MEMORANDUM ON THE OBJECTS OF THE INSURANCE BILL, 2015

BACKGROUND TO THE BILL

1. BACKGROUND

1.1 The Insurance Bill of 2015 ("the Bill") provides a consolidated legal framework for the prudential supervision[1] of insurers.

1.2 The Bill gives effect to important national government policy objectives by enhancing—

- access to insurance through the introduction of a micro-insurance[2] regulatory framework;
- the financial soundness of insurers and the financial services sector, and the protection of policyholders through—
  - introducing a new Solvency Assessment and Management (SAM) regime;
  - introducing a framework for insurance group supervision; and
  - enhancing reinsurance arrangements; and
- alignment with international standards (adapted to South African circumstances) in accordance with South Africa's G20 commitments.

2. THE ENVISAGED EFFECTIVE DATE OF 1 JANUARY 2016

2.1 It is envisaged that the Bill will replace those sections of the Long-term Insurance Act No. 52 of 1998 and the Short-term Insurance Act No. 53 of 1998 ("the Insurance Acts") relating to prudential supervision, with effect from 1 January 2016.

2.2 It is important that the Bill be effective from 1 January 2016, for the following reasons:

- The Bill has been in development for 5 years, and the development process has been comprehensive and inclusive.
- Dual reporting has already commenced and insurers have started with the

---

[1] Prudential supervision is necessary to promote and enhance the safety and soundness of insurers to protect policyholders against the risk that insurers may fail to meet their obligations, and to assist in maintaining financial stability.

[2] Micro-insurance refers to insurance that is accessed by the low-income population, provided by a variety of different providers and managed in accordance with generally accepted insurance practice.

development of the necessary processes and systems to meet the requirements of the Bill. A delay in implementing the Bill may result in increased implementation costs and a loss of momentum.

3. COMPLEMENTING BROADER FINANCIAL SECTOR REFORMS

3.1. The Bill facilitates a seamless transition into the Twin Peaks model of financial regulation that is envisaged in the Financial Sector Regulation Bill in respect of prudential supervision.

4. OBJECTIVE OF THE BILL

4.1. The objective of the Bill is to promote the maintenance of a fair, safe and stable insurance market for the benefit and protection of policyholders by establishing a legal framework for insurers and insurance groups that -

- facilitates the monitoring and preserving of the safety and soundness of insurers;
- enhances the protection of policyholders and potential policyholders;
- increases access to insurance for all South Africans;
- contributes to the stability of the financial system in general.

The key policy objectives that are sought to be achieved by the Bill are discussed below.

5. POLICY OBJECTIVE 1: ENHANCING ACCESS TO INSURANCE

5.1 A well-functioning micro-insurance market is essential to financial inclusion, as it allows low-income households access to a variety of good-value formal financial products appropriate to their needs. Greater financial inclusion has positive effects on economic growth and the reduction of income inequalities. Financial stability at household level is essential to growth and prosperity for individuals, companies and communities. Without the protection against unexpected loss provided by insurance, even those households and businesses that have established some financial security may find themselves in poverty.

5.2 The Bill gives effect to the National Treasury's *Micro-insurance Policy Document* released in July 2011. It supports the development of an inclusive insurance sector through the proportionate and appropriate regulation and supervision of micro-insurance. It balances lowering regulatory barriers to entry, so as to facilitate access and support affordability, while at the same time ensuring that there is appropriate and sufficient consumer protection in place.

5.3 The Bill achieves the above by—

- Facilitating formalisation by currently informal providers, and in the process promoting the formation of regulated and well-capitalised insurers and small business development;
- Lowering barriers to entry, which should encourage broader participation in the market and promote competition among insurers, further supporting poverty alleviation through, economic growth and job creation, and by providing protection against losses;
- Enhancing consumer protection within this market segment through appropriate prudential[3] regulation and improved enforcement of compliance; and
- Facilitating effective supervision and enforcement and supporting the integrity of the insurance market as a whole.

5.4. The Bill allows for a lower minimum regulatory capital requirement for micro-insurers, as well as a simpler, dedicated prudential regulatory model suited to the risk profile of micro-insurers. To support the ease and effectiveness of supervision, the Bill provides that entities must be registered as dedicated micro-insurers, under a separate licence, in order to benefit from the lighter prudential requirements.

5.5. Following the release of the National Treasury's Micro-insurance Policy Document in July 2011, a Micro-insurance Steering Committee consisting of members from the National Treasury and the Financial Services Board was established with the mandate of facilitating the development of the micro-insurance regulatory framework and the drafting of micro-insurance legislation. The Steering Committee established four working groups, tasked with making detailed recommendations on product standards, requirements with respect to advice and intermediation, prudential requirements and tax treatment.

5.6. The recommendations of the working groups were released as part of a Micro-insurance Update published in February 2015, and those recommendations informed the Bill. The Micro-insurance Update is available on the website of the Financial Services Board (www.fsb.co.za).

[3] Enhanced conduct of business regulation will be facilitated through dedicated Conduct of Business / Market Conduct legislation. The legislation will provide for specific requirements relating to advice and intermediation, and product standards.

6. POLICY OBJECTIVE 2: ENHANCING FINANCIAL SOUNDNESS

THE NEW SOLVENCY ASSESSMENT AND MANAGEMENT (SAM) REGIME

6.1 The prevailing legal framework no longer adequately meets the objectives of prudential supervision. The prevailing framework is rules-based and primarily relies on historical information. This does not allow for a proactive and risk-sensitive approach to prudential supervision, whereby the supervisory requirements are based on the amount of risk that an insurer takes on.

6.2 The new SAM regime introduces a forward-looking risk-based approach to solvency, by aligning the capital requirements with the underlying risks of an insurer.

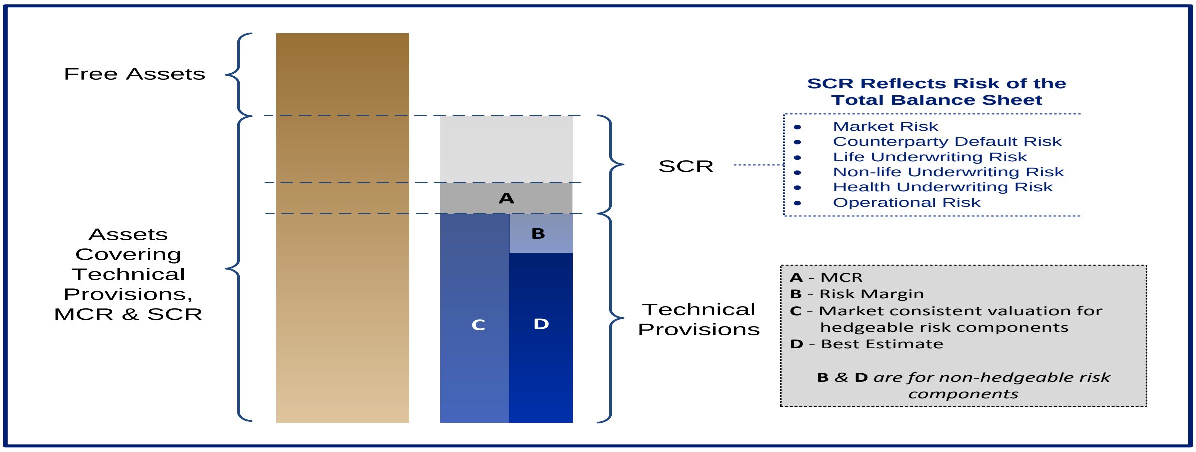
6.3 Its primary objective is the protection of policyholders and beneficiaries.

6.4 It also has the following additional objectives:

- Alignment of capital requirements with the underlying risks of an insurer;
- Establishment of a proportionate, risk-based approach to supervision with appropriate treatment both for small insurers and large, and cross-border insurance groups;
- Providing incentives to insurers to adopt more sophisticated risk monitoring and risk management tools; and
- Helping to maintain financial stability.

6.5 The SAM regime is principles-based regulation based on an economic balance sheet, and utilises a three pillar structure of capital adequacy (Pillar 1), systems of governance (Pillar 2), and reporting requirements (Pillar 3).

6.6 ***Pillar 1*** sets out the quantitative requirements for assessing the financial soundness of insurers. The economic balance sheet approach to be adopted under SAM integrates the interdependencies between all assets and liabilities, calculated at market consistent values. The insurer is required to hold enough capital to meet the solvency capital requirement (SCR), which is based on the risk profile of the insurer. The minimum capital requirement (MCR) sets a minimum lower capital boundary for an insurer's capital requirement. The different levels of capital requirements allow the supervisor to take stronger supervisory action as the insurer's financial soundness position deteriorates. The solvency balance sheet is illustrated below.



6.7 ***Pillar 2*** sets out the governance and risk management requirements for insurers. Effective risk management and sound governance structures are of equal importance to an insurer's solvency. Weaknesses in these areas may create susceptibility to an external 'trigger event', ultimately resulting in a solvency problem. A shortcoming in regulatory frameworks highlighted by the Global Financial Crisis has been the lack of sufficient mechanisms to provide supervisors with an early warning of a potential solvency concern, or sufficient powers to intervene. Pillar 2 addresses this issue, by assessing the effectiveness of corporate governance and risk management. Pillar 2 serves as a major link between Pillar 1 and Pillar 3 of SAM, by considering the extent to which the corporate governance structure is embedded in the day-to-day running of the business.

6.8 A key tool in this regard is an insurer's Own Risk and Solvency Assessment (ORSA) process. The ORSA encompasses maintenance and embedding of the risk management system, forward-looking capital planning and management, stress and scenario testing and emerging risk management. Under the ORSA process, insurers are required to conduct at least annually, and at any instance of a material change in the risk profile of the business, a self-assessment of their risks and the level of solvency needed to cushion those risks. The ORSA is intended to identify, assess, monitor, manage, and report all material and complex risks that the insurer faces It is also intended to enable the insurer to continuously meet its solvency needs. The ORSA integrates risk and capital management, because it reflects an insurer's own risk appetite. It is important that an insurer is able to demonstrate that the ORSA is an integral part of managing the business against the chosen strategy, and that any changes to strategy or risk appetite consider the effects on solvency needs.

6.9 ***Pillar 3*** focuses on supervisory reporting and public disclosure. It seeks to create transparency, with the aim of harnessing market discipline in support of regulatory objectives. The quality and quantity of data which is requested from insurers on a quarterly and annual basis will be enhanced, which in turn will allow a supervisory process that is more risk-based and forward-looking than the supervisory process which is followed under the current Insurance Acts. The enhanced data will also facilitate the monitoring of financial stability risks that will be required for macroprudential supervision. Sensitive information, the disclosure of which would result in significant undue competitive disadvantage, or which is subject to policyholder or other counterparty confidentiality obligations, will be reported confidentially to the regulator.

6.10 The SAM regime is based on Solvency II – the prudential supervisory framework of the European Union – but is adapted to South African circumstances. This was informed by the fact that South Africa has strong economic links with Europe and the fact that Solvency II represents international regulatory best practice. It will also assist South Africa in attaining Solvency II 3rd country equivalence, which will help ensure that South African based insurers may continue doing business in the European Union (EU) and other jurisdictions without concerns with respect to the quality of their home supervision.

6.11 A number of other emerging economies such as Brazil, India and China are also enhancing their prudential supervisory frameworks.

7. THE FRAMEWORK FOR INSURANCE GROUP SUPERVISION

7.1 The prevailing legislative framework does not allow for insurance group supervision.

7.2 A significant number of South African licensed insurers are currently operating within a group structure. Insurance groups benefit from the pooling and diversification of risk, intra-group financing, and integrated governance structures. However, being part of a group also presents a range of risks to an insurer. These may include, for example, direct or indirect risk exposures to other group entities, conflicts of interest and inadequate risk assessment. The recent global financial crisis has demonstrated that the failure of one entity within a financial conglomerate may damage, or even cause the failure of, related entities.

7.3 The Bill introduces a new group-wide supervision regime for insurers. This allows the regulator to regulate and place requirements on the controlling companies, in order to protect policyholders and beneficiaries from risks emanating from the insurance group. The regime follows a similar structure to that of the SAM regime discussed above. It is principles-based regulation based on an economic balance sheet, and utilises a three pillar structure of capital adequacy (Pillar 1), systems of governance (Pillar 2) and reporting requirements (Pillar 3).

8. ENHANCING REINSURANCE ARRANGEMENTS

8.1 The reinsurance market in South Africa plays a crucial role in the insurance sector, as indeed it does in most other insurance markets across the world. Reinsurance contributes to the stability of insurance markets. It assists in improving the risk profile and the financial soundness of insurers, by diversifying and limiting accumulations of exposure, and consequently creating underwriting capacity. It provides insurers with lower or more predictable claims costs. It also reduces volatility, and thus the uncertainty of the insurers' pricing risks, by pooling.

8.2 However, to achieve the above, reinsurers must be able and willing to meet their obligations as they fall due. It is critical to have a prudential framework that protects the financial position of insurers from non-performance by reinsurers, specifically reinsurers operating outside South Africa, noting the different standards of supervision that non-resident reinsurers may be subject to in their home jurisdictions.

8.3 The prevailing legislative framework inadvertently allows for undesirable regulatory arbitrage and an un-level playing field.

8.4 The current framework could be improved to enhance the role played by reinsurance in the insurance sector. In this regard, the Bill facilitates a new reinsurance regulatory framework that allows for a wider recognition of reinsurance, including through the use of branches, with appropriate recognition of the risks of different reinsurance structures in a manner that is consistent with South Africa's international trade obligations. The new framework also—

- establishes a level playing field;
- increases competition;
- addresses certain supervisory concerns relating to inward reinsurance;
- facilitates the maintenance and improvement of the current skill levels of the South African reinsurance industry for the benefit of the wider economy; and

- enhances and strengthens the ongoing development of the local reinsurance industry as a hub for reinsurance business into Africa.

9. POLICY OBJECTIVE 3: ALIGNMENT WITH INTERNATIONAL STANDARDS

9.1 Since the 2008 Global Financial Crisis, the G20 (of which South Africa is a member), guided by the International Monetary Fund and the Financial Stability Board (of which South Africa is a member by virtue of its membership of the G20), has led the process to make the global financial sector safer. Given that insurers operate globally, but are regulated nationally, it is imperative that national regulators coordinate the supervision of multinational institutions by setting and applying international standards. Also, by committing to international standards, our financial institutions are able to operate in other countries with greater ease, as the different country regulators work together.

9.2 In respect of insurers, the international standard setting body is the International Association of Insurance Supervisors ("IAIS"), which has issued Insurance Core Principles ("ICPs") with which all jurisdictions must comply.

9.3 The prevailing legislative framework has not been subject to a comprehensive review since 1998, and is, therefore, no longer consistent with the IAIS ICPs. This has been confirmed by the assessments conducted by the International Monetary Fund and World Bank in 2008, 2010 and 2014 in respect of insurance regulation in South Africa in terms of their joint Financial Sector Assessment Program (FSAP). The Bill aligns the regulatory framework for insurance in South Africa to the IAIS ICPs.

SUMMARY OF THE BILL

10. MAIN FEATURES OF THE BILL

10.1 PROPORTIONALITY

The Bill entrenches the principle of proportionality, which means that regulatory requirements will be applied in a manner which is proportionate to the nature, scale and complexity of the risks inherent in the business of an insurer (and reinsurer), so that requirements imposed on small and medium-size insurers are not too onerous. An insurer’s own risk profile will serve as the primary guide to assess the application of the principle. Proportionality will be applied coherently across all aspects of the

Bill.

10.2 FRAMEWORK LEGISLATION

10.2.1 The Bill is drafted as framework legislation. It is enabling or empowering (and should be in respect of the new solvency regime). This means that it contains the fundamental policy or underlying principles of legislation that are unlikely to change over time. It provides for the basic or minimum issues and powers necessary to regulate insurers, and delegates the power to make secondary legislation and other authority to implement and enforce the Bill to the Financial Services Board.

10.2.2 The delegation of the power to make secondary legislation and other authority to implement and enforce the Bill is important because, amongst other reasons, of the specialised and/or technical nature of the subject matter the Bill deals with, and to allow for or facilitate—

- expert input into its design and technical language to be used in its wording; and
- flexibility in responding to events, emergencies and industry developments.

11. STRUCTURE OF THE BILL

11.1 *Chapter 1* of the Bill deals with the interpretation and objective of the Bill.

11.2 *Chapter 2* addresses the overarching framework for conducting insurance business and insurance group business by insurers, branches of foreign reinsurers, Lloyd's and insurance groups, and the general principles for conducting insurance business or insurance group business.

11.3 *Chapter 3* deals with the requirements for significant owners and key persons of insurers, branches of foreign reinsurers, Lloyd's and insurance groups (directors, senior managers, heads of control functions, auditors, and representatives and trustees of branches of foreign reinsurers and Lloyd's).

11.4 *Chapter 4* deals with the licensing framework for insurers and branches of foreign reinsurers.

11.5 *Chapter 5* deals with the governance framework requirements for insurers, branches of foreign reinsurers, Lloyd's and insurance groups.

11.6 *Chapter 6* deals with the financial soundness requirements for insurers, branches of foreign reinsurers, Lloyd's and insurance groups.

11.7 *Chapter 7* deals with the reporting and public disclosure requirements for insurers, branches of foreign reinsurers, Lloyd's and insurance groups.

11.8 *Chapter 8* deals with matters relating to the transfer of business and other significant transactions by insurers, branches of foreign reinsurers, Lloyd's and insurance groups.

11.9 *Chapter 9* deals with matters relating to the resolution of insurers, branches of foreign reinsurers, Lloyd's and insurance groups.

11.10 *Chapter 10* provides for the administration of the Bill and the powers and functions of the regulator.

11.11 *Chapter 11* provides for general matters such as savings, consequential amendments, repeal of laws and transitional provisions.

12. ORGANISATIONS AND INSTITUTIONS CONSULTED

The process for the development of the Bill was comprehensive and inclusive.

12.1. In order to govern the development of the SAM regime (which is given effect to in the Insurance Bill), a SAM Steering Committee was established in 2009. The SAM Steering Committee then established various Sub-Committees, Task Groups and working groups to provide input on the various components of the SAM regime. The stakeholders included in the SAM Governance Structure comprise the following:

- National Treasury;
- Financial Services Board;
- South African Reserve Bank;
- South African Revenue Service;
- Independent Regulatory Board of Auditors; and
- professional bodies, industry and industry associations such as insurers, the South African Insurance Association ("SAIA"), the Association for Savings and Investment South Africa ("ASISA"), the Actuarial Society of South Africa ("ASSA"), and the South African Institute of Chartered Accountants ("SAICA").

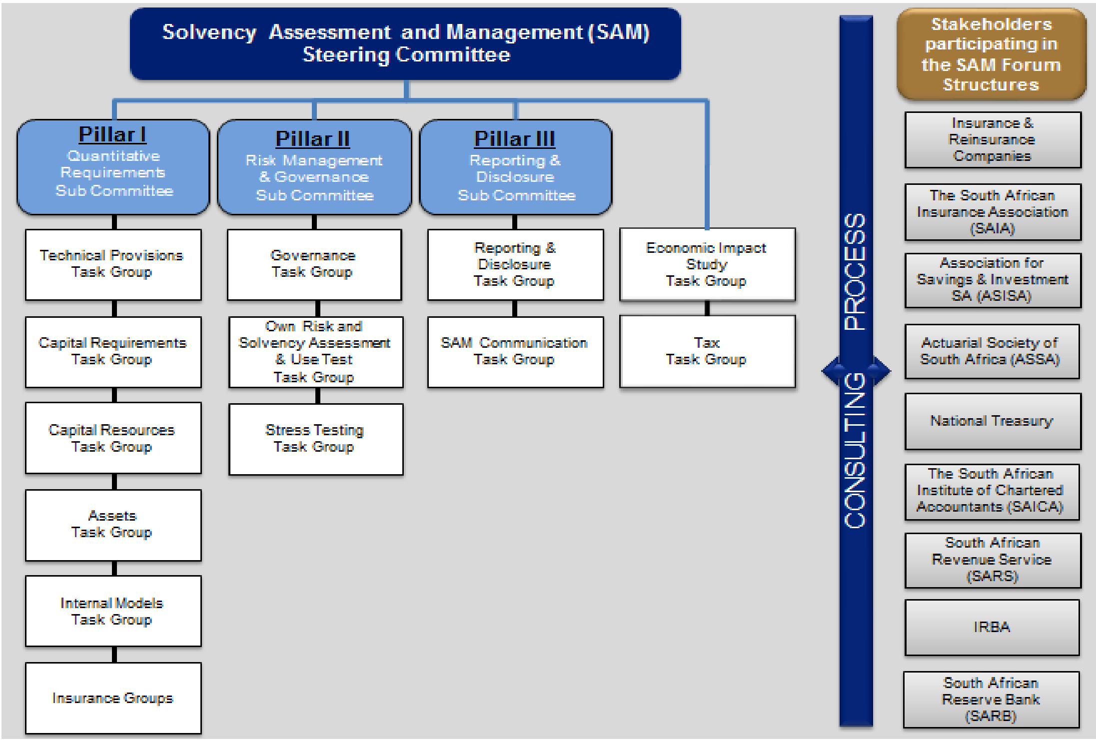
ENHANCING FINANCIAL SOUNDNESS

13. THE NEW SOLVENCY ASSESSMENT AND MANAGEMENT (SAM) REGIME & THE FRAMEWORK FOR INSURANCE GROUP SUPERVISION

13.1 *The Governance Structure*

13.1.1 In order to govern the development of the SAM regime, a SAM Steering Committee was established in 2009. The SAM Steering Committee then established various Sub-Committees, Task Groups and working groups to provide input on the various components of the SAM regime.

13.1.2 The stakeholders included in the SAM Governance Structure include public bodies such as the National Treasury, the Financial Services Board ("FSB"), the South African Reserve Bank and the South African Revenue Service, as well as professional bodies, industry and industry associations. The following figure illustrates the SAM Governance Structure:



13.1.3 The Bill has been developed over a period of 5 years by producing various versions which have been subject to a closed consultation process through the SAM Governance Structure.

13.2 *Quantitative and Qualitative Impact Studies*

13.2.1 The Bill has also been informed by impact studies that have been completed on both the quantitative and qualitative aspects of the SAM regime.

13.2.2 Three quantitative impact studies have been completed to test the quantitative financial soundness requirements. 13.2.3 In addition to the quantitative impact studies, there have been two qualitative studies to consider the readiness of the industry to comply with the governance and risk management requirements under Pillar 2.

13.2.4 The reports from all quantitative impact studies and the Pillar 2 readiness review studies are available on the website of the Financial Services Board (www.fsb.co.za).

13.3 *Parallel Run*

To prepare the industry for the implementation of the SAM Framework from 1 January 2016, a parallel run has been initiated, in which insurers are required to report information under the SAM regime along with the existing reporting required under the Insurance Acts. This process started on 1 July 2014, and will continue until the full implementation of the SAM regime. The key benefits from this dual reporting process is that the insurers are able to provide the information that will be expected when the SAM regime goes live on 1 January 2016, and that any remaining issues are dealt with before implementation.

14. ENHANCING REINSURANCE ARRANGEMENTS

The reinsurance arrangements are informed by—

- a research project commissioned by the Financial Services Board, which consisted of—
    - an international scan of issues in other jurisdictions and international best practice and trends in the structuring of global reinsurance operations;
    - a market survey that took the form of interviews with reinsurers operating in South Africa to understand their strategies and business challenges; interviews with local insurers to understand their reinsurance needs and key factors influencing their reinsurance decisions; interviews with local reinsurance brokers to understand the factors driving reinsurance placements; and
    - a public policy assessment that examined national interest issues with respect to the local reinsurance industry in the context of the National Treasury's Gateway to Africa initiative;
- international trade obligations, and international standards & guidance; and
- supervisory concerns and considerations.

15. ALIGNMENT WITH INTERNATIONAL STANDARDS

15.1. The process of aligning the Bill with the IAIS ICPs was informed by the IAIS ICPs and the findings of the assessments conducted by the International Monetary

Fund and World Bank in 2008, 2010 and 2014 in respect of insurance regulation in South Africa in terms of their joint Financial Sector Assessment Program (FSAP).

16. FINANCIAL IMPLICATIONS FOR THE STATE

16.1. There are no significant financial implications envisaged for the fiscus, as the regulator will continue to be funded through fees and levies imposed on financial institutions (this is consistent with the prevailing situation).

17. FINANCIAL IMPLICATIONS FOR INSURANCE INDUSTRY, CONSUMERS, AND THE BROADER ECONOMY- A COST-BENEFIT ANALYSIS

17.1 Greater financial inclusion has positive effects on economic growth and the reduction of income inequalities. Financial stability at household level is essential to growth and prosperity for individuals, companies and communities.

17.2 In addition to the quantitative impact studies described above, an Economic Impact Study on the impact of the SAM regime was commissioned. This study considered the direct costs and benefits, as well as the potential indirect impacts from changes in behaviour from the introduction of the SAM regime. These results were then used to model the wider economic impact of the introduction of the SAM regime on the South African economy.

17.3 Not only does SAM increase compliance with international standards, but the introduction of SAM facilitates a forward looking and risk-based approach to insurance supervision. The SAM framework will also enhance the risk management within the insurance industry. The alignment of risk to capital and enhanced management and supervision of risk is expected to lead to a more financially stable insurance industry. This, in turn, is expected to lead to a more stable financial sector, due to the interconnectedness of the South African financial sector. Given the potential financial stability risks that a systemic failure could result in, the costs introduced by SAM are small in comparison to the cost of a financial sector collapse.

17.4 The Economic Impact Study shows that the implementation of SAM does not result in a cost to the economy, but rather that there is evidence to believe that the implementation of SAM may have a neutral to slightly positive impact on the overall economy and contribute towards GDP growth and employment.

17.5 The implementation of SAM will result in additional costs to the insurance industry. These costs will be offset by the benefits described above, although they are more difficult to measure. Even if these costs are passed on to consumers in the medium term, they are likely to be small, and may even be negligible given the difficulty in quantifying counterbalancing benefits and the fact that pricing may be influenced by many other factors.

17.6 The study has also identified some other potentially negative impacts of SAM, most notably the potential negative impact on financial inclusion. The introduction of a dedicated micro-insurance regulatory framework and a proportionate approach to the implementation of the SAM framework can help mitigate these negative impacts.

17.7 The study has further identified a number of recommendations relating to some of the detailed requirements in order to facilitate a smooth transition to the SAM Framework. These recommendations relate to clarifications of the SAM Framework, the supervisory approach taken, further transitional considerations and the application of proportionality.

17.8 Overall, the study suggests that the implementation of SAM is likely to lead to better risk management at a direct cost that is small when seen in the context of the size of the South African insurance industry. This additional cost to the insurance industry will lead to a neutral to slightly positive impact for the economy as a whole, while also contributing to a more sustainable and stable financial sector.

17.9 Given that insurers operate globally, but are regulated nationally, it is imperative that national regulators coordinate the supervision of multinational institutions by setting and applying international standards. Also, by committing to international standards, our financial institutions are able to operate in other countries with greater ease, as the different country regulators work together.

17.10 In conclusion, the measures contained in the Bill will result in additional costs to the insurance industry. These costs will be offset by improvements to the sustainability of the insurance industry, better protected customers and the stability of the financial system as a whole.

18. CONSTITUTIONAL IMPLICATIONS

None.

19. PARLIAMENTARY PROCEDURE

19.1 The State Law Advisers and the National Treasury are of the opinion that this Bill must be dealt with in accordance with the procedure prescribed by section 75 of the Constitution, since it contains no provision to which the procedure set out in section 74 or 76 of the Constitution applies.

19.2 The State Law Advisers are of the opinion that it is not necessary to refer this Bill to the National House of Traditional Leaders in terms of section 18(1)(a) of the Traditional Leadership and Governance Framework Act, 2003 (Act No. 41 of 2003), since it does not contain provisions pertaining to customary law or customs of traditional communities.