLUS ASSET RATIO	33
TABLE 4.1 - THE STAKEHOLDERS IN THE TRANSITION TO FCR ARE AS FOLLOWS:	49
TABLE 4.2 - NAMES OF PARTICIPANTS OF THE RESEARCH PANEL	50
TABLE 5.1 - REPRESENTATION OF THE PANEL BY COMPANY	56
TABLE 5.2 - CONSOLIDATION OF THE ISSUES.....	57
TABLE 5.3 - CONSOLIDATION OF THE PERCEIVED IMPACT OF FCR.....	58
TABLE 5.4 - ALLOCATED SCORES FOR RANKING	59

LIST OF FIGURES

FIGURE 2.1 - FORCES DRIVING INDUSTRY COMPETITION	7
FIGURE 2.2 - INSURANCE INDUSTRY'S CONTRIBUTION TO GDP	15
FIGURE 2.3 - MARKET SHARE SPLIT BETWEEN PRIMARY AND REINSURANCE MARKET	16
FIGURE 2.4 - SPLIT OF MARKET SHARE OF THE PRIMARY MARKET BY SEGMENT	16
FIGURE 2.5 - SPLIT OF MARKET SHARE OF PRIMARY MARKET AND SPLIT OF GROSS PREMIUMS	17
FIGURE 2.6 - UNDERWRITING AND OPERATING RESULTS FOR PRIMARY	19
FIGURE 2.7 - UNDERWRITING RESULTS BY TYPE OF BUSINESS	20
FIGURE 2.8 - THE MARKET CAP OF THE INSURANCE SECTOR ON THE JSE	21
FIGURE 2.10 - THREE SOLVENCY MODELS FOR FCR	26
FIGURE 2.11 - GRAPHICAL REPRESENTATION OF FCR	29
FIGURE 2.12 - MAIN COMPONENTS OF MCR	30
FIGURE 5.1 - REPRESENTATION OF THE PANEL BY SECTOR	56
FIGURE 6.1 - SOLVENCY II: THE MAIN CHALLENGES FACING THE INSURANCE INDUSTRY	65
FIGURE 6.2 – HISTOGRAMS OF TOP TEN ISSUES SHOWING FREQUENCY OF SCORES	66
FIGURE 6.3 – THREE-PILLAR STRUCTURE OF SOLVENCY II	70
FIGURE 6.4 – TOP OBJECTIVES FOR IMPROVING RISK AND CAPITAL MANAGEMENT	71

LIST OF ABBREVIATIONS

ASSA	:	Actuarial Society of South Africa
DFA	:	Dynamic Financial Analysis
EU	:	European Union
FCR	:	Financial Condition Reporting
FSB	:	Financial Services Board
IFRS	:	International Financial Reporting Standards
JSE	:	Johannesburg Stock Exchange
MCR	:	Minimum Capital Requirement
RBS	:	Risk Based Supervision
SASRIA	:	South African Special Risks Insurance Association
STAR	:	Short-Term Annual Statutory Return

CHAPTER 1: INTRODUCTION TO THE RESEARCH PROBLEM

1.1 BACKGROUND TO THE PROBLEM

Major corporate failures, such as Enron and Worldcom, have put the spotlight on corporate governance, transparency and risk management and have spurred a move towards a stricter regulatory environment across global markets. These international developments have led to new supervisory models for the financial services sector. The capital supervisory model for banks has been changed by the work done by the Basel Committee and with Solvency II, the European Commission is pursuing similar aims for the insurance sector (Schubert and Griessmann, 2005).

In South Africa, the Financial Services Board (FSB) is following the global trend for regulators to move towards a risk based capital approach for the short-term insurance sector. One of the main objectives of this new regulation is to match the risks insurers face more closely to the capital they hold to ensure they can meet their liabilities (Felsted and Jopson, 2006). The current regulatory framework and existing capital requirements in South Africa do not take into account real risks and complexities undertaken by insurance companies and it is therefore not analogous for all companies within the industry (Stipp, 2005). Financial Condition Reporting (FCR) will regulate the risk management procedures of insurers and assess their capital requirements, based on the specific nature of the underlying business.

This new legislation comes at a time when the South African short-term insurance industry is doing exceptionally well and achieving outstanding results (Gillingham, 2005), however the proposed new minimum capital requirements with which the short-term industry will soon be faced, indicates that the estimated capital shortfall could be as high as R7,6 billion (Van Heerden, 2006).

1.2 MOTIVATION FOR RESEARCH

The ABSA Sectoral Financial Ratios (2006) for the Short-term Insurance sector, aspects of which are summarised in table 1.1, indicates that the industry is in a healthy state and that over the last three years shareholders have realised excellent returns. The new capital goalposts for the industry could impact negatively on these returns. For example the Minimum Capital Requirement (MCR) under FCR will be almost double the current statutory capital requirements of the industry, (Van Heerden, 2006).

Table 1.1 - ABSA Sectoral Financial Ratios (2006) Short-term Insurance

	Latest	2004	2003	2002	2001	2000	1999	Average
Asset structure								
Total asset turnover	0,80	0,27	0,34	0,30	0,30	0,76	0,58	0,56
Solvency and liquidity structure								
Current ratio	1,69	1,60	1,86	1,57	1,47	1,16	0,84	1,22
Debt to assets	0,27	0,10	0,11	0,16	0,14	0,39	0,48	0,27
Debt to equity	0,72	0,92	0,82	1,40	0,95	0,79	0,93	0,78
Profitability structure								
Operating profit margin (%)	21,59	22,17	15,05	8,03	14,54	12,09	12,40	13,84
Return on equity (%)	34,76	40,55	26,81	10,31	21,03	13,63	7,88	16,10
Return on external investments (%)	6,53	1,46	2,02	1,94	3,52	16,17	9,60	7,02
Share statistics								
Net asset value per share (Rand)	11,04	10,49	10,06	8,62	8,95	8,81	9,22	10,54
Cash flow per share (Rand)	2,73	3,08	2,56	3,32	2,67	1,91	0,71	1,95
Price/earnings ratio	5,79	5,73	5,83	13,95	18,58	28,24	14,51	13,99

In addition to the rigorous capital requirements, FCR will require insurers to have stringent risk management systems in place. Risk-based capital is a complete departure from the way insurers are currently regulated and the new rules will force insurers to assess and measure all their risks (Reactions, 2006). Compliance with FCR is therefore likely to push up insurers' operational costs.

In the European market, Solvency II is largely expected to increase the amount of regulatory capital held by insurers, which will further exacerbate the plight of small insurance companies, who have limited access to fresh sources of capital and have felt the impact of the lasting slump in the equities market, which has lowered returns on investments and eaten into their capital (Reactions, 2005). Stipp (2005) states that the capital requirements will impact each insurer differently and will depend on such matters as size of the insurer, the type of risks that they insure, the reinsurance programme of the insurer, their expenses and their reserving practices. Smaller insurers will have to set aside a larger portion of premiums, as they are expected to have more variable claims experience. The implementation of FCR is therefore likely to have a significant impact on small insurers and new entrants to the industry.

The financial services industry regulator should pursue three key objectives: consumer protection, market stability and competitive efficiency (Bäte, 2006). The pursuits of these objectives in a perpetually changing global environment with borderless markets and increasing threats of terrorism and political

instability, climate change and market crises requires regulatory frameworks and processes to constantly adapt. Schiro (2006) argues that regulatory interventions must be designed to meet economically sound goals and to ensure that regulation will be flexible enough to keep up with the dynamics of insurance markets, should be principles-based as opposed to rules-based.

The literature suggested that a move towards risk-adjusted capital management will on the one hand drive insurers to be more scientific and sophisticated about their capital requirements and improve risk management levels, which will lead to a deeper understanding and control of the risks facing their organisations, but at the same time increase the complexity of their business models and put a further strain on already stretched resources which are having to deal with a barrage of new and more rigorous regulatory and reporting requirements. The impact is expected to hit smaller players and new market entrants, who lack the resources of their larger counterparts the hardest; and could put them at a significant competitive disadvantage to the larger players.

The landscape of the insurance industry in South Africa could therefore be forever changed if smaller players are driven out or consolidated into larger players and new entrants are discouraged from entering the industry because the barriers to entry are set too high.

1.3 PROBLEM STATEMENT

FCR could bring the South African insurance industry in line with world class regulatory systems and earn the financial services sector the respect of developed markets, but at what cost to the industry, shareholders and consumers?

1.4 RESEARCH OBJECTIVES

The aim of the research is to evaluate whether the changes to the current regulatory framework will enhance the robustness and efficiency of the industry or whether the more stringent capital, risk management and disclosure requirements will drive out smaller players and stifle new entrants from coming into the market due to higher capital charges and therefore lead to a more staid and less competitive industry.

1.5 SCOPE OF RESEARCH

The research focuses on the identification of key issues facing the short-term insurance industry in the transition to FCR. The research examines how the industry structure may be affected by the developments of FCR and the long term impact on the industry's competitiveness. Porter's five forces has been used as a mechanism for measuring and understanding the impact of FCR on the short-term insurance industry structure and as a framework to measure the perceived impact of industry experts of this new supervisory model.

CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION

The literature review begins with a synopsis of Porter's work on industry analysis. This is followed by an overview of the structure and performance of the short-term industry and then the background and international context of risk-based supervision within the financial services industry is discussed. The international role of industry regulators and the main components of FCR are then examined and this is followed by a review of current literature on international regulatory trends in the financial services sector and the impact on the insurance industry in the transition to risk based capital management.

2.2 PORTER'S FRAMEWORK FOR INDUSTRY ANALYSIS

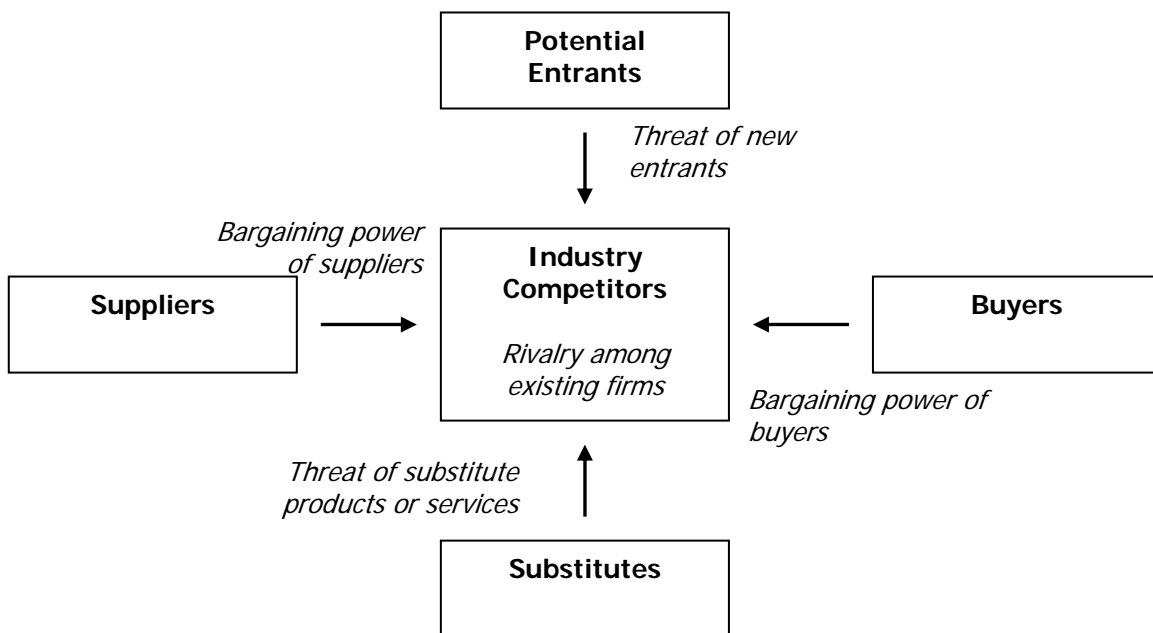
Porter's work on competitive strategy and his framework for analyzing industries and competitors has been used by practitioners as a powerful tool for measuring and understanding the forces driving industry competition and structure for more than two decades.

Porter (1998) argues that the essence of formulating competitive strategy is relating a company to its environment and that the key aspect of the firm's environment is the industry in which it competes. Industry structure in turn strongly influences the competitiveness of the industry as well as the strategies potentially available to individual firms within the industry. External forces have

a significant impact on the industry, since they usually affect all firms in the industry. FCR is such an outside force, as it will regulate all firms competing in the short-term insurance industry.

Porter (1998) argues that the state of competition in an industry is rooted in its underlying economic structure and depends on five basic competitive forces, as depicted in figure 2.1 below. The collective strength of these forces determines the ultimate profit potential in the industry and as such the attractiveness of the industry to investors.

Figure 2.1 - Forces driving industry competition



Source: Porter, M (1998)

Porter argues that the strength of each competitive force is subject to a number of important economic and technical characteristics of an industry, which are discussed below with specific relevance to the South African Short-term Insurance Industry:

2.2.1 Threat of Entry

New entrants to an industry bring new capacity and resources and increase competition. The threat of new entrants coming into an industry depends on the barriers to entry that exist and the reaction of existing competitors that the new entrant can expect. Porter lists the six major barriers to entry as being economies of scale, product differentiation, capital requirements, switching costs, access to distribution channels and government policy.

Economies of scale refer to declines in unit costs of a product as the absolute volume per period increases. The insurance industry is unique in that it sells a product for which the ultimate cost is not known when it is sold and is only determined when and if a claim is made against the policy. Economies of scale are therefore not as relevant to this industry, as for example the manufacturing sector.

Product differentiation means that established firms have brand identification and customer loyalties. Brand identification is built through advertising, product and service offerings or by being first into the industry. For example OutSurance built its brand around being first to offer cash back to

customers who do not claim against their policies and Auto & General who were first to offer short-term insurance products direct to the public. Differentiation creates a barrier to entry by forcing new entrants to spend heavily to attract customers away from existing loyalties.

Capital requirements to enter the market create a barrier to entry. The higher the financial investment required to compete in the industry, the larger the barrier to entry. Some industries, like banking and insurance, require minimum levels of capital to maintain a licence to trade. FCR regulates the minimum capital requirements of short-term insurers and could therefore have significant impact on potential new entrants.

Switching costs are the costs facing the buyer of switching from one supplier's product to another's. If the switching costs are high, then the new entrant must offer major improvements in costs or benefits in order to encourage the buyer to switch from their existing supplier. In the short-term insurance industry switching costs are generally low. Insurers only charge premiums for the time they have been on risk, if a policy is lapsed or cancelled early there are usually no penalties. As such, switching costs do not present a major barrier to entry in the short-term insurance industry.

Access to distribution channels can be a barrier to entry if the new entrant has to secure a distribution channel for its product. In the short-term insurance

industry in South Africa, almost all commercial business and the majority of personal lines business is placed through brokers. Four large brokers; Alexander Forbes, Glenrand M.I.B, Marsh and Aon dominate the broker market. FAIS and other compliance regulations have contributed to the consolidation of the broker market. New entrants to the short-term insurance industry, who do not choose a direct marketing strategy, will therefore need to persuade the broker market to sell their products.

Government Policy is considered by Porter as a major source of a barrier to entry. Through their policies governments can limit or even prevent entry into industries with controls such as licensing (particularly relevant in the telecommunication industry in South Africa) and by limiting access to raw materials. The South African financial services industry is highly regulated and supervised, which impacts on the attractiveness of the industry to potential new entrants. Compliance with regulations is also costly and increases the complexity of insurers' operations.

Another factor that can impact on the threat of entry is the potential entrant's expectation about the reaction of existing competitors. If the potential entrant expects existing competitors to respond aggressively to their entrance into the industry, this may act as a deterrent. The short-term insurance industry is dominated by four large players, with substantial resources to fight back against new entrants to the market. However historical industry results show

that the industry is very competitive and there is a history of new entrants, like Hollard and OutSurance, gaining substantial market share. Industry growth over the past five years has been satisfactory which indicates the industry could absorb new entrants, without significantly depressing the sales and financial performance of existing firms.

2.2.2 Intensity of rivalry among existing competitors

Competitors use various tactics like price competition, advertising battles, increased customer service or product enhancements, to improve their position within the industry. Porter argues that some forms of competition, such as advertising or promotion of the industry (consumer awareness) can lead to expanded demand or enhanced product differentiation and be beneficial to the industry, whereas other forms, notable price competition usually leaves the entire industry worse off. Interacting structural factors that result in intense rivalry, that are particularly relevant to the short-term insurance industry in South Africa are:

Structural factor	Reasons
Numerous or equally balanced competitors	When firms are numerous, the likelihood of mavericks is high. If firms within the industry are relatively balanced they are prone to take each other on for market share
Slow industry growth	Industry is not expanded sufficiently for firms to improve results without attacking for market share
Lack of differentiation or switching costs	Where the service is perceived as a commodity, choice by the buyer is largely based on price and service, and this results in intense price and service competition amongst rivals

Factors that determine the intensity of competition in industries can and do change. For example as industries mature, its growth rate generally slows which in turns results in intensified rivalry. Acquisitions and consolidation can also introduce a new personality to an industry, as has been the case for the short-term industry following the acquisition of Guardian National by Santam and the acquisition of CGU Insurance Limited by Mutual and Federal, which resulted in those two insurers controlling dominate positions in the market.

2.2.3 Pressure from substitute products

Substitute products are those that can perform the same or similar function as the product or service of the industry. The availability of substitute products limits the profits of an industry. In respect of short-tem insurance products there are few substitutes. Consumers and businesses have several choices when confronting risks, these are summarized below:

- Risk avoidance - for example choosing not to open a business or purchasing a new house because of the risks involved;
- Risk mitigation – installing smoke detectors and fire fighting equipment to mitigate and reduce the inherent risk
- Self-insurance – accepting the risk
- Insurance – protecting the financial downside by passing on the risk to insurers

However for the majority of consumers and companies there is no real effective substitute to insurance.

2.2.4 Bargaining power of buyers

Porter argues that buyers compete with the industry by forcing down prices, bargaining for higher quality or more services, and playing competitors against each other, all at the expense of industry profitability. The power of an industry's important buyer groups depends on a number of characteristics of the market. The circumstances that lead to powerful buyer groups, and that are particularly relevant to the short-term insurance industry are summarized below:

Buyer group is concentrated or purchases large volumes relative to seller sales	If a large portion of sales is derived from one or a few large buyers, then this raises the importance of the buyer to the firm and therefore the bargaining power of the buyer
The product or service that the buyer purchases from the industry represents a significant portion of the buyer's total costs	Buyers will expend more resources and tend to shop for favourable prices
Products/services purchased from the industry are standard or undifferentiated	Buyers have more choice from alternative suppliers
Low switching costs	Low switching costs can lead to lower loyalty amongst buyers
The buyer has full information	Buyers that have full information about demand, actual market prices and supplier costs, gives them greater bargaining leverage

In summary, companies and individuals purchasing insurance are generally fragmented and therefore lack group buying power. However buyers that give insurers access to large distribution channels, for example furniture and retail groups, do have considerable bargaining power and in some cases can pose a credible threat of backward integration. There is evidence of this in the short-

term insurance industry with furniture retailers and motor dealers holding their own insurance licenses. Insurance generally does represent a significant cost to companies and consumers and as switching costs are low, clients can easily shop around. Insurers have to comply with a series of new legislation, such as the Financial Advisory and Intermediary (FAIS) Act and the Policy Holder Protection Rules (PPR) Act which aim to protect consumers against poor financial advice and gives them greater access to information to make informed decisions when purchasing insurance.

2.2.5 Bargaining power of suppliers

According to Porter suppliers can exert bargaining power over a participant in an industry by threatening to raise prices or reduce the quality of purchased goods and services. As FCR does not have a direct impact on the power of suppliers, this report does not go into any further aspects of this force. However FCR will have an impact on service providers to the industry such as auditors and actuaries, which will be discussed in more detail under the literature review of risk based capital supervision.

The above framework will be used to measure the perceived impact of FCR on the crucial structural features of the short-term insurance industry. Not all of the factors identified above will be important in this analysis and the author has therefore focused on those forces that are pertinent to FCR and risk based supervision (RBS).

2.3 OVERVIEW OF THE SHORT-TERM INSURANCE INDUSTRY

2.3.1 GENERAL

There are 92 primary insurers and 8 reinsurers operating in the South African short-term insurance industry (Financial Services Board 2005 Annual Report).

The short-term insurance industry is categorized into two markets, the primary market and the reinsurance market. The primary market is further divided into general, cell captive, specialist, banking and captive segments.

Figure 2.2 shows the contribution by the combined long-term and short-term industries to the Gross Domestic Product from 1994 to 2004. The industry plays an important role in the economy, by providing an efficient and effective mechanism for businesses to pass on risk that their shareholders would be unwilling or unable to provide for out of share capital. This allows businesses to manage their risks effectively and to be able to continue trading even in the event of a catastrophe that, but for insurance, would put them out of business.

Figure 2.2 - Insurance Industry's contribution to GDP

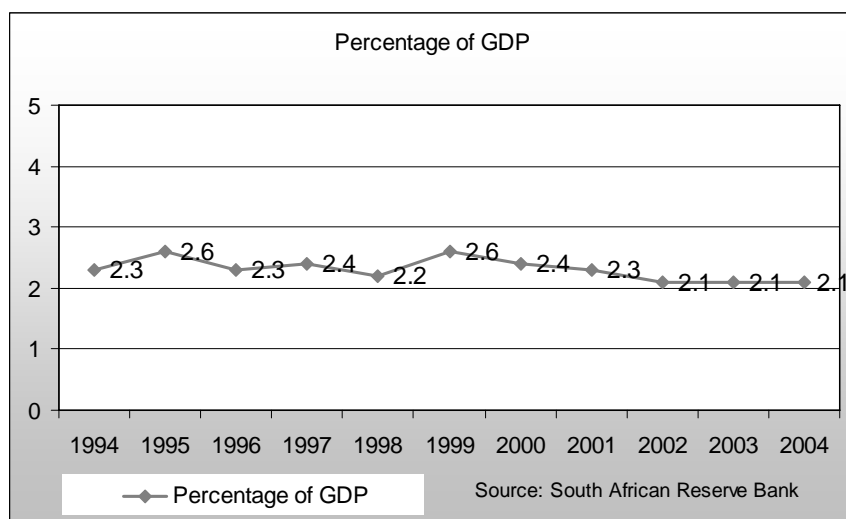


Figure 2.3 shows the split of market share between the primary market and reinsurance market and Figure 2.4 shows the split of market share of the primary market by segment.

Figure 2.3 - Market share split between primary and reinsurance market

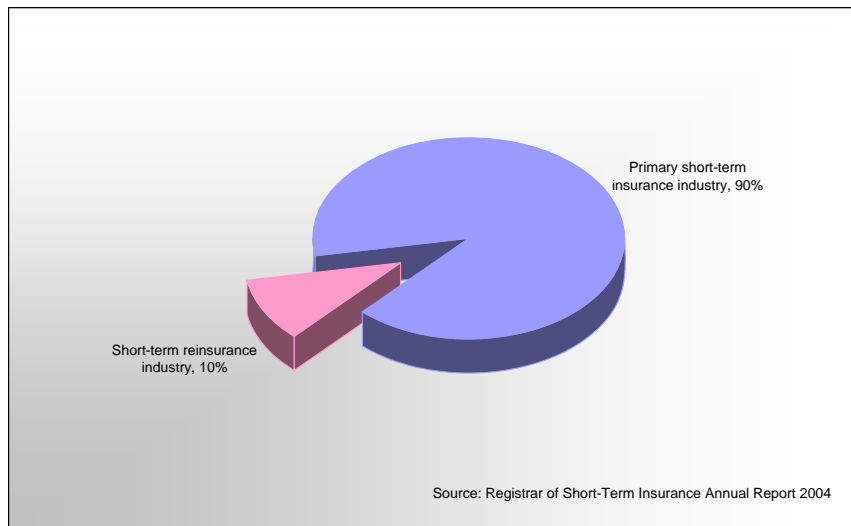
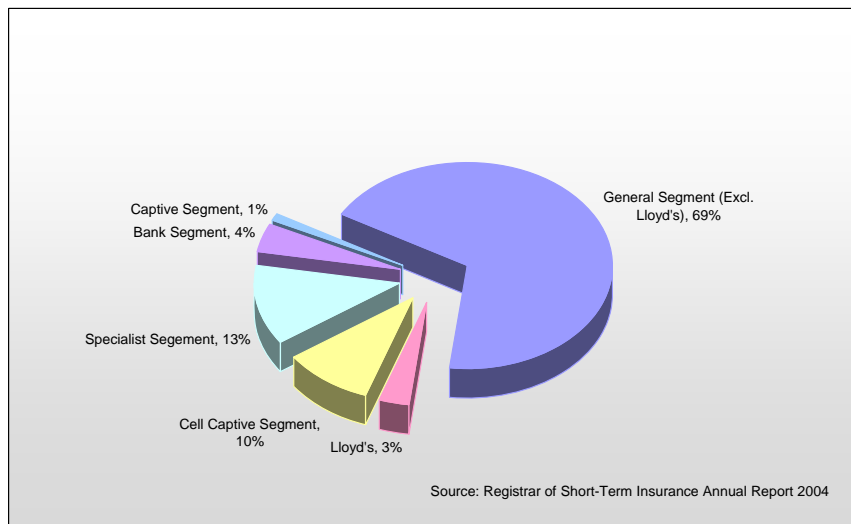


Figure 2.4 - Split of market share of the primary market by segment



In their 2005 Annual report, the Financial Services Board (FSB) lists the key challenges facing the industry as: increasing competition, a tighter regulatory environment focusing on a risk-based capital approach, changes in international

accounting standards and a more rigorous risk control and compliance environment.

2.3.1.1 Primary Market

Gross premiums written by the primary insurance market amounted to just under R40 billion in 2004. Over the past ten years there has been significant consolidation in the short-term insurance industry. Fifty percent of the primary market is controlled by just four insurers; Santam (20.0%), Mutual & Federal (14.8%), Hollard (8.4%) and SA Eagle (6.8%). Figure 2.5 shows the split of market share of the short-term insurance primary market and the composition of the gross premiums per policy type of primary insurers, excluding The South African Special Risks Insurance Association (SASRIA). Table 2.1 shows the percentage share of and amount of gross premiums written in the segment.

Whilst figure 6 illustrates

Figure 2.5 - Split of market share of primary market and split of gross premiums

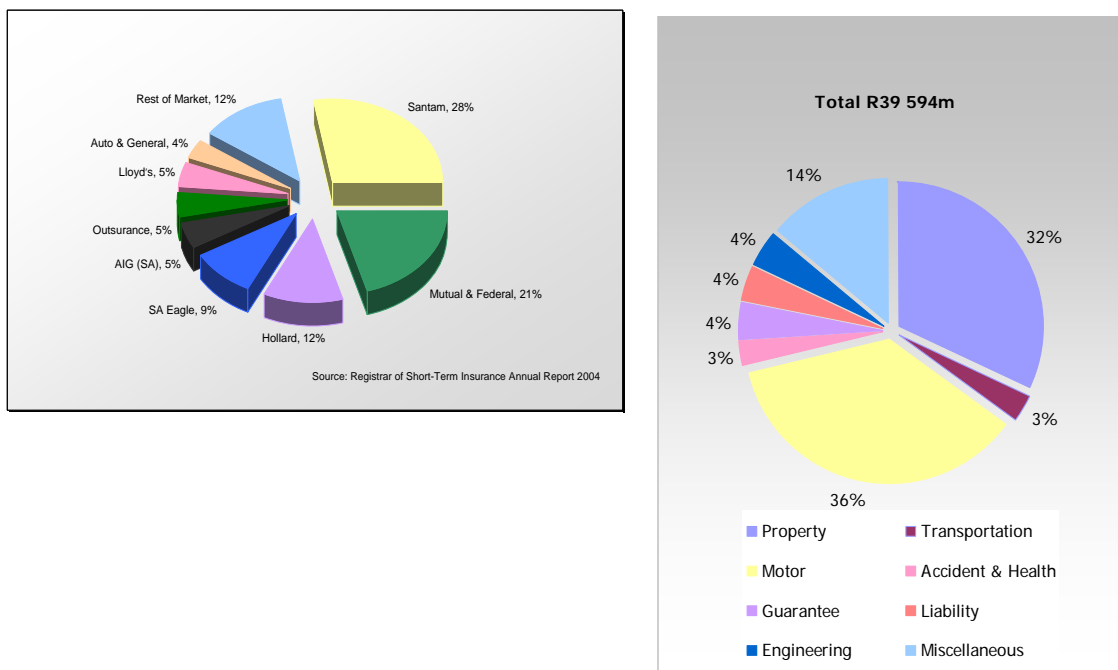


Table 2.1 - Percentage share of and amount of gross premiums written in the general segment

SHORT-TERM INSURANCE: MARKET SHARES 2004	Share of Total of segment	Total Gross premiums written	Share of Total primary market
GENERAL SEGMENT	%	R'000	%
Santam	27.7	8368572	20.0
Mutual & Federal	20.5	6189947	14.8
Hollard	11.7	3530192	8.4
SA Eagle	9.4	2840241	6.8
AIG (SA)	5.0	1506322	3.6
Outsurance	4.8	1460448	3.5
Lloyd's	4.6	1377859	3.3
Auto & General	3.8	1135201	2.7
Regent	3.1	933269	2.2
Constantia	2.9	886945	2.1
Lion of Africa	1.9	567899	1.4
Compass	1.2	363484	.9
New National	1.0	311379	.7
Guardian National	.7	205847	.5
Renasa (unaudited annualized figure)	.5	160909	.4
Global	.4	112204	.3
Dial Direct	.3	105341	.3
Alexander Forbes	.2	53058	.1
Safire	.2	50851	.1
Total	100	30159968	72.1

2.3.2 FINANCIAL OVERVIEW

Gross premiums of the primary insurers in the short-term insurance industry grew by 12.1% in 2004, compared to a 13.4% increase in 2003 and an increase of 18.5% in 2002. The increases in 2004 were attributed to inflationary increases in premiums coupled with sharp increases in the value of residential properties (Registrar of Short-term Insurance, Annual Report 2004).

2.3.2.1 Underwriting performance

There was a further substantial improvement in the underwriting results for the primary short-term insurance industry, from 6% in 2003 to 12% in 2004. All classes of businesses showed underwriting profits, except for miscellaneous business class. The strong performance was also in part attributed to the absence of any major catastrophes or natural disasters during 2004. Figure 2.6 shows how underwriting results and operating results (which include investment income) of primary insurers have fluctuated over the past 12 calendar years (Registrar of Short-Term Insurance Annual Report 2004). The figures exclude SASRIA. Figure 2.6 also highlights the importance of investment income for short-term insurers.

Figure 2.6 - Underwriting and operating results for primary

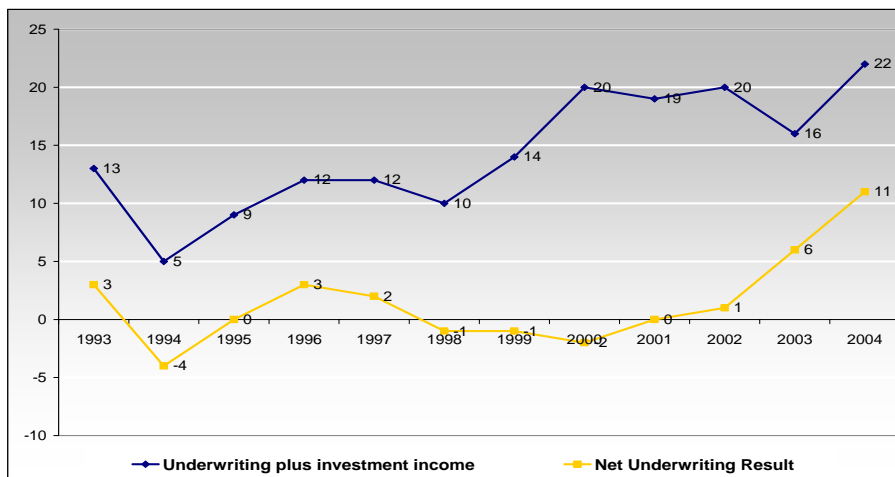
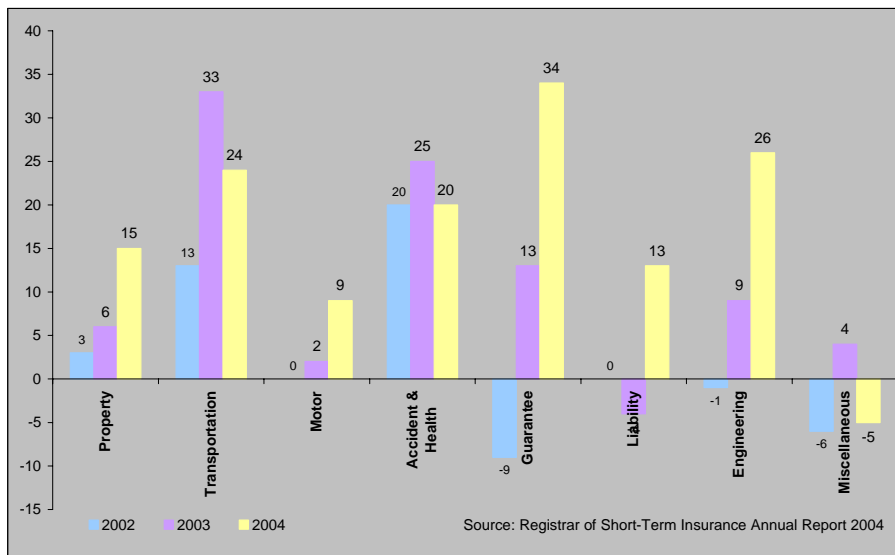


Figure 2.7 shows how the underwriting results, as a percentage of net premiums, per type of policy for primary insurers, have fluctuated over the past three calendar years. The figures exclude Sasria. These fluctuations in results

have been explicitly accounted for in the FSB-FCR recalibration of the industry's solvency requirements.

Figure 2.7 - underwriting results by type of business



2.3.2.2 Investment performance

Investment income contributed to a 24% operating profit expressed as a percentage of net premiums (after deducting reinsurance premiums) for 2004 compared to 17% in 2003. The insurance industry is an important source of funds for the Johannesburg Stock Exchange (JSE). The market capitalization of the short-term insurance sector on the JSE amounted to R22.0 billion on 31 December 2004, or 0.86% of the total market capitalization on the JSE. Figure 2.8 illustrates the market capitalization of the combined long-term and short-term insurance sectors on the JSE since June 1995, as at 30 June each year until June 2004 and then from December 2004 as at 31 December each year (Registrar of Short-Term Insurance Annual Report 2004). FCR will introduce capital requirements for investment risks and may encourage insurers to take

less investment risk by reducing the share of stocks in their investment portfolios.

Figure 2.8 - The market cap of the insurance sector on the JSE

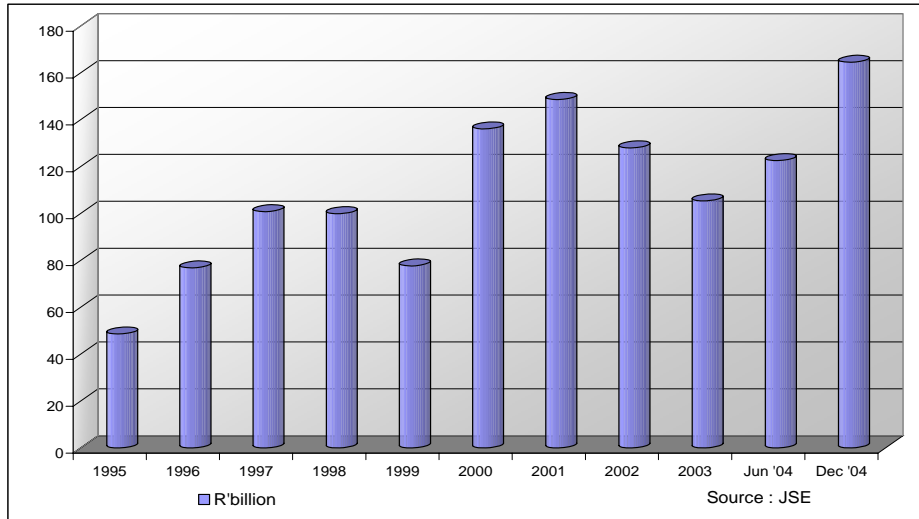


Table 2.2 below shows the total investment spread for the short-term insurance industry excluding Sasria.

Table 2.2 - Investment Spread

Kinds of assets	2002		2003		2004	
	R'm	%	R'm	%	R'm	%
Shares	14 399	33.9	15 094	32.8	17 468	33.6
Stocks	5 684	13.4	5 479	11.9	6 953	13.4
Debentures and mortgages	251	.6	455	1.0	1 003	1.9
Cash and deposits	13503	31.8	15 740	34.2	16 850	32.4
Fixed assets	513	1.2	519	1.1	558	1.1
Outstanding premiums	3 162	7.4	3 159	6.9	3 511	6.8
Debtors	4 976	11.7	5 555	12.1	5 595	10.8
Total	42 288	100	46 001	100	51 938	100

Source: Registrar of short-term Insurance Annual Report 2004

The Registrar, in the Short-term Insurance 2004 Annual Report, reported that surplus assets as a percentage of net premiums of primary insurers increased from 74% in 2003 to 76% in 2004. The report further went on to state that in the low interest rate and inflation environment short-term insurers are focusing their attention on optimizing the allocation of capital across business activities.

2.3.2.3 Financial Strength

Table 2.3 below shows the surplus asset ratio of the industry, which gives an indication of the financial strength of the short-term insurance market. Surplus asset ratio is net surplus assets expressed as a percentage of net premiums written by primary insurers. This table is specifically relevant to this report as FCR sets the minimum capital requirements for short-term insurers and is expected to reduce the number of insurers with surplus asset ratios below 30%.

Table 2.3 - Surplus Asset Ratio

Surplus asset ratio %	Number of insurers		
	2002	2003	2004
Below 15%	0	2	1
Between 15% and 20%	4	1	1
Between 20% and 25%	4	3	1
Between 25% and 30%	3	6	6
Between 30% and 40%	4	5	11
Between 40% and 50%	10	8	7
Between 50% and 100%	15	15	12
Above 100%	35	32	33

2.4 *FINANCIAL CONDITION REPORTING*

2.4.1 *Background to FCR*

Over the past five years the FSB has been reviewing the legislation covering the solvency and reporting requirements of short-term insurers in South Africa. The FSB is following the worldwide trend in moving to a risk based capital approach of monitoring the solvency of short-term insurance companies. A key part of the proposed changes is Financial Condition Reporting (FCR), which includes changes to the reserving and capital requirements of short-term insurers. The current solvency requirements will give way to a methodology that will calculate an insurer's minimum capital requirements using a risk-based approach for insurance risk, investment risk and concentration risk. Unlike the current regulatory framework, FCR will regulate the risk management procedures of insurers and assess their capital requirements based on the specific nature of the underlying business. Current indications from the FSB are that the new basis will be implemented in 2008.

In their draft proposal for new solvency assessments (2004), the FSB argues that capital and good management are the cornerstones of an insurer's strength. Capital provides a buffer against losses that have not been anticipated and, in the event of unforeseen circumstances, enables the insurer to continue operating while those problems are addressed or resolved. The maintenance of adequate capital resources can therefore engender confidence on the part of all stakeholders, creditors and the market as to the financial soundness and

stability of the insurer. In essence under FCR, an insurer will be required to hold capital commensurate with its overall risk profile. The FSB (2004) further argues that good management is the essence of corporate governance, which is required to manage the operational risks of the company and an insurer will therefore be required to have suitable systems in place to identify, manage and monitor the risks associated with its business activities.

The FSB's proposal for new capital and risk management regulation aims to ensure that the security of policyholder obligation of all insurers is established at an appropriate level by requiring that each insurer maintain at least a minimum amount of capital. The FSB (2004) states that it is the responsibility of an insurer's Board and senior management to ensure that the insurer's capital resources are appropriate for the size, business mix and complexity of its business.

2.4.2 Overall Framework of FCR

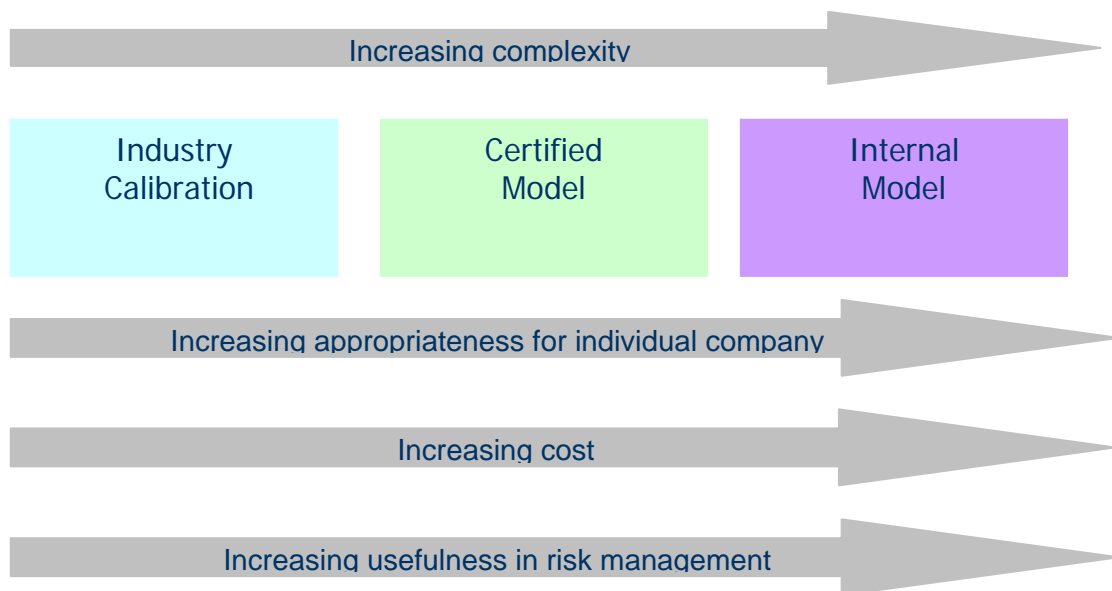
Actuarial & Insurance Solutions at Deloitte, and Insight ABC, were appointed by the FSB in April 2005 to calibrate FCR requirements for the short-term insurance industry in South Africa. Broadly the aim of the recalibration was to construct a formula, on the basis of data from STAR returns (Company data submitted by each registered insurer to the FSB), and Dynamic Financial Analysis (DFA), which would be an appropriate basis for a solvency requirement for the industry. The formula had to take into account international

developments, but at the same time be suitable for application in South Africa given available data in the STAR returns.

Deloitte had two major constraints throughout their project, namely that STAR returns did not contain the data required or that data was not reliable and secondly that the application of a central formula to the short-term industry as a whole will inevitably lead to situations where the formula does not “fit” individual companies with specific circumstances (Deloitte, 2005). Due to these constraints and to reward companies with good risk management under the new basis, insurers will have the choice of using the prescribed basis or apply to the FSB for approval to determine a different level of capital, using an internal model to calculate their minimum capital requirements (MCR). For those companies that do not construct a complete risk-based internal model, Deloitte (2005) has proposed the option of a certified model that allows companies to adapt elements of the regulatory framework to take into account their specific circumstances without having to set up a complex internal model. Further, it is understood that the FSB will be open to approaches by companies with particular circumstances and needs that may not be taken into account in the industry framework, to apply for special dispensation for the company to hold capital at a different level to any of the three models listed above. These companies would probably include reinsurers, cell-captive insurers, those operating on behalf of government with effective government guarantees and selected companies in niche markets. For this reason these companies do not

form part of the scope of this research report. The framework of industry calibration vs certified model vs internal model, is represented graphically in figure 2.10 below:

Figure 2.10 - Three solvency models for FCR



Source: Deloitte (2005)

In summary the Industry calibration is necessarily approximate as it must be prudent for all companies. However it may not be appropriate for specific circumstances of individual companies. The Certified model is more precise for the liabilities and individual circumstances of companies. However because it involves judgement, it requires professional certification. Finally the Internal model allows for maximum precision for liabilities and assets. It also requires professional certification and provided the models are transparent and realistic this leads to greater understanding of risks. For this reason the FSB will encourage all insurers to develop an in-house capital measurement model to calculate their MCR (FSB, 2004).

Deloitte (2005) argues that the above overall framework is preferable to the existing capital requirements (effectively 25% of Net Written Premium (NWP)), which:

- Does not take into account the real risks faced by companies (i.e. it does not take into account the size of the insurer, the class of business written, the combination of classes of business written (i.e. correlation and diversification), expenses and so on)
- Requires a level of capital which is prudent for some companies but not prudent for others.

Deloitte (2005) further argues that the only advantage of the current model is its simplicity. Although the mathematics of FCR is complex, Deloitte have developed a spreadsheet-based model contained in the STAR returns, which will allow companies to determine their new capital levels after completion of the STAR return.

Figure 2.11 is a graphical representation of the new solvency requirements, and applies regardless of whether a company uses the industry calibration, a certified model or an internal model. This model indicates that the new framework would establish the following principles for FCR (Deloitte, 2005):

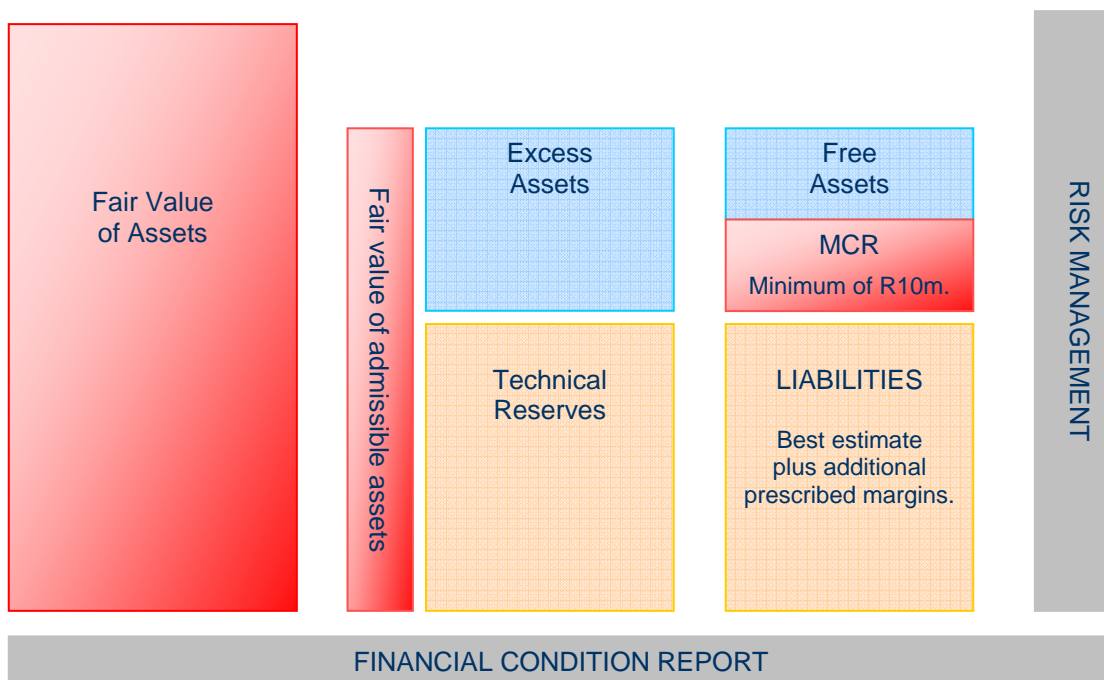
1. Assets should be valued at fair value.
2. Some assets will continue to be inadmissible for solvency calculation purposes (e.g. art).

3. A certain proportion of assets will be regarded as covering, or allocated to, insurance liabilities, or reserves.
4. For this purpose, insurance liabilities will consist of:
 - a. claims reserves, which in turn consists of:
 - i. incurred-but-not-reported (IBNR) claims; and
 - ii. outstanding reported claims; and
 - b. premium reserves, which consist of:
 - i. the Unexpired Premium Reserve (UPR); and
 - ii. where appropriate and needed, the Unexpired Risk Reserve (URR); and
5. The claims and premium reserves should be determined to be best estimates of the appropriate reserves.
6. A prescribed margin added to this takes the insurance liabilities up to the 75th percentile.
7. Once this has been done, the minimum capital requirement is determined in such a way that the total capital minus the prescribed margins will reflect a certain level of sufficiency: 98%, 99% or 99.5%. In other words, the total required capital minus the prescribed margins would represent the minimum capital requirement, or MCR. Terminology such as “75th percentile” or “sufficiency at the 98% percentile level” or “99% sufficient” are all phrases which express the same concept. To determine MCR and reserving requirements, DFA is used to construct a probability distribution of outcomes for a company (i.e. a distribution

reflecting the number of times out of many possible scenarios where a company's total capital would not be sufficient to meet its liabilities), and then measures the capital requirement at a point which would be sufficient for example to protect a company against insolvency half the time (set at the 50th percentile), or against the 3rd worst loss out of 4 (75th percentile), or against the worst loss out of 200 (99.5th percentile).

8. For smaller companies, the MCR would be subject to a minimum of R10 million.
9. Excess assets are admissible assets in excess of insurance liabilities (at a 75% level of sufficiency), and the MCR must be covered by excess assets under this framework.

Figure 2.11 - Graphical representation of FCR

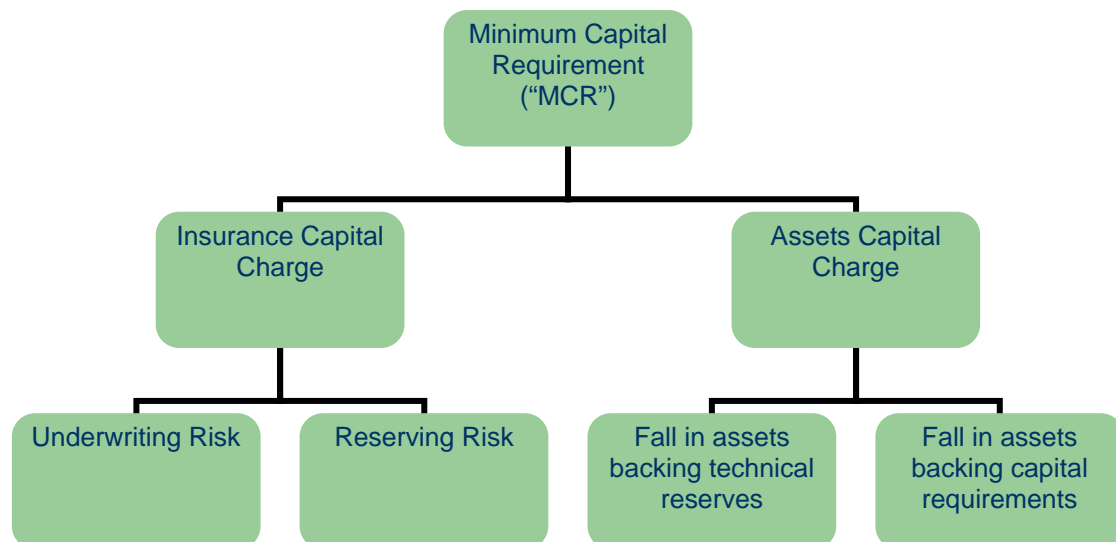


Source: Financial Services Board (2004)

2.4.3 Main components of FCR

The MCR is calculated as the amount of capital that will ensure that a company remains solvent at a set percentile of all circumstances in the coming year. The basis used by international regulators in the UK, Europe, Australia and other first world markets is the 99.5th percentile (i.e. that the company has a chance of 199 in 200 of being solvent in the coming year). Figure 2.12 below gives a high level graphical presentation of the various elements that the MCR will attempt to address.

Figure 2.12 - Main Components of MCR



Source: Quindiem consulting (2005)

The figure indicates that MCR consist of two main components, namely the insurance capital charge and the asset capital charge. These will be discussed in more detail below.

Insurance capital charge

The insurance capital charge was designed to cover the following risks:

- **Underwriting risk**, the risk that premium earned in future periods is insufficient to cover claims in those periods, thus forward looking
- **Reserving risk**, the risk that claims incurred historically is greater than the claims reserved for, thus backward looking.

Deloitte (2005) proposes a building-block approach for the calculation of the required insurance capital to promote transparency and flexibility in the use of the framework. In setting the insurance capital charge the following aspects are allowed for:

- The type of business underwritten and the relative risks and rewards of the type of business
- The amount of business written and concomitant diversification effects
- The relative amount of underwriting risk versus reserving risk
- The mitigation of risk through use of reinsurance
- Expenses
- Correlation between classes of business
- Diversification effects of writing different classes of business

The insurance capital charge is calculated in the following five steps (Quindiem Consulting, 2005):

- **STEP1:** Calculate the gross stand-alone risk capital for each STAR line of business. The size of the capital charge depends on the Gross Written Premium (GWP) and gross unearned premium reserve (“GUPR”) for each line of business.

The GUPR is the amount as published in the latest STAR returns, while the GWP is the premium that the company expects to write for that particular STAR line in the next 12 months.

- **STEP2:** Reduce the gross capital charge to allow for the company’s reinsurance on the specific line of business. This is done by multiplying the gross stand-alone risk capital by NWP/GWP .
- **STEP3:** Add an allowance for expenses and commission. These numbers are again obtained from the latest STAR returns.
- **STEP4:** Combine the capital charges from all lines to obtain the total capital required. The total capital charge will not be the sum of the individual charges. The total capital charge will be reduced to allow for the fact that one does not necessarily expect all lines to have their worst year simultaneously. This is where the allowance for correlation and diversification is made. Thus, if a company only underwrites one line of business there will be no reduction in this step.

- **STEP5:** Make allowance for the investment return that the company expects to earn on the assets backing technical reserves. This expected return is then deducted from the capital charge.

Asset capital charge

This charge covers the investment risk of short-term insurers. Investment risk is confined to the market risk aspect, i.e. the risk that market movements cause a loss in value of the assets held to back liabilities and capital requirements to such an extent that solvency is threatened (Deloitte, 2005). Table 2.4 shows the classes of assets as specified in the STAR returns, with the capital charge at the 99.5th percentile shown in column 2.

Table 2.4 - Surplus Asset Ratio

Asset Class	Capital Charge at 99.5%
Cash	0%
Fixed interest 1 year	6.67%
Fixed interest 2 years	11.27%
Fixed interest 5 years	19.75%
Fixed interest 7 years	24.6%
Fixed interest 10 years	27%
Property	32.5%
Equity	38%

The investment capital charge gives a set of capital adjustment factors for each asset class that should provide protection up to a specified level of confidence but not necessarily against all eventualities. The capital adjustment factor is applied to the value of the assets held in that class to arrive at an amount of capital to be held as a charge for investment risk (Deloitte, 2005).

2.5 LITERATURE REVIEW ON RISK-BASED CAPITAL APPROACHES TO SUPERVISION

2.5.1 *Relevant theory base*

The literature review and supporting theory base used in this section seeks to identify the key issues facing the South African short-term insurance industry in the transition to FCR. Globally there has been a strong trend for regulators to move towards a risk-based capital approach for the financial services industry, which started in the banking environment with Basel II and has filtered through to the insurance sector, as seen for example in Solvency II and changes made to the supervision of the short-term insurance industry by the Australian Prudential Regulatory Authority. This section of the literature review examines the international developments in risk-based capital, to identify the drivers of regulatory change across international territories and to determine the actual and perceived impact of new solvency regulation on the global short-term insurance industry.

2.5.2 *Background and international context of risk-based capital*

The insurance industry carries significant importance to the global economy, as it provides cover against various risks facing citizens, corporations, governments and other organisations. Pressman (2006) states that the insurance industry is a critical foundation of the global economy and that because the world is rapidly changing, insurers need to change with it and

recognize the broader, global reality in which insurance businesses are operating. Pressman (2006) argues that the industry has a joint responsibility to support free, fair and competitive markets so that customers can be provided with value and effective risk solutions and that the industry also has an obligation to maintain and strengthen its businesses so that it can provide long-term security to its customers. Recent catastrophic events – whether natural or man-made – have highlighted the significance of having a stable and solvent insurance sector. The industry, which as a whole, has been under challenge for some time for its inability to deliver consistent returns also faces a credibility crises on the fundamental issue of integrity (Pressman, 2006). The industry therefore has a shared interest with regulators worldwide in creating stable markets with transparency and balanced regulation.

An appropriate prudential framework for insurance is therefore a key interest to a large number of stakeholders (Linder, U. and Ronkainen, V., 2004). Globally there has been a strong trend for regulators to move towards a risk based capital approach for insurers (Deloitte and Insight ABC, 2005). Linder and Ronkainen (2004) argue that the objective of this change in capital regulation should be to create a prudential framework that more appropriately reflects the risks facing insurance undertakings, but at the same time the system should also include incentives for companies to assess and manage their risks. Solvency II, which is the insurance sector's equivalent of banks' new Basel II norms, is planned to be introduced in the European Union in 2010 and in

essence will demand that insurance companies have a far more precise grasp of the individual risks they are underwriting and require a commensurate allocation of capital for these risks (Felsted and Jenkins, 2006).

2.5.3 The impact of FCR on shareholder returns

The new minimum capital requirements under FCR will be almost double the current statutory capital requirements (Van Heerden, 2006). FCR is therefore expected to increase the amount of regulatory capital held by insurers. British insurers are preparing to step up lobbying over sweeping new European Union solvency legislation (Solvency II) that could force them to hold “deadweight” capital at great cost to their business (Felsted and Jopson 2006). Trainar (2006) argues that because capital is a scarce and therefore costly commodity that all sectors of the economy seek to attract and retain, the level of capital that public policymakers decide is necessary for the insurance business, is no simple micro-economic matter but first and foremost a macro-economic decision, with an impact on growth and development. At the release of AXA’s half-yearly figures, Mr. Henri de Castries (Chairman of the French insurance group) said that companies could be forced to hold excessive buffer capital under the EU’s Solvency II regulation, protecting against the unlikeliest of risks and leading to increased prices, which would reduce investment levels in the industry (Willis Re, 2006). Any additional statutory capital that insurers will be required to hold will have a cost, which is likely to reduce shareholder return and reduce the attractiveness of the industry.

2.5.4 The impact of FCR on insurance industry investment

Insurance companies are the third biggest source of capital for the European private equity (PE) industry, after banks and pension funds (Grant, 2005). Grant (2005), argues that unlike the current solvency rules which are very prescriptive about types of assets and levels of exposure permissible for insurers, the new solvency regime is likely to be more flexible and less stringent when it comes to investment portfolios of insurers', as long as the calibration of capital is appropriate to the relative risk in the investment. In South Africa, the market capitalisation of the combined long- and short-term insurance sectors on the JSE amounted to R105 billion on 30 June 2003 (Registrar of Short-term Insurance, 2002), making the insurance industry a very important source of capital commitments. The high asset capital charge for investments that are designated risky under FCR, may have an impact on the investment strategies of insurers, which could see funds moving out of equities into more conservative investments.

2.5.5 The impact of FCR on operational risk management

According to Speer (2005), Solvency II will facilitate a growing requirement for European insurers to improve their transparency and make more detailed information available to regulators, which will represent a radical change in current reporting practices for many European insurers, and analysts predict it will take many companies two to three years to put proper technologies in place to comply. O'Hara (2006) argues that the key to insurers' survival in a world that is becoming more complex and perilous, is a better understanding of the

changing characteristics of the risks they underwrite and an ability to assess the complex dynamic of the scope and correlation of these risks. Serio (2006), argues that because insurers are facing a number of serious issues from external forces, not the least of which has been a significant increase in regulatory and enforcement actions by American and International authorities, that the insurance industry will not be able to meet those challenges facing its various constituencies without being at peak operational, financial and ethical effectiveness and efficiency. Stein (2006), argues that Insurers cannot wait for the final text of Solvency II to put in place a strong risk management structure that will serve as the foundation for any required capital assessment.

Conaghan (2005) argues that companies and their offices need to turn governance, risk and compliance issues, such as Sarbanes-Oxley, Solvency II and Basel II, into strategic and economic value, as responsible management of risk is key to unlocking business value and creating wealth for shareholders. The new solvency regimes, both overseas and in South Africa, will require insurers to have in place a comprehensive risk-management strategy to identify, manage, monitor and report on their key risks. These more stringent regulatory requirements will come at a cost and create an international consulting industry feeding frenzy not seen since the days of Y2K, but this level of spending is not sustainable and companies must seek to embed the right sort of culture, systems and processes to ensure that governance and risk management are part of the fabric of the organisation (Conaghan, 2005).

The rigorous assessment of risks under Solvency II and FCR could prove a strain for some. In particular smaller insurers, who lack the resources of their larger counterparts, may struggle. Smaller insurers are also less likely to have the resources to develop their own internal models, and so could be at the mercy of the regulators' calculations (Reaction, 2005).

2.5.6 The international role of regulatory bodies

Bäte (2006) contends that regulation of the financial industry should pursue three key objectives: consumer protection, market stability and competitive efficiency. Stein (2006), argues that the revision of solvency regulations across the United States and Europe is being driven by the need for a consistent approach to valuing assets and liabilities and that harmonisation of the solvency system in European member states is a key European Commission objective. Since 2000, the European Commission has been working towards creating a single insurance market with a common regulatory and legal framework (Life Insurance International, 2005). However according to Speer (2005), many insurers question the necessity of additional standards and reporting, whether it is under Sarbanes Oxley (SOX) or Solvency II. They also question whether promulgation of additional reporting requirements here or abroad will really help or fix any inherent problems. In addition to the above, some stakeholders have raised concerns that if a territory's new regulatory regime is too onerous, that this might affect the attractiveness of the industry to foreign investors (Reactions, 2005). Regulatory bodies therefore need to balance the need for market stability and consumer protection with market efficiency.

2.5.7 Convergence of supervisory models across the financial services industry

The revision of the solvency regime for insurance companies aims to achieve for insurance what Basel II has for banking, by linking regulatory capital requirements to risk (Grant, 2005). Risk based capital aims to promote best practice and further convergence in prudential standards setting across the financial services industry. International Financial Reporting Standards (IFRS), Basel II and Solvency II represent a common front, which will broaden the scope of disclosure of risk and capital management and is likely to open companies up to ever greater market scrutiny at a time when competition is increasing as the line between banking, insurance and other financial services sectors continues to blur (McDonnell, 2006). McDonnell (2006), states that IFRS is designed to increase the comparability between companies across industries and borders. McDonnell (2006) argues that risk Management, regulatory and financial reporting and investor relations teams need to work together to optimise the synergies between IFRS, and Basel II/Solvency II, as effective risk and capital management disclosures are emerging as a competitive imperative with important implications for share prices and the cost of capital.

The International Association of Insurance Supervisors (IAIS) has adopted a paper that its drafters say lays the foundation for a worldwide solvency standard for insurers (Miller, 2005). According to Miller (2005), the so-called “cornerstone” document will serve as a useful framework for both developed

insurance markets and for some emerging markets, as the solvency standards paper outline eight fundamental cornerstones that form the basis of any “decent solvency regime”.

2.5.8 South African context

Post 1994, the democratic government has undertaken regulatory changes designed to protect the most vulnerable consumers of financial services – this has included recent market conduct legislation in the form of the Financial Advisory and Intermediary Services Act (FAIS Act), the Policy Holder Protection Rules (PPR) and the Financial Services Ombud Schemes Act (FSOS Act); as well as planned changes to the Pension Funds Act and ongoing work in reviewing competition, disclosure and consumer protection in the banking and insurance industries. FCR can be seen as part of these broader regulatory changes. The new solvency assessment proposal for short-term insurers (FCR) aims to ensure that the security of policyholder obligations of all insurers is established at an appropriate level by requiring that each insurer maintain capital resources that are appropriate to the size, business mix and complexity of its business (Financial Services Board, 2004). However because FCR is expected to increase the amount of regulatory capital held by insurers, this could have a negative impact on the Financial Services Charter, in respect of attracting black investors into the industry.

2.6 CONCLUSION TO LITERATURE REVIEW

Insurance differs from other industries in two important ways. First, in most industries, companies and individuals attempt to shed risk, but the insurance industry is in the business of attracting risk. Secondly, the insurance industry is unique in that it sells a product for which the ultimate cost is not known when it is sold General Re, (2005). Therefore an insurer's ability to anticipate environmental developments that impact on their business and understand these factors better, so as to align their company with the positive forces and take steps to protect their company against the negative ones, is crucial for survival in the new global economy.

There is sufficient evidence from the literature review to suggest that the transition to FCR will pose a significant challenge to the short-term insurance industry in South Africa. At the same time however there are also several opportunities and benefits awaiting those insurers who embrace the principles of risk based solvency and take the steps necessary to develop their own internal capital and risk models.

CHAPTER 3: PROPOSITIONS

Because of the important role that the insurance industry plays within the global economy, there is a lot of debate currently taken place around the impact and effectiveness of changing regulatory capital and prudential models around the world. The specific research propositions that will be made, to validate the existing theory base and to assess the perceived impact of FCR on short-term insurers, are:

PROPOSITION 1:

The transition to FCR will put the South African Short-term industry at the leading edge of global markets in respect of risk management and corporate governance, which will improve consumer and other stakeholders' confidence in the industry.

PROPOSITION 2:

The likely increased capital requirement for the industry will drive down shareholder returns from the short-term insurance industry and as a result put upwards pressure on the pricing strategy of insurers and lead to higher cost of insurance for consumers.

PROPOSITION 3:

The high asset capital charge for equity assets under FCR will change the investment strategies of short-term insurers.

PROPOSITION 4:

The increased capital requirements for smaller and mono-line insurers will lead to further consolidation in the short-term industry and a less competitive environment.

PROPOSITION 5:

The more stringent capital, risk management and disclosure requirements will stifle new entrants from coming into the market.

CHAPTER 4: RESEARCH METHODOLOGY

4.1 RESEARCH METHOD

Due to the technical nature of this research and the small population of relevance, the method of research was qualitative. This study also lends itself to qualitative research as the required results are non-statistical in nature and it is insights into the research problem that are required, rather than explicit data. The Delphi technique was used to solicit expert opinion and consensus on the expected impact of FCR on the short-term insurance industry and to identify the major issues in the transition to the proposed new capital adequacy requirements.

4.1.1. Background to the Delphi Technique

The Delphi technique was developed during the 1950s by workers at the RAND Corporation as a procedure to obtain the most reliable consensus opinion from a group of experts (Rowe, G, Wright, G and Bolger, F, 1991). Since then it has been used and adapted to address a variety of complex future-oriented questions (Taylor-Powell, E, 2002). According to Rowe et al. (1991) the main criterion for Delphi's employment is the indispensability of judgemental information, which may arise in cases where no historical data exists. The purpose of the Delphi technique is to elicit information and judgements from participants to facilitate problem-solving, without physically assembling the contributors, through mediums such as surveys, questionnaires and e-mails (Dunham, 1998). A key advantage of the Delphi technique is that it avoids

direct confrontation of the participants (Okoli and Pawlowski, 2006, Riggs, 1983, Taylor-Powell, 2002).

4.1.2 The Delphi Process

The Delphi technique is an iterative process that involves mailing repeated rounds of questionnaires to a selected panel, considered to be experts in a given subject matter. Responses to each round are summarised and developed into the next round questionnaire that seeks to develop insights and meaningful consensus of the group of experts (Taylor-Powell, 2002).

The key features that characterise a Delphi procedure are anonymity, iteration, controlled feedback, and statistical aggregation of group response (Rowe et al. 1991).

4.1.3 Defence of the Delphi technique for this research

The Delphi technique was chosen for this research report for the following reasons:

- There are a limited number of experts on the topic of FCR in South Africa. Literature from Delphi recommends a panel size of between 10 to 18 people (Okoli and Pawlowski, 2006), which makes it a suitable research methodology for this survey.
- The Delphi technique is inexpensive and has reasonably good prediction accuracy over different time horizons (Gupta and Clarke, 1996). It is also a reasonably simple process to manage and with the medium of e-mail, easily

executable. This was a major advantage due to time constraints of the panel of experts.

- Recent evidence from Delphi literature appears to show that either two or three rounds of questionnaires are preferred for discovering the opinions of the panel (Hasson, Keeney & McKenna, 2000). This is another advantage for using this technique, due to the limited time available for the research and the time constraints of the panel of experts.
- Webler, Levine, Rakel and Renn (1991) argue that the Delphi technique is a useful tool to help predict future conditions when there is uncertainty and incomplete knowledge surrounding a major decision. The introduction of FCR by the FSB represents such a decision and the literature review clearly indicates a large degree of uncertainty surrounding the impact of this proposed new legislation.

4.2 UNIT OF ANALYSIS / POPULATION OF RELEVANCE

FCR regulates the short-term insurance industry and therefore the population of relevance encompasses all registered short-term insurers in South Africa. According to the Financial Services Board's 2005 annual report, there are currently 100 short-term insurers operating in the South African market, of which eight are reinsurers.

4.3 SAMPLING METHOD AND SIZE

The sample was selected stratified randomly based on the type of insurer according to the Financial Services Board's definition of insurers. The short-term insurance industry is categorized into two markets, the primary market and the reinsurance market. The primary market is further divided into general, cell captive, specialist, banking and captive segments. The largest sub-category of insurers is typical insurers, which make up more than 70% of the market (Financial Services Board, 2005).

The cell-captive, specialist, bank and captive segments were excluded from this research, as at the time of writing it was still not completely clear how these segments would be regulated under the proposed new capital adequacy requirements. Lloyd's approved correspondents were also excluded from this research, as Lloyd's capital solvency is governed by UK legislation. The population of relevance was therefore the nineteen insurers registered under the general segment of the primary market of short-term insurers in South Africa.

4.4 DATA GATHERING PROCESS AND ANALYSIS APPROACH

Data was gathered and analyzed using the Delphi Technique and the constant comparative method. The steps performed in the Delphi process for this research are presented below.

4.4.1 Identification and selection of panel of experts

The selection of the panel of experts is one of the key decisions in the preparation of the process, as the quality and accuracy of responses to a Delphi are only as good as the expert quality of the participants who are involved in the process (Taylor-Powell, 2002). Webler et al. (1991) argue that the foremost concern in assembling the expert panel is to ensure the entire array of perspectives is represented within the discipline. For the above reasons the researcher put the selection process through a rigorous assessment to ensure the panel had sufficient knowledge on the topic and that the panel broadly represented the groups that are impacted by FCR, as shown below in Table 4.1.

Table 4.1 - The stakeholders in the transition to FCR are as follows:

GROUP	ROLE
FSB (regulator)	Responsible for developing the framework, policies and regulation of FCR
Actuarial Society of South Africa	Offer guidance and support to the FSB in developing Risk Based Supervision framework
Insurers	Recipients of Risk Based Supervision
Consultants	Assist insurers to develop their risk management and capital models
Auditors	Responsible for reporting on effective implementation and auditing of FCR within the industry
Customers	The primary aim of FCR is protection of customers of the industry

The FSB has formed three working groups to refine the guidelines, principles, policies and procedures of FCR, to assist the industry with the implementation of RBS. The groups are the internal model committee, certified model

committee and disclosure and risk management committee. Each committee is made up of representatives from government (FSB and SARS), short-term insurers, auditing firms and the Actuarial Society of South Africa. The participants on the committees are all knowledgeable on FCR and their presence on the committees implied they were up to speed with the latest developments of RBS.

Participants of the above committees and other individuals that were identified as being knowledgeable and/or influential in the transition to FCR were invited to join the research panel. The researcher contacted these experts via e-mail and briefly explained the planned process to determine their willingness to participate. Of the original 40 invites that were sent out, 24 (60%) responded positively. The names of the panel are listed below in table 4.2.

Table 4.2 - Names of participants of the research panel

First Name	Last Name	Company	Sector
Alex	Thomson	Quindiem	Actuarial Consulting
Andre	van Vuuren	FSB	Government
Andrew	Warren	Quindiem	Actuarial Consulting
Annemarie	Sinclair	Hollard	Insurer
Anthony	Dienst	Guardrisk	Insurer
Asher	Grevler	Santam	Insurer
Bob	Killops	SARS	Government
Chris	Kemp	Mutual & Federal	Insurer
David	Kirk	KPMG	Auditing/Consulting
Gary	Ankcorn	Aon Re	Broker
Ian	Ross	Hollard	Insurer
Mark	Dunn	Constantia	Insurer
Marthinus	Visser	Outsurance	Insurer
Philippa	Wild	Munich Re	Reinsurer
Sumarie	Greybe	Quindiem	Actuarial Consulting
Wynand	Viljoen	Quindiem	Actuarial Consulting
Andre	Jordaan	Guardrisk	Insurer

First Name	Last Name	Company	Sector
Lisa	Pines	EMB SA	Actuarial Consulting
Nigel	England	Auto & General	Insurer
Riaan	Botes	Guy Carpenter	Broker
Wilhelm	von La Chevallerie	Hannover Re	Reinsurer
Emile	Stipp	Deloitte	Auditing/Consulting
Sam	Isaacson	Deloitte	Auditing/Consulting
Gerdus	Dixon	KPMG	Auditing/Consulting

4.4.2 Data gathering and analysis

Three rounds were used to gather the data. A deadline for the return of responses for each survey round was provided and the researcher followed up with those participants who did not respond by the target date. Please see Annexure A for sample details of the communication that was sent out to the participants, including the invitation to participate.

The first round requested the participants to list what they viewed as the major issues that face the short-term insurance industry in the transition to FCR and what impact they perceive FCR will have on the short-term insurance industry. The participants were requested to list 5 – 10 views in total on the above topics, in a brief and concise manner, using a template which was attached to the e-mail for their answers. The participants were provided with a deadline date to respond and all 24 participants responded to the first questionnaire.

The collection and analysis of the data was done simultaneously. The constant comparative method was used for the analysis of the data received from the first questionnaire to summarise the responses for the ranking exercise. The

constant comparative method of data analysis, which involves constant comparisons of sets of data collected from interviews and questionnaires etc., has been used by researchers not seeking to build a substantive theory (Merriam, 1998). According to Merriam (1998) content analysis is used in qualitative research to analyse data for themes and recurring patterns of meaning. The process involves the simultaneous coding of raw data and the construction of categories that capture relevant characteristics of the content.

The answers to the first questionnaire were collated and saved into a single spreadsheet. A total of 154 statements/views were received from the participants. The data was then divided into categories which grouped responses with similar themes and meaning. According to Hasson et al (2000), where different terms are used for what appears to be the same issue, the researcher can group them together so as to provide one universal description of the issue. Messages with the same meaning were therefore summarised into single statements and a synopsis of the responses on the two questions listed above was compiled.

The second round requested the participants to review the summary of the responses received on the first question of the research, i.e. the major issues facing the short-term insurance industry in the transition to FCR and to select from the list, the top ten issues that they felt will have the most impact in the transition to FCR. Participants were requested to rank order their selection from

one to ten in order of importance. Twenty (83%) participants responded to the second questionnaire.

The final questionnaire requested the panel to select from a summary list of perceptions on the impact of FCR, the top ten views that they felt have the highest probability of impacting on the short-term insurance industry. Participants were again requested to rank order their selection from one to ten in order of importance. Sixteen (67%) participants responded to the third questionnaire.

4.4.3 Reporting on the results

According to Hasson et al. (2000) the literature on Delphi shows a number of approaches have been used for reporting findings of Delphi surveys. These include graphical representations and textual presentations of statistical results outlining central tendencies and ranks.

The results of this survey have been reported under chapter 5, which shows the ranks of the top ten issues and perceived impact of FCR on the short-term insurance industry in South Africa.

4.5 RESEARCH LIMITATIONS

The following was regarded as research limitations for this study:

- The move towards risk-based capital in international markets is still in its early stage and there is therefore limited data on the impact of solvency changes to base the research on.
- FCR will only be implemented in South Africa in 2008 and the proposed capital and regulatory guidelines may still be amended.
- Because the proposed implementation date is only in two years time, insurers and other stakeholders may not as yet have applied sufficient thought to the changes to give meaningful insights into the impact of FCR.

CHAPTER 5: RESULTS

5.1 INTRODUCTION

The objective of the survey was to identify the key issues facing the short-term insurance industry in the transition to FCR and to solicit the perceived impact of FCR on the industry, from industry experts and those that are influential in shaping the new supervisory framework.

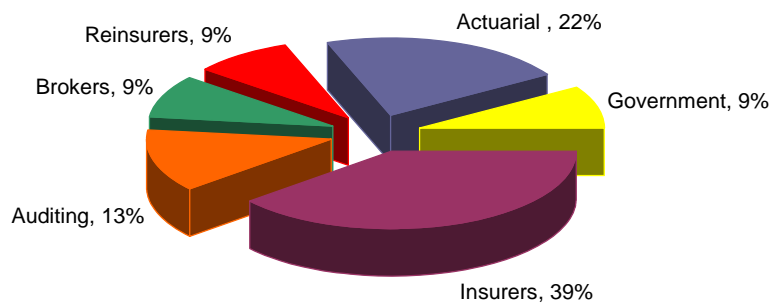
Three rounds were used to complete the Delphi. In the first round participants were requested to list 5 – 10 views in total on the above topics, in a brief and concise manner. The second round requested the participants to review the summary of the responses received on the first question of the research, i.e. the major issues facing the short-term insurance industry in the transition to FCR and to select from the list, the top ten issues that they felt will have the most impact in the transition to FCR. The third round requested the participants to select from a summary list of perceptions on the impact of FCR, the top ten views in rank order that they felt are the most important in the transition to FCR.

The panel was made up of 24 participants. Table 5.1 shows the representation of the panel by company and Figure 5.1 shows the representation of the panel by sector.

Table 5.1 - Representation of the panel by company

Primary Market	Reinsurance Market	Government	Auditing Consulting	Actuarial Consulting	Broker
Hollard	Munich Re	FSB	KPMG	Quindiem	Aon Re
Santam	Hannover Re	SARS	Deloitte	EMB SA	Guy Carpenter
Mutual & Federal					
Auto & General					
Outsurance					
Constantia					
Guardrisk					

Figure 5.1 - Representation of the panel by sector



5.2 RESULTS OF ROUND ONE

The synopsis of the answers to the questions on the issues that will have the highest impact in the transition to FCR and the participants' perception on what impact FCR will have on the short-term insurance industry are shown below in

table 5.2 and 5.3 respectively. Please see Annexure B for the full list of answers received from round one.

Table 5.2 - Consolidation of the issues

Synopsis of issues facing insurers in the transition to FCR
Many companies will need to consider how to address the requirements of building an in-house model to satisfy the FSB requirements for FCR, this will include whether or not to hire or outsource the services of actuaries.
The willingness of company management to integrate FCR and Risk-based Supervision into the day-to-day management of the company
There are several challenges facing SA (and other countries) regarding calibration of certain aspects of internal models. For example the calibration of operational risk into the internal and prescribed models and a lack of a common appreciation of catastrophe modelling
Obtaining industry-wide agreement on the proposed legislation and getting the legislation through parliament
The transition to FCR will be extremely costly and time consuming.
The communication of FCR to stakeholders is a complex process and may be misunderstood.
The level of sophistication of IT within the Short term Insurers and their supporting UMA will have to increase.
Lack of in-house skills within smaller companies, reliance on out-sourcing of actuarial skills
The resources necessary for compliance with FCR will be substantial
Prescribed method generally over-stating capital requirements
The FSB will need to demonstrate that they have the capacity to audit in-house models and regulate FCR.
The FSB and the industry will need to convince SARS that any additional reserving via whatever mechanisms are available is allowable for tax purposes.
The introduction of FCR will significantly raise the barrier to entry for new entrants to the industry
Additional capital requirements may cause investor concern for the Short-term insurance industry and may also affect intended BEE deals.
The prescribed model, does not properly reflect the long-term value of non-proportional reinsurance, since the SA industry has not experienced large catastrophe losses over the last 5 years in comparison to Europe and the US.
The small pool of available trained non-life actuaries in SA to do the work required in the transition to FCR
For those companies with increasing capital requirements, competitiveness may be compromised, as some proportion of the cost of capital would have to be funded from premiums.
Short term insurers will need to get a much improved and deeper understanding of the risks being written by their underwriters both in-house and through separate Underwriting Managers

Synopsis of issues facing insurers in the transition to FCR

The transition to FCR will likely be unsettling to the industry as management spend time working towards the implementation of FCR within the company.

The current uncertainty with respect to the ultimate FCR guidelines and regulations (legislation) is creating confusion and may lead to a problematic transition.

Table 5.3 - Consolidation of the perceived impact of FCR

Synopsis of the perceived impact of FCR

FCR should improve the focus on company-wide risk management and lead to a more rigorous assessment and understanding of insurance risk and capital. This focus should, if implemented correctly, ensure that the industry is better able to withstand internal & external shocks

Those insurers that develop an internal model will have a deeper understanding of the various risks that impact on their organisation and how they interact, which will lead to an improved and more integrated and coordinated approach to risk management.

FCR will probably encourage companies to apply a more scientific approach to capital allocation decisions, as there will be a definite link between the risk associated with a line of business and the capital required to support it.

FCR will significantly increase regulatory costs of insurers; in respect of management time, resources and systems required for statutory compliance.

FCR will bring South Africa in line with international standards in risk assessment, which is essential as the industry operates in a global market.

FCR will improve the quality of companies' information systems and the accuracy of their data, increasing management's understanding of the actual risk inherent in the business that they write.

FCR will increase the complexity of both business operations and system requirements, particularly for those companies who develop an internal model.

The capital requirements under FCR will significantly raise the barrier to entry and make the industry less attractive to potential new entrants.

FCR will increase the demand for professional consulting firms, especially in respect of peer review and independent verification of internal models.

The onerous capital requirements and cost of implementation of FCR will pose a significant challenge to small and monoline insurance companies.

Under FCR more emphasis is likely to be placed on capital management with respect to insurers' reinsurance purchase considerations.

Consumers could be affected through higher prices (to meet the cost of capital in pricing), but will enjoy the benefits of a more secure insurance market.

Insurers may follow a more conservative approach to their investment strategies, with more investments in cash and bonds and less in equities, as companies aim to reduce the capital charge for asset risk.

Synopsis of the perceived impact of FCR
The new capital requirements under FCR will impede the industry's efforts to transform the industry and meet the BEE ownership goals of the Financial Services Charter.
FCR may encourage companies to diversify their lines of business.
FCR is likely to have a negative impact on RoE and could also impact on dividend policies, as insurers will be required to retain higher levels of shareholders' funds.
FCR is likely to speed up further consolidation of the short-term insurance industry.
FCR will help build the confidence of consumers in the industry, particularly as firms that have developed their own internal models will be able to clearly demonstrate their capital strength.
FCR will continue the global trend towards convergence of capital and insurance markets and will ease the way to a single financial services regulatory environment.

5.3 RANKING THE RESULTS

In rounds two and three participants were requested to select from the two synopses above, ten statements from each synopsis, which they felt were the most importance. The panel was requested to rank order their selection from one to ten, one for the statement of highest importance down to ten. The scoring system below (Table 5.4) was used to rank the overall top ten issues and top ten views on the impact of FCR.

Table 5.4 - Allocated scores for ranking

Selection	Allocated Score
No selection	0
10	1
9	2
8	3
7	4
6	5
5	6
4	7
3	8
2	9
1	10

The scores for each statement were then summed and the ten statements with the highest scores, in rank order, were then identified.

5.4 RESULTS OF ROUND TWO

The top ten issues facing the short-term insurance industry from the results of the Delphi are listed below, together with a histogram showing the spread of the frequency per score for each statement.

1. For those companies with increasing capital requirements, competitiveness may be compromised, as some proportion of the cost of capital would have to be funded from premiums.
2. Short term insurers will need to get a much improved and deeper understanding of the risks being written by their underwriters both in-house and through separate Underwriting Managers.
3. The introduction of FCR will significantly raise the barrier to entry for new entrants to the industry.
4. The FSB will need to demonstrate that they have the capacity to audit in-house models and regulate FCR.
5. The transition to FCR will be extremely costly and time consuming.

6. The resources necessary for compliance with FCR will be substantial.
7. The small pool of available trained non-life actuaries in SA to do the work required in the transition to FCR.
8. The level of sophistication of IT within the Short term Insurers and their supporting UMA will have to increase.
9. Many companies will need to consider how to address the requirements of building an in-house model to satisfy the FSB requirements for FCR, this will include whether or not to hire or outsource the services of actuaries.
10. Additional capital requirements may cause investor concern for the Short-term insurance industry and may also affect intended BEE deals.

5.5 RESULTS OF ROUND THREE

The top ten views on the perceived impact of FCR on the short-term insurance industry from the results of the survey are listed below, together with a histogram showing the spread of the frequency per score for each statement.

1. FCR should improve the focus on company-wide risk management and lead to a more rigorous assessment and understanding of insurance risk and capital.

This focus should, if implemented correctly, ensure that the industry is better able to withstand internal and external shocks.

2. Those insurers that develop an internal model will have a deeper understanding of the various risks that impact on their organisation and how they interact, which will lead to an improved and more integrated and coordinated approach to risk management.

3. FCR will probably encourage companies to apply a more scientific approach to capital allocation decisions, as there will be a definite link between the risk associated with a line of business and the capital required to support it.

4. FCR will significantly increase regulatory costs of insurers; in respect of management time, resources and systems required for statutory compliance.

5. FCR will bring South Africa in line with international standards in risk assessment, which is essential as the industry operates in a global market.

6. FCR will improve the quality of companies' information systems and the accuracy of their data, increasing management's understanding of the actual risk inherent in the business that they write.

7. FCR will increase the complexity of both business operations and system requirements, particularly for those companies who develop an internal model.

8. The capital requirements under FCR will significantly raise the barrier to entry and make the industry less attractive to potential new entrants.

9. FCR will increase the demand for professional consulting firms, especially in respect of peer review and independent verification of internal models.

10. The onerous capital requirements and cost of implementation of FCR will pose a significant challenge to small and monoline insurance companies.

CHAPTER 6: DISCUSSION OF THE RESULTS

6.1 INTRODUCTION

When interpreting the results of a Delphi survey it is important to bear in mind that this method of research merely helps identify areas that one group of participants or experts consider important in relationship to the topic and therefore the existence of a consensus does not necessarily mean that the correct answer, opinion or judgement has been found (Hasson et al, 2000). The writer has taken cognisance of this in the discussion and interpretation of the results.

A summary of the key findings of the survey is discussed below and this is followed by an evaluation of the results in terms of the research propositions and the literature review.

6.2 KEY FINDINGS OF THE SURVEY

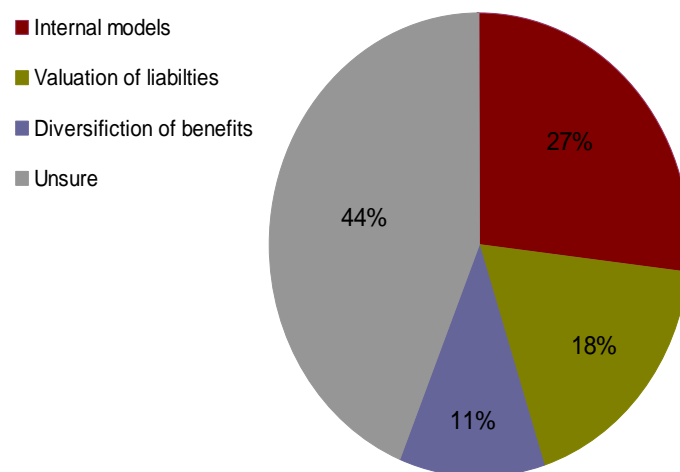
An analysis of the impact of FCR can only be preliminary without the new solvency regulation being in place at the time of this research. This limitation notwithstanding, the key messages from the survey are:

- In general there is overall support for FCR and the principles of RBS. The survey indicates that FCR will lead to improved risk and capital management within the industry. Similar to Solvency II, FCR will introduce an integrated

risk approach for solvency calculations, which will most likely lead to a more stable insurance industry. This will meet the primary objectives of FCR which is protection of policyholders and a solvency regime which better matches insurers' capital requirements to the risks they carry.

- Again similar to Solvency II, there is a large degree of uncertainty surrounding the impact of FCR. Forty-four percent of the 294 companies surveyed in the KPMG Capital Assessment Practice Survey (2006) were unsure as to what Solvency II may bring (see figure 6.1). Similarly in South Africa, the PricewaterhouseCoopers (2006) Insurance Industry Survey indicates that a number of South African insurance companies are unsure of the full ramifications of FCR.

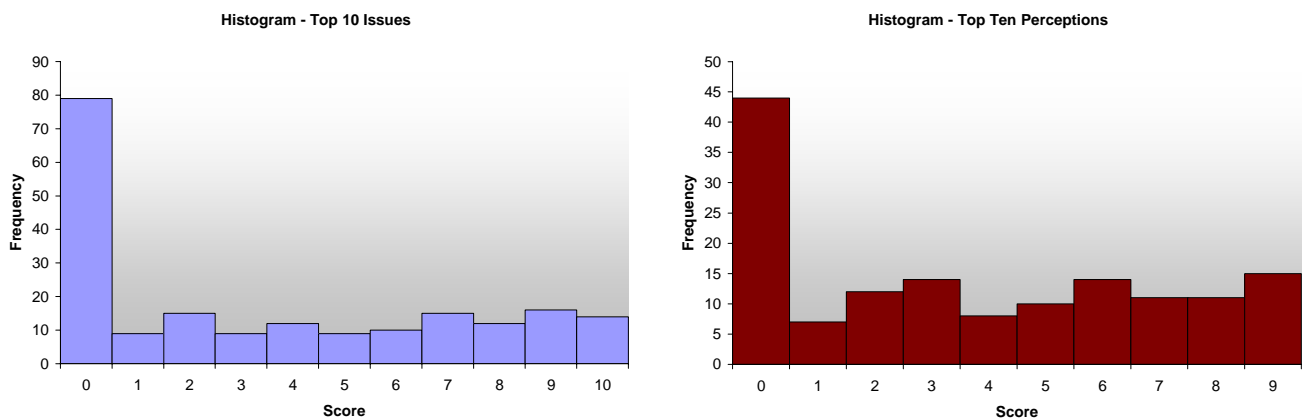
Figure 6.1 - Solvency II: The main challenges facing the insurance industry



Source: KPMG International, June 2006

- There are strong differences in opinion on the key issues and main challenges for implementing FCR requirements amongst the participants. Figure 6.2 shows the frequency of scores for the top ten issues and perceptions as ranked by the panel. A zero score indicates that the statement did not receive a score and was therefore not rated by the participant, whereas a score of 10 indicates the statement was rated as the most important by the participant. Figure 6.2 clearly indicates that even on the key issues there are strong differences of opinion amongst the experts on the impact FCR will have on the industry. This is further evidence of the high degree of uncertainty surrounding the full ramifications of FCR.

Figure 6.2 – Histograms of top ten issues showing frequency of scores



- There are also significant differences of opinions across the segments of the panel on some of the key issues and main challenges for implementing FCR requirements, most notably from the primary market. The main differences

of opinion between the primary market segment and the panel as a whole are listed below:

- The primary market segment believes the prescribed method is generally overstating capital requirements. This statement was ranked 6th by primary insurers participating in the survey, compared to 13th by the panel as a whole.
- The primary market is concerned about the lack of in-house skills, particularly within smaller companies, to cope with the implementation of FCR and the reliance on out-sourcing of actuarial skills. This statement was ranked 8th by the primary market and 14th by the panel as a whole.
- The uncertainty regarding the tax implications on the additional or more prudent reserving requirements was ranked 9th by the primary market, but only 16th by the panel as a whole.
- The perceptions of the impact of FCR are fairly similar across all segments. The only noticeable difference is that the primary market is concerned that the new capital requirements under FCR will impede the industry's efforts to transform the industry and meet the BEE ownership goals of the Financial Services Charter. This statement

was ranked 8th by the primary market, but only 14th by the panel as a whole.

- While FCR is not likely to reveal major undercapitalisation for the industry as a whole, the impact for certain companies may be substantial. FCR is expected to be a particular challenge for smaller and mono-line (single class) insurers. The new capital requirements could also reduce shareholder returns and compromise the competitiveness of those companies that are forced to fund some portion of the cost of capital from premiums.
- Those companies that choose to develop their own internal models will have a deeper understanding on the various risks that impact their business and a more sophisticated approach to managing capital within their organisations. This should lead to better alignment between risk management functions and business strategy and result in fewer negative surprises and greater financial stability.
- The transition to FCR is expected to be extremely costly and time consuming. Developing an effective risk management framework takes resources and time, and the survey results suggest that a lack of staff with appropriate knowledge, limited availability of trained non-life actuaries and data availability are major obstacles. Many insurers will need to invest in enhancing the level of sophistication of their IT systems, to improve the

quality and availability of data to the level required to build risk and capital management models.

- The introduction of FCR is expected to significantly raise the barrier to entry for new entrants to the industry. In the long-term this will reduce the level of competition within this market, if this issue is not addressed.
- By incorporating international developments into its framework, FCR follows the trend towards global harmonisation of quantitative and qualitative supervisory models, which aim to further promote convergence in prudential standard setting. FCR will bring South Africa in line with international standards in risk assessment.
- A major concern emerging from the survey is the perceived lack of capacity of the FSB to audit in-house models and regulate FCR, particularly as other recent surveys indicate that most insurers plan to develop their own internal model and with almost 100 primary insurers operating in the South African short-term insurance industry, the workload will be substantial.
- The investment capital charges under FCR could prompt insurers to follow a more conservative approach to their investment strategies by reducing their exposure to stock markets.

6.3 VALIDATION OF PROPOSITIONS

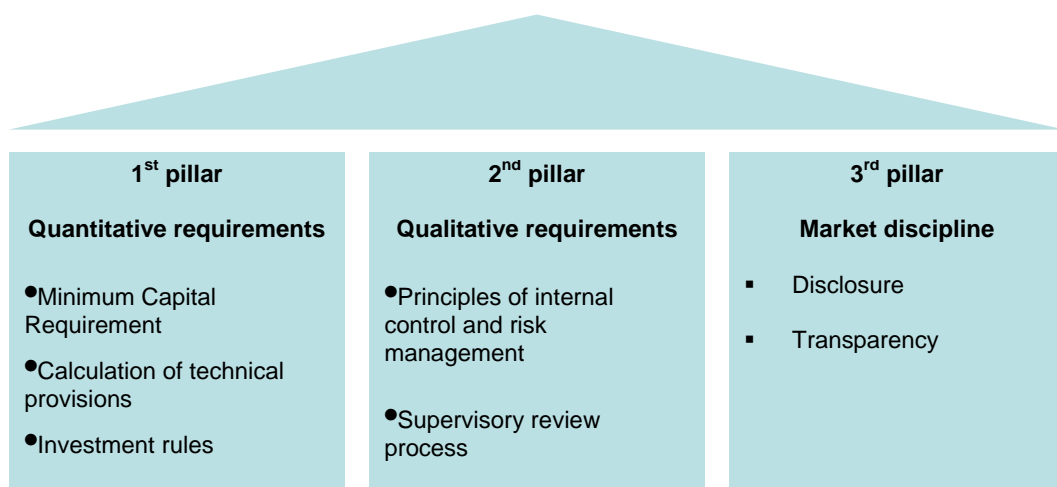
The Delphi technique was used in this research to solicit expert opinion and consensus on the key issues and main challenges for implementing FCR requirements. The results of the survey are discussed in the section below in terms of the research propositions and in terms of the theory base discussed under chapter 2.

6.3.1 Proposition 1:

The transition to FCR will put the South African Short-term industry at the leading edge of global markets in respect of risk management and corporate governance, which will improve consumer and other stakeholders' confidence in the industry.

Like Solvency II, FCR is based on a Basel-type three-pillar framework, which is depicted in figure 6.3 below.

Figure 6.3 – three-pillar structure of Solvency II

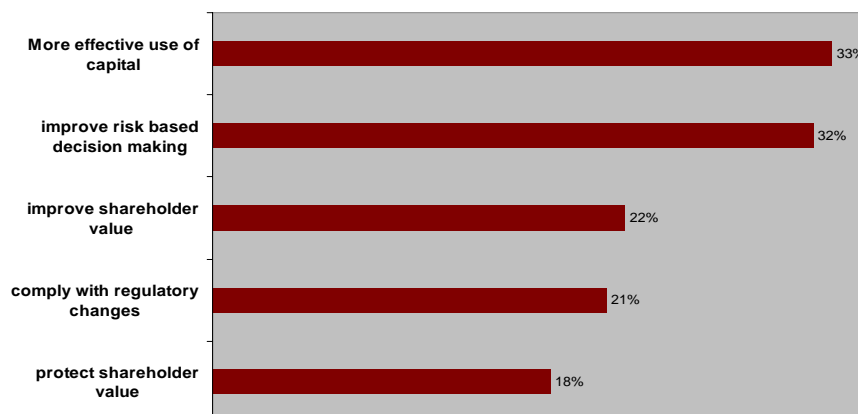


Source: Swiss Re Economic Research & Consulting

One of the key features of this framework is the incentive for insurers to determine their own capital through the development of an internal model, using sophisticated DFA tools and by demonstrating integrated enterprise wide risk management.

The FCR framework, as depicted in figure 2.10, indicates that as insurers move from the prescribed model to the certified model and finally to their own internal model, the level of complexity increases and so does the cost of implementing the framework. Despite this, the majority of South African insurers plan on using an internal model (PricewaterhouseCoopers, 2006). Similarly in the EU, 64% of short-term insurers there already have capital models in place and a large percentage of those that don't, plan on using one in the future (KPMG International, 2006). This would suggest that the main drivers for improving risk and capital management appear to be business, rather than compliance based. The results of the KPMG International survey (2006), aspects of which are depicted in figure 6.4, add weight to this suggestion.

Figure 6.4 – top objectives for improving risk and capital management



Source: KPMG International, June 2006

KPMG International (2006) argues that a well built capital model should give firms a good idea of the level of funds needed to support their business and survive potential disasters. Additionally, investors are beginning to challenge insurers to show that they are underwriting 'good' business and managing the volatility of their books to a reasonable level. This supports Conaghan's (2006) suggestion that companies need to turn governance, risk and compliance issues into strategic and economic value, as responsible management of risk is key to unlocking business value and creating wealth for shareholders.

Insurers that do develop their own internal model will be in a better position to manage their capital more effectively and increase the usefulness of their risk management strategy. There therefore appears to be sound commercial reasons for improving risk and capital management and a growing acceptance of this practice. This supports Linder and Ronkainen (2004) argument that new capital regimes should not only create prudential frameworks that more appropriately reflect the risks facing insurers, but also include incentives for companies to assess and manage their risks and capital better.

The survey results from this research also support the proposition above. The panel's top three perceptions on the impact of FCR indicate that risk and capital management will improve substantially under FCR, particularly for those companies who develop their own internal model.

There is evidence in the survey results to support McDonnell's (2006) view on the importance of effective risk and capital management disclosures on share prices and the cost of capital. The survey results also suggest that FCR will ensure that the industry is better able to withstand internal and external shocks and that the new solvency framework will bring South Africa in line with international standards in risk assessment.

6.3.2 Proposition 2:

The likely increased capital requirement for the industry will drive down shareholder returns from the short-term insurance industry and as a result put upwards pressure on the pricing strategy of insurers and lead to higher cost of insurance for consumers.

The results of the survey confirm that FCR is generally expected to increase the level of solvency capital requirements for short-term insurers, although to varying degrees across the industry. There is also evidence of the same concerns of Felsted and Jopson's (2006) and Trainar (2006) around the economic impact of insurers being forced to hold "deadweight" capital.

The issue of top concern for the panel was that the competitiveness of those insurers who are forced to hold additional solvency capital will be compromised, as they will be forced to pass some of the additional cost of capital onto

policyholders by increasing premiums. Shareholder returns may also be compromised, as the market will only bear some of the increased cost.

Insurers are also likely to apply a more scientific approach to capital allocation decisions across classes of business, as there will be a direct link between the risk associated with a line of business and the capital required to support it. Explicitly assigning a risk-based capital charge to underwriting risks may lead to price increases or changes in product design or alternatively insurers may decide to discontinue writing certain classes of business altogether. At the same time, as FCR explicitly recognises the effect of diversification, insurers may be able to write additional classes of business at marginal capital costs.

6.3.3 Proposition 3:

The high asset capital charge for equity assets under FCR will change the investment strategies of short-term insurers.

Solvency II is expected to have a major impact on insurers' investment strategies. Capital charges for investment risk may prompt insurers to reduce their exposure to stock markets (Swiss Re, 2006).

Almost 40% of respondents expressed the view that FCR will impact on insurers' investment strategy, mainly in respect to the higher risk investment classes such as property and equities.

Although the impact of investment risk did not come out as a top ten issue, there is still a high probability that insurers will need to re-assess their investment strategies in light of FCR. As short-term insurers have generally hold large portions of their portfolios in cash and bonds, to meet short-term liabilities, the impact of the capital charges under FCR may not be too major. However, the short-term insurance sector is still an important source of funds for the JSE, as depicted in table 2.2, and any reduction in shares and stocks will have a negative impact on the markets.

Although there is not conclusive evidence on what impact FCR will have on insurers' investment strategies, it is probable that investment strategies will become more integrated with the business strategy, which should lead to better matching of assets and liabilities.

6.3.4 Proposition 4:

The increased capital requirements for smaller and mono-line insurers will lead to further consolidation in the short-term industry and a less competitive environment.

The survey results concur with the assessment of Reactions (2005) that smaller companies, who lack the resources of their larger counterparts to develop their own internal models, may struggle with the new solvency and supervisory requirements and so could be at the mercy of the regulators' calculations. The

panel ranked this issue as one of the main challenges facing smaller and mono-line insurers in the transition to FCR.

To add to this, under the risk-based capital assessment, insurers will be able to get credit for diversity, as the more diverse a portfolio of risks, the less chance that a single event could put a company into default. Larger companies are generally more diversified than smaller ones and mono-line insurers, by their very nature have no diversity. The quote below proposes a possible impact of the above issue on the insurance industry structure:

“The new regime is giving large groups incentives to be more scientific and sophisticated about their capital requirements, it is possible that certain larger more diversified companies will be able to operate with a lower level of capital than smaller companies. Perhaps the smaller companies won't be able to produce enough return. It is probably going to force consolidation.” Rob Jones, director of financial services at rating agency Standard & Poor's.

Porter (1998) argues that factors that determine intensity of competition in industries can and do change. If further consolidation occurs as a result of the challenges facing smaller and mono-line insurers, the industry structure could move closer to the personality of an oligopoly and as a result, rivalry among existing firms in the industry may diminish.

McGahan (2004) argues that industries follow distinctive change trajectories and that leaders need to understand how their industries are changing as a whole, in order to make intelligent investment decisions. The short-term insurance industry in South Africa is characterised by progressive change and the industry incumbents have incentives to preserve the status quo.

According to McGahan (2004), the most profitable corporate strategies in progressive change industries generally involve carrying out distinct positions based on geographic, technical, or marketing expertise, as OutSurance has successfully achieved with the marketing of its “Out Bonus”. Over the long run, companies within progressive change trajectories can create substantial returns for shareholders and any external factor, such as FCR that can speed up the consolidation phase could further enhance shareholder returns of the larger players.

However, fewer players in the industry, particularly where the industry is already dominated by a few large companies, generally results in lower bargaining power of buyers and “sticky” prices. The main driver of FCR is consumer protection, but if the new solvency regulation results in further consolidation of the industry, consumers may end up paying the “price” of higher insurance costs and less choice.

6.3.5 Proposition 5:

The more stringent capital, risk management and disclosure requirements will stifle new entrants from coming into the market.

The results of the survey indicate that there is a high probability that the introduction of FCR will significantly raise the barrier to entry to this market and make the industry less attractive for potential new investors and entrepreneurs.

FCR impacts directly on two of the six of Porter's major barriers to entry; namely capital requirements and government policy. Higher barriers to entry reduce new capacity, resources and competition. The results of the survey and the literature review also suggest that the new regulatory environment will increase complexity and costs for insurers, which will further repel potential new entrants.

Of particular concern to South Africa is that increasing the barrier to entry could slow down transformation and stifle black entrants from coming into the industry.

The long term impact of fewer new entrants and therefore less competition may slow down innovation and market efficiencies. However, in a global market, the South African insurance industry not only competes with local players, but also with much larger global players. These multinational

corporations have the resources and capacity to pose a serious threat to the South African industry. At the same time, as FCR will bring the South African insurance industry in line with international best standards in risk assessment, there is an opportunity for those South African companies who successfully implement FCR and integrate RBS in their businesses to compete on an equal playing field overseas with larger and more established players.

CHAPTER 7: CONCLUSION

This study attempted to identify the key issues and main challenges for the short-term insurance industry in the transition to FCR. Whilst there appears to be general support for this new insurance regulation, there are several key issues that the industry and the regulator will need to deal with to ensure a smooth transition to the new regulatory environment.

Firstly there appears to be a fair degree of uncertainty around how the FSB will regulate FCR and what the specific requirements will be for internal model approval. The primary market, at which this new regulation is aimed, generally believes that the new capital requirements for the industry are overstated. Smaller players and potential new entrants are likely to be affected the most and in the long run this could have severe consequences for the industry in terms of attracting new capacity, resources and innovation. If the plight of smaller and mono-line insurers forces further consolidation, the industry will lose some of its competitiveness, which will be to the disadvantage of consumers.

At the same time there are several key benefits to the move to risk-based supervision, which the writer believes in the long run will far outweigh the challenges of implementing such a system. Firstly there appears to a healthy and growing awareness of the benefits of improving risk and capital

management and this is being driven for business, rather than compliance purposes. FCR will introduce a fundamental shift to the way insurers manage their business as it will force management to consider all the risks facing their organisation as it focuses on the overall solvency position of the insurer. Implemented correctly, it will provide management with a valuable tool for more effective use of capital by linking risk management to business strategy and reinforcing the focus on economic value creation. Finally FCR will bring the South African insurance industry in line with the top financial services industries in the world, in terms of risk and capital management frameworks, which is key for South Africa to continue to compete in the global market.

The writer recommends that the industry, the regulator and other key stakeholders actively engage and debate the issues raised above and consistently evaluate the framework to ensure it reflects economic principles and puts trust in market mechanisms by relying on increased transparency. It is important for stakeholders to recognise the current transformation needs of the South African financial services industry and to take these into account by phasing in the implementation of FCR over a medium term period to avoid major shocks to the industry.

This research has helped to identify important variables in the area of transition to risk-based regulatory models and could help to streamline work for further investigation once FCR has been implemented. The writer suggests that deeper

research on the key issues and main challenges raised by the panel is needed in the form of quantitative research. Further areas of interest are what impact the new international risk and capital management frameworks will have on Africa, in terms of the continent's ability to compete in the global economy.

FCR will continue to reinforce insurers' focus on risk versus return fundamentals and will increase the level of sophistication of risk and capital management within the short-term insurance sector. It seems appropriate then to end this study with the following quote, which encapsulates the challenge facing the industry as it enters this new environment.

"If the industry embraces the objective of this regulation, it is possible that it can turn it into a competitive advantage rather than regarding it as a regulatory burden." Rob Jones, director of financial services at Standard and Poor's

REFERENCES

ABSA (2006) *Sectoral Financial Ratios 1996 – 2005*. Johannesburg: The SA Financial Sector Forum

Bäte, O., (2006), Stochastic Modelling – Boon or Bane for Insurance Industry Capital Regulation?, *Geneva Papers on Risk & Insurance – Issues & Practice*, Vol. 31 Issue 1, p57-82

Commission's Solvency II project presents challenges, (2005), *Life Insurance International*. London. Pg. 14

Conaghan, J., (2005), Governing Insurance Risk: Managing Business Performance through Governance, Risk and Compliance, *The Interpreter*. Vol. 78, Issue 4, p8

Deloitte and Insight ABC (2005), *Financial Condition Reporting for South African Short-term Insurers*. Johannesburg

Dunham, R.B., (1998), *The Delphi Technique*, Wisconsin: University of Wisconsin School of Business. Summary available at <http://instruction.bus.wisc.edu/obdemo/readings/delphi.thm> (assessed 25/08/2006)

Felsted, A and Jopson B (2006), ABI to step up lobbying over EU directive insurance, *Financial Times*. London (UK):Mar 16, 2006. pg. 28

Financial Services Board 2005 Annual Report. Available from: <http://www.fsb.co.za/> (accessed 31 May 2006).

Financial Services Board (2004), *Proposal: New solvency assessment for short-term insurers regulated under the short-term insurance act 53 of 1998*. Pretoria

Fire, C., Ross, S.A., Westerfield, R.W. and Jordan, B.D. (2004) *Fundamentals of Corporate Finance*. Berkshire: McGraw-Hill Education

General Re, (2005), Topics No. 13, *Underwriting in a Changing World*, Montross F, Stamford

Gillingham, A., (2005) The Insurance Industry: On Crest of a Wave, Business Day Survey, pg 4.

Grant, J, (2005), Solvency II – insurance industry investment, *European Venture Capital Journal*, Issue 123, p40-41

Gupta, U, Clarke, R, (1996), Theory and Applications of the Delphi Technique: A Bibliography (1975 – 1994), *Technological Forecasting and Social Change*, Vol 53, p185-211

Hasson, F, Keeney, S, McKenna, H, (2000), Research guidelines for the Delphi survey technique, *Journal of Advanced Nursing*, Vol. 32 (4), 1008-1015

KPMG, (2006), *Risk and Capital Management for Insurers*. U.K.:302054

Linder, U. and Ronkainen, V., (2004), Solvency II – Towards a new insurance supervisory system in the EU, *Scandinavian Actuarial Journal*, Vol 2004, Issue 6, p462-474

McGahan, A.M., (2004), How Industries Change, *Harvard Business Review*, p87-94

Merriam, S.B., (1998), *Qualitative Research and case Study Applications in Education*, San Francisco: Jossey-Bass Inc.

Miller, R., (2005), Regulators' group unveils framework for worldwide solvency standards, *Business Insurance*, Vol.39, Issue 43, pg. 3

O'Hara, B, (2006), Risk and Value: Changing Perceptions and Cultural Challenges for the Property and Casualty Industry, *The Geneva Papers*, Vol. 31, 83-87

Okoli, C, Pawlowski, D, (2004), The Delphi method as a research tool: an example, design considerations and applications, *Information and Management*, Vol. 42, 15-29

Porter, M., (1998), *Competitive Strategy*, New York: The Free Press

Pressman, R., (2006), Our World, *Geneva Papers on Risk & Insurance – Issues & Practice*, Vol. 31 Issue 1, p38-45

PricewaterhouseCoopers, (2006), *Emerging Trends and Strategic Issues in South African Insurance*. Johannesburg

Quindiem Consulting (2005), *Broad overview of the prescribed basis of financial condition reporting*. Johannesburg

Riggs, W, (1983), The Delphi Technique: An Experimental Evaluation, *Technological Forecasting and Social Change*. Vol. 23, 89-94

Rowe, G., Wright, G., Bolger, F., (1991), Delphi, A Re-Evaluation of Research and Theory, *Technological Forecasting and Social Change*, Vol. 39, 235-251

Schiro, J., (2006), External forces impacting the Insurance Industry: Threats from Regulation, *The Geneva Papers*, Vol. 31, 25-30

Schubert, T. and Griessmann, G., (2005), What banks can learn from Solvency II, *Risk*, Vol. 18, Issue 3; pg. 55

Serio, G.V., (2006), External Forces Shaping the Future of the Insurance Industry, *Geneva Papers on Risk & Insurance – Issues & Practice*, Vol. 31 Issue 1, p31-37

Stein, R.W., (2006), Are you ready for Solvency II?, *Best's Review*, Vol. 106 Issue 11, p88 (AN 20092774)

Stipp, E., (2005), The Insurance Industry: New rules on cards, *Business Day Survey*, pg 9.

Swiss Re, (2006), Solvency II: an integrated risk approach for European insurers, *Sigma*, Vol. No 4/2006

Taylor-Powell, E., (2002), *Collecting Group Data: Delphi Technique*, Madison: Program Development & Evaluation Cooperative Extension. Summary at <http://www.uwex.edu/ces/pdande/resources/index.html> (assessed 25/08/2006)

Trainar, P., (2006), The Challenge of Solvency Reform for European Insurers, *Geneva Papers on Risk & Insurance – Issues & Practice*, Vol. 31 Issue 1, p169-185

Van Heerden, H., (2006), *Financial Condition Reporting: Get Ready*. Cover Magazine, Volume 18 No. 10, pg 34

Welman, J.C. and Kruger, S.J., (2001) *Research Methodology*, Cape Town: Oxford University Press

Willis Re, (2006), *WillisRisenshinE International Headlines*. Willis Re: London

ANNEXURE A – PANEL COMMUNICATION

Sample Personal Invitation to recruit Delphi Participant

Subject: THE PERCEIVED IMPACT OF FINANCIAL CONDITION REPORTING (FCR) ON THE SHORT-TERM INSURANCE INDUSTRY

Dear

I am in the process of completing my MBA with the Gordon Institute of Business Science (GIBS) and have selected the above topic for my dissertation.

I would be extremely grateful if you would agree to assist in this process by participating in a series of 3 short e-mail research questionnaires aimed at establishing the overall perception of policy makers and influencers in our industry on the transition to Financial Condition Reporting in the South African short-term insurance industry.

Participant responses will be kept anonymous and on completion of the research you will be forwarded a copy of the survey findings.

The first questionnaire will be sent out on Friday, 8 September 2006 and I would therefore be grateful if you would advise me if you are willing to participate in this survey by simply responding to this e-mail with a YES or NO.

Thanking you in anticipation of your support,

Regards,

Richard Heilig

PS For reference purposes I have attached a letter from GIBS confirming my research as part of the MBA programme.

Sample letter accompanying first questionnaire

Subject: FW: THE PERCEIVED IMPACT OF FINANCIAL CONDITION REPORTING (FCR) ON THE SHORT-TERM INSURANCE INDUSTRY

Dear

Thank you for your willingness to participate in the above research. You are one of 24 participants on a panel which represents government, the primary insurance market, the reinsurance market, auditing and consulting firms and actuarial consulting firms.

As mentioned in my previous e-mail this is the first of a series of three rounds of the survey, which focuses on the following questions:

- **What are the major issues that face the short-term insurance industry in the transition to FCR?**
- **What impact will FCR have on the Short-term Insurance Industry?**

Each round should take you no more than 15 minutes to complete. When formulating your answers to the above question, please take the following areas into account:

- impact on the robustness of the industry
- impact on the competitiveness of the industry
- impact on shareholders (including BEE deals)
- impact on the complexity of business operations and systems
- impact on potential entrants to the market
- impact on consumers
- impact on the use and role of reinsurance
- impact on the role of professional consulting firms
- impact on investment strategies
- any other area you feel could have a material impact on the industry

Please list 5 – 10 views on the above topic in a brief, concise manner, using the attached template for your answers. Below are a few examples of potential responses:

- FCR will result in a more integrated approach for insurers risk management processes
- The introduction of FCR will significantly raise the barrier to entry for potential new entrants
- The key barrier to achieving first class compliance or internal model approval under FCR will be the complexity and cost associated with the new regulatory environment
- The transition to FCR will put the South African Short-term Industry at the leading edge of global markets in respect of risk management and corporate governance

Please return your completed list by e-mail by the 15th of September 2006.

Should you have any questions, please contact me via e-mail or on 083-643-5210. Once again thank you for your interest and participation.

Regards,

Richard Heilig

Sample letter accompanying second questionnaire

Subject: FW: THE PERCEIVED IMPACT OF FINANCIAL CONDITION REPORTING (FCR) ON THE SHORT-TERM INSURANCE INDUSTRY

Dear

Thank you for your response to the first questionnaire. Attached is a summary of the responses received on the first question of the research, i.e. **the major issues facing the short-term insurance industry in the transition to FCR**. Issues that were similar were consolidated under one statement. Please select from the list the top ten issues that you feel will have the most impact in the transition to FCR. Please rank order your selection by placing your numbers from 1 - 10 under column A of the attached spreadsheet (1 for the issue of highest importance down to 10).

The final questionnaire will ask you to select from a summary list of perceptions on the impact of FCR, the top ten views that you feel have the highest probability of impacting on the short-term insurance industry. There will be some degree of overlap between the major issues and perceptions on the impact of FCR.

I would be extremely grateful if you could return your selection by e-mail by the 29th of September 2006.

Regards,

Richard Heilig

Sample letter accompanying third questionnaire

Subject: FW: THE PERCEIVED IMPACT OF FINANCIAL CONDITION REPORTING (FCR) ON THE SHORT-TERM INSURANCE INDUSTRY

Dear

Thank you for your continued participation in the above research. This is the final questionnaire for this survey. Attached is a summary list of perceptions on the impact of FCR on the short-term insurance industry. Perceptions that were similar and of the same subject matter have been consolidated under one statement.

Please select from the attached list the top ten views that you feel have the highest probability of impacting on the short-term insurance industry. Please rank order your selection by placing your numbers from 1 - 10 under column A of the attached spreadsheet (1 for the statement of highest importance down to 10).

I would be extremely grateful if you could return your selection by e-mail to me by the end of this week, as I need to finalize my report by the 31st of October.

Regards,

Richard Heilig

ANNEXURE B – FULL LIST OF DATA GATHERED FROM ROUND ONE

List of responses to Round One of FCR survey

Many companies will need to consider how to address the requirements of building an in-house model to satisfy the FSB requirements for FCR, this will include whether or not to hire or outsource the services of actuaries.

The willingness of company management to integrate the internal model into the day-to-day management of the company

One of the major issues that face the short term insurance industry in the transition to FCR is the building of internal models to assess their individual capital requirements (Especially the smaller companies)

There are several challenges facing SA (and other countries) regarding calibration of certain aspects of internal models. For example a lack of a common appreciation of catastrophe risk in SA may lead to a problem of consistent implementation.

Obtaining industry-wide agreement on the proposed legislation and getting the legislation through parliament

The current uncertainty with respect to the ultimate FCR guidelines and regulations (legislation) is creating confusion and may lead to a problematic transition.

The transition to FCR will be extremely costly and time consuming.

The communication of FCR to stakeholders is a complex process and may be misunderstood.

The level of sophistication of IT within the Short term Insurers and their supporting UMA will have to increase.

Lack of in-house skills within smaller companies, reliance on out-sourcing of actuarial skills

Prescribed method generally over-stating capital requirements

FCR is not a significant barrier to entry in terms of cost. The expensive complex models would apply to companies which already have complex, developed structures.

FCR will significantly increased regulatory costs, both for the FSB and the insurer

The transition (i.e. as it is happening, in the short-term) to FCR will likely be unsettling to the industry as management spend time working towards the implementation of FCR within the company.

The FSB will need to demonstrate that have the capacity to audit in-house models and regulate FCR.

The FSB and the industry need to convince SARS that any additional reserving via whatever mechanisms are available is allowable for tax purposes.

New entrants to the market will have higher capital requirements than before, but this is a good thing, as their risks are higher. The FSB will allow new entrants to build up the required capital over time.

Increasing capital requirements obviously impact shareholders, and may also affect intended BEE deals. Nevertheless, the FSB has indicated repeatedly that they are willing to consider companies individual circumstances but that every company should still take part in the capital process.

Some insurers may cease to exist. Capital injections may be needed which may cause investor concern.

The prescribed model does not properly reflect the long-term value of non-proportional reinsurance, since the SA industry has not experienced large catastrophe losses over the last 5 years in comparison to Europe and the US.

The small pool of available trained non-life actuaries in SA to do the work required in the transition to FCR

For those companies with increasing capital requirements, competitiveness may be compromised, as some proportion of the cost of capital would have to be funded from premiums.

Short term insurers will need to get an much improved and deeper understanding or the risks being written by their underwriters both in-house and through separate Underwriting Managers

List of responses to Round One of FCR survey

There are several positive impacts of FCR: it will improve companies' understanding of their own risks, force them to implement proper risk management initiatives, improve capital efficiency, and protect consumers better against sudden failure of companies.

Those insurers that do develop an internal model will have a better understanding of the various risks and how they interact.

FCR will increase the complexity of both business operations and system requirements.

FCR could result in increased complexity in business systems for those companies who choose the internal modeling route.

FCR is likely to require enhanced systems

Complexity: an additional system/process will need to be put in place. From a risk management perspective this cost is mitigated by the increased understanding of risk it should bring

FCR in itself should not increase the complexity of business operations significantly, but may require investment in systems where companies do not have data available on their underlying risks - depending on whether they adopt the industry model, certified model or internal model.

Insurers will struggle to provide the capacity of technical resources required for FCR

Impact: Increase in compliance costs and management time dealing with compliance

FCR will increase the cost of statutory compliance for short term companies

FCR will force insurers to improve the quality of policy and claims data and this might cause additional expenses.

FCR will have an enormous impact on costs and how business is done as currently proposed with an unworkable office model. Many Niche insurers and small insurers will close shop because of capital requirements and cost of implementation

It will increase complexity and operational costs.

Business systems and operations will become more complex.

FCR may prevent new entrants in the industry due to the capital requirements.

FCR will make it more difficult for new players to enter the market and be competitive compared to existing players.

FCR limits the profile of potential new entrants to the market

Potential entrants: will be faced with the R10m minimum

FCR has got a cost, assuming the internal model method. The minimum capital requirement is higher, so again, the cost of entry is higher. However, "fly-by-nights" will be minimised.

The prescribed basis in its current form will create a barrier to entry for brand new companies that do not have any historic information to enable them to build an internal model. This might also jeopardize BEE transactions.

Significantly increased capital requirements will become a huge barrier to entry. This will not only effect the existing insurers but will significantly impact on effort by Government to transform and introduce black ownership

It could potentially increase the entry barriers into the market.

FCR should be positive for the public perception of the industry, but may initially be negative for quoted company share prices due to lower dividend yields.

Share prices will drop due to FCR. In general larger well diversified companies will find it easier to conclude BEE deals whereas smaller niche insurers may struggle to conclude BEE deals.

FCR is likely to disrupt dividend streams

Shareholders: regulatory capital is increasing which is bad for ROC. However, capital levels were commonly much higher than previous minimums!

Higher capital costs will discourage "start up" BEE companies/individuals from entering the industry

Issue: Possible government overriding of FCR

Issue: Shareholders may not be happy with additional capital requirement, but may be happy due to the added security provided. However, this could reduce expected returns, as the investment becomes less risky. Impact & BEE impact: not sure.

Comparing financials statements and positions will be more difficult.

List of responses to Round One of FCR survey

Don't expect much impact on BEE deals

I believe some companies will utilise reinsurance vehicles to partly satisfy the additional solvency requirement.

The use of proportional reinsurance will increase, as this can be used to decrease the capital requirement on the prescribed method.

Reinsurance (especially non-proportional) is likely to be bought especially by smaller insurers.

Reciprocal agreements are likely to emerge

Reinsurers role: capital management may become more of an emphasis in the sale of products going forward

The use of non-proportional reinsurance in particular reduces capital requirements under certified and internal models. It is likely that FCR will create a more efficient market for non-proportional reinsurance.

Impact 3: Reinsurance purchasing decisions will form part of the capital management process

The reinsurance landscape should change, with more focus placed on capital relieve than previously

Impact: Greater use of catastrophe reinsurance; lower use of other types of reinsurance

As with direct product pricing, reinsurance pricing and structures will have more emphasis on capital adequacy. Reinsurance transfers risk and the impact on statutory capital levels will form part of the conversation when purchasing reinsurance. Reinsurance product innovation will also naturally occur to specifically cater for the new dispensation.

Impact: Better understanding of reinsurance purchase

If applied correctly it could lead to the more efficient use of reinsurance.

Along with accounting, tax and regulatory changes that reduce the value of financial reinsurance, the risk focus of FCR and internal modeling will probably push reinsurance programmes to be more tailored to the individual companies and their mix of risk. It is not clear whether reinsurance would increase or decrease overall.

FCR will increase the robustness of the industry.

FCR should improve the industry's ability to withstand adverse events.

FCR should increase robustness

Industry robustness: FCR encourages insurance companies to adopt best practice capital management techniques

FCR is far more accurate in taking into account the risk characteristics of the underlying businesses than the existing model and hence will improve the robustness of the industry

Impact: In the long-term, with appropriate leadership, FCR should benefit the industry as a whole.

Impact: Increased strength of the industry as the probability of insolvency will reduce. Product innovation due to RBC approach impacting on all areas of business. i.e. insurers will need to consider impact on risk in all decisions.

Impact: FSB has a better understanding of the financial strength of insurers

If applied accurately it could reduce the number of potential insolvencies in case of adverse events.

FCR will reduce competition in the insurance industry.

Brokers may find it more difficult to operate in the new regulatory environment since there will be competitive barriers for new entrants as explained earlier. A lack of new competitors will reduce the options available to brokers and insureds. This may reduce brokers negotiation power with existing insurers.

FCR could indirectly hamper or improve competitiveness

FCR is likely to influence merger and acquisition activity

Competitiveness: by being applied to all players equally it shouldn't effect one company over the other. However, there are advantages to being a large company in that relatively less capital is needed for incremental risk

If FCR demands that a much higher level of capital is required it will force a major shake up in the industry. This could lead to mergers, take-overs or marginal companies leaving the industry.

List of responses to Round One of FCR survey

Impact: Industry consolidation

Consolidation of licences.

It could increase the level of competition in the market.

The pace of implementation of FCR could have a large impact for companies who don't currently comply.

FCR will increase consumer costs in the short-term but the benefit may outweigh the cost to consumers in the long-term.

Consumers could be affected through higher prices (to meet the cost of capital in pricing), but will enjoy the benefits of a more secure insurance market.

FCR costs money and someone needs to carry the cost

Consumers: to the extent that it adds costs this will increase premiums. However, there will be a greater level of security if properly applied

Higher capital costs will lead to an increased cost to the consumer through increased premiums

If managed well, and if a company already has sufficient capital, there would be no impact on consumers. Those companies with low capital relative to the risks they take on, or who do not take action to manage their capital efficiency, will probably have to pass on premium increases to consumers.

FCR will cost money - ultimately this will be borne by the consumer. However the consumer will have greater security and a higher probability that his/her claims will be met.

If applied too onerous it could lead to higher cost of capital which in turn would make insurance less affordable.

Only impact on customers may be through more accurate premiums reflecting not only the expected claims but a better measure of the cost of capital associated with bearing that risk.

FCR will increase the demand for professional consulting firms, especially in respect of peer review and independent verification of internal models.

There will be increased opportunities for consulting services in companies that do not have the expertise to deal with FCR, or where there is a lack of internal resources.

Professional consultants are likely to earn more fees

Consulting firms: this is an opportunity for them to play a role in the industry

Some professional consulting firms have the computer models and skills to help companies implement certified and internal models. The use of external consultants is in no way compulsory however and the industry model is freely available for use and analysis by companies. Even if companies use internal or certified models, these can be designed and implemented by internal professional staff with suitable qualifications.

They will have a significant role to play considering the shortage of short term actuarial resource.

Their approach, within the guidelines will probably set precedent.

FCR will increase actuarial and statistical involvement in the short term insurance industry

Impact: Increased opportunities for actuaries in short-term insurance as well as increased work for consulting companies and software suppliers

Professional consulting firms will be in demand because very few insurers have the in-house skills to develop their own internal model.

FCR will create a need for short-term actuarial skills and it is possible that the industry might experience a shortage of actuaries with the necessary experience to develop these models

It could lead to more business for professional consulting firms.

There may be short-term supply and demand imbalances for experienced technical and actuarial staff as demand increases more rapidly than supply.

FCR may force investment strategies more towards matching the characteristics of liabilities as companies aim to reduce the capital charge for asset risk.

Insurers are likely to reconsider effective investment strategies

Investment strategies: are allowed for in FCR but are not usually a major risk for short-term insurers who historically have had large cash holdings

For most companies in the industry, there will be no impact on investment strategies. Only if

List of responses to Round One of FCR survey

smaller companies with lower levels of capital relative to the industry model invest significantly in equities and property will they attract high capital charges, and might then decide to alter their investment strategy to be more cash and bonds-based.

Impact: Investment away from equities into cash and bonds.

I have limited experience of short term investment strategies. It is my understanding that most companies are investing conservatively and hence FCR shouldn't have a material impact. It could, however, cause companies with large equity exposures to reduce these, where capital levels are a concern.

Investment strategies will need to become more integrated into the company's risk management.

Impact: Move away from "risky" asset classes in order to reduce capital requirements

It could lead to better matching of assets to liabilities.

Investment strategies may fork. Some insurers will decide, in spite of the costs in terms of capital required, to continue to invest heavily in equities. Others will decide to run a leaner company matching risks and generating "alpha" for investors.

The additional capital requirements relative to the current level of capital held by insurers will almost certainly increase the premium rates that insurers will have to charge. Insurers with higher levels of risk will be influenced to a greater extent than those with lower levels of risk.

Increased capital requirements could result in higher required rates of return on capital employed in the business, as a large amount of capital will be needed to cover the capital requirement.

Impact 2: Capital allocation decisions will become more robust, as there will be a definite link between the risk associated with a line of business and the capital required to support it

Impact 4: Companies will be encouraged to diversify their lines of business

FCR will possibly bring more science to the pricing approach used

FCR will affect the way in which insurance companies assess the performance of various products and staff and hence the company's overall business strategy

Margins in some classes may come under pressure

Impact: More accurate allocation of capital between classes of business

FCR will introduce differentiated capital requirements based on the inherent riskiness of the insurer.

FCR will enable insurers to evaluate different lines of business by looking at the return on capital

A lack of capacity might develop over time for certain lines of business where the required return on capital is very high

The prescribed model in its current form will cause an inefficient use of capital because of the broad based approach that was used in the development of the model.

There are huge limitations as the FSB currently sees things. What is needed is a workable official model that gives results that will still enable shareholders to obtain their expectations in terms of return. The official model can be done at a reasonable cost but the internal model cannot. An M&F, or a Santam or a Hollard can do an internal model but a Constantia for example cannot afford to do so. Equally there is limited expertise in SA to do internal models

It should result in returns on capital which reflect the underlying risk more accurately. This could make the comparisons between insurers more equitable.

Impact 1: The quality of management information will improve, if an internal model is used

There will be a more sophisticated approach to risk management in the industry

Issue: Lack of appropriate skills

Impact: FSB will have more options for involvement insurers.

Improved risk management and data quality

FCR will improve the quality of companies' information systems and the accuracy of their data, increasing management's understanding the actual risk inherent in the business that they write as well as the risk associated with how they manage this risk.

FCR will define the responsibilities of the board, as it relates to risk management, more clearly

The short term insurance industry has been managing their business in a very unscientific manner

List of responses to Round One of FCR survey

to date. FCR will require a radical mind shift from the insurers to ensure that they can comply with requirements such as integrated risk management strategies, internal modeling etc.

Current lack of data and systems makes more detailed risk management very difficult.

Risk management by EWRM may lead to a new approach of risk & capital management. (enterprise wide risk management)

Impact: Improved risk management in companies using an internal model. Companies using the prescribed method may fall behind.

Impact: Increased communication within the insurer in order to produce the FCR

FCR will lead to a more rigorous assessment and understanding of insurance risk and capital, both for individual insurers and the industry as a whole.

It will take a while for FCR to settle and become integrated into each company's risk management process.

Issue 1: The ability of the industry to develop internal models

The capital requirements seem to be higher, especially for mono-line insurers. Since new entrants are generally mono-line, this will increase barrier to entry

FCR will be barrier to entry for smaller and mono-line companies

Monoline writers will be under pressure to prove their solvency.

Agree with the statement that the barrier to entry under the current proposal is very stringent.

Competitiveness will change in three areas. It is clear that new entrants and smaller companies will be at a disadvantage, which may limit the competition from the perspective of the number of firms. However, non-risk-bearing companies (brokerages and others) may spring up to fill the space and provide more competition at the retail and distribution levels. These companies will have increased bargaining power with risk-bearing short-term insurers, thus creating pressure on prices. Thirdly, large short-term insurers may now need to compete more closely because there will be less opportunity to generate RoE for shareholders by holding relatively less capital as a "competitive strategy" and will be forced to compete on price, service and brand awareness.

Issue: Regulation is being developed to follow the form of international regulatory developments, but not the substance.

Impact: SA insurers brought in-line with global standards

FCR will continue the global trend towards convergence of capital and insurance markets and will ease the way to a single financial services regulatory environment.

It is impossible for SA to avoid FCR if it is to stay in line with international progress in risk assessment