EXECUTIVE SUMMARY

This Position Paper sets out the final reforms to be introduced in respect of the reinsurance prudential regulatory framework in South Africa. The reforms aim to ensure that reinsurance arrangements within South Africa allow for and support the objectives of insurance regulation, i.e. to promote the maintenance of a fair, safe and stable insurance market for the benefit and protection of policyholders.

The document responds to the comments received on the Reinsurance Regulatory Review Discussion Paper, April 2015 (“the Discussion Paper”) and indicates how these final reforms will be implemented.

The FSB would like to thank all commentators on the Discussion Paper for their constructive contributions to the development of these proposals.

Summary of key amendments to proposed reforms mooted in the Discussion Paper:

- Microinsurers will be allowed to conduct microinsurance reinsurance business if specifically so authorised (section 2.2);
- Cell captive insurers will only be prohibited from insuring the risks associated with the insurance obligations of another insurer licensed in South Africa, i.e. they may reinsure risks from other countries (section 2.2);
- In respect of the equivalence assessments of the regulatory frameworks of foreign jurisdictions in which reinsurers are based, the FSB will provide an initial list of equivalent jurisdictions (section 2.3);
- Reinsurance placed with branches of foreign insurers or Lloyd’s underwriters by local direct insurers or local professional reinsurers will be treated the same for purposes of solvency assessment to reinsurance placed with a local professional reinsurer or a local direct insurer (sections 2.3 and 2.4). The FSB will provide a clear definition of what will constitute soliciting business in South Africa (section 2.5);
- The FSB will allow composite reinsurance licences, but not when writing reinsurance of investment classes (section 3.1);
- Reinsurance contracts relating to international insurance programs are excluded from calculating the limit in the reforms addressing fronting arrangements (section 3.4);
- Reinsurance of linked investment business will be allowed (section 3.5);
- For purposes of the solvency assessment of insurers, the credit quality step used for purposes of counterparty default risk will be as follows (section 5.2):
  - In respect of local subsidiaries of foreign reinsurers and local direct insurers, an upgrade can be applied to the credit quality step to offset any downgrade in the rating arising from the sovereign rating cap; and
  - In respect of branches of foreign reinsurers, Lloyd’s of London and cross-border supply by reinsurers in equivalent jurisdictions, the international rating may be used; and
- Pay-as-paid clauses will be allowed, but only for certain commercial policies, and subject to certain conditions (section 6).
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1. INTRODUCTION

1.1. Background

The Financial Services Board (FSB) published its Reinsurance Regulatory Review Discussion Paper (“the Discussion Paper”) in April 2015. Against the background of the new risk-based solvency regime, Solvency Assessment and Management (SAM), for insurers (both direct insurers and reinsurers) the Discussion Paper mooted proposed reforms to the prudential regulatory framework for reinsurance in South Africa.

The Discussion Paper put forward a number of proposed regulatory reforms aimed at meeting the objective of the reinsurance regulatory review carried out by the FSB, i.e. to promote the maintenance of a fair, safe and stable insurance market for the benefit and protection of policyholders.

A total of 264 comments from local and international commentators were received on the Discussion Paper through the formal consultation process that ended on 1 June 2015. The FSB has undertaken a comprehensive review of the comments and concluded its final regulatory proposals during the interim period.

1.2. Purpose of Position Paper

The purpose of this Position Paper is to:

- Set out the final reforms on how to best achieve the objectives of insurance supervision, i.e. to promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders in respect of reinsurance, while supporting broader national policies on financial inclusion;
- Respond to key issues raised in the comments received on the Discussion Paper; and
- Indicate how these final reforms will be implemented.

1.3. Scope of Position Paper

The Position Paper, as with the Discussion Paper, focuses primarily on the prudential (safety and soundness) considerations relating to reinsurance. Accordingly, the reforms relate directly to the current prudential framework for reinsurance. The reforms will be given effect to in the proposed Insurance Bill, 2016 that will entrench the SAM regime in the regulatory framework, Prudential Standards to be made under the Insurance Bill and other measures available under the Bill.

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1 The paper does not propose market conduct reforms (including in respect of the intermediation or distribution of reinsurance) in relation to reinsurance activities. This is not to say, however, that these activities are not under regulatory scrutiny. The regulatory framework for these activities will be reviewed as part of the broader conduct of business reforms that are underway, which will culminate in the proposed Conduct of Financial Institutions Bill (see the National Treasury document “Treating customers fairly in the Financial Sector: a draft market conduct policy framework for South Africa”, December 2014, http://www.treasury.gov.za/public%20comments/FSR2014/).
The reforms therefore focus on the prudential requirements for the conduct of reinsurance business and the recognition or treatment of reinsurance in assessing the solvency of insurers. The reforms span across permitted institutional forms, permitted reinsurance business, acceptable contractual arrangements and the three pillars of the SAM regime (Pillar I: Financial Soundness, Pillar II: Governance and Pillar III: Reporting).

The Insurance Bill was tabled in Parliament on 28 January 2016 and will be subjected to comments and public hearings in accordance with Parliament’s processes and procedures. The Prudential Standards to be made under the Insurance Bill will be subjected to rigorous informal and formal consultation during the course of 2016 and early 2017.

1.4. Structure of Position Paper

This Position Paper discusses each of the reforms mooted in the Discussion Paper in turn in the following sequence:
- Proposed reform;
- Brief summary of the comments received on the proposed reform;
- Where comments did not support proposed reforms, the FSB’s response to the comments received;
- Final reform; and
- Implementation of the reform.

2. PARTICIPATION IN THE REINSURANCE MARKET

2.1 Locally registered professional reinsurers

The Discussion Paper proposed that locally registered professional reinsurers would be permitted to conduct reinsurance business with direct insurers in South Africa, subject to the same legislative requirements as local direct insurers, but licensed to conduct reinsurance business only, i.e. no direct insurance business will be allowed.

Commentators did not raise any substantial concerns in respect of this proposed reform, although it was highlighted that currently some locally registered professional reinsurers do in some cases conduct direct insurance business with pension funds and medical schemes.

The FSB has considered current practices and has decided to adjust the proposed reform to allow professional reinsurers to conduct direct business with medical schemes, in recognition of the fact that the nature of medical schemes business approaches that of insurance business. The same arguments do not apply as fully to pension fund business, and the insurance needs of pension funds may be adequately met by direct insurers.

The FSB would also like to clarify that it would be possible to establish a professional micro-reinsurer conducting only microinsurance reinsurance, but with the condition that such a reinsurer would not be permitted to be a private company (i.e. it must be a public company registered under the Companies Act or a co-operative registered under the Co-operatives Act).

Final reforms: Locally registered professional reinsurers will be permitted to conduct reinsurance business with direct insurers in South Africa, subject to the following limitation, conditions and requirements:
The same legislative requirements as local direct insurers will apply, but professional reinsurers will be licensed to conduct reinsurance business only, i.e. no direct insurance business will be licensed other than with medical schemes; and

A professional reinsurer conducting only microinsurance reinsurance will be permitted, but such a reinsurer may not be a private company.

The reforms will be given effect to in the Insurance Bill.

2.2 Local direct insurers

The Discussion Paper proposed that local direct insurers would be permitted to conduct reinsurance business with other insurers in- and outside South Africa, subject to the following limitations, conditions and requirements:

- Specific authorisation as part of the Insurance Act licensing requirements will be required to conduct reinsurance business.
- Inwards retrocession from other local direct insurers or foreign insurers that are part of the same insurance group as the local insurer will be subject to approval, which approval will be regularly reviewed by the Prudential Authority.
- Cell captive insurers will not be authorised to conduct any reinsurance business.
- Microinsurers will not be authorised to conduct any reinsurance business.

Specific authorisation required to conduct reinsurance business: Commentators argued that it is current practice for direct insurers to write facultative reinsurance, and that this practice should be allowed to continue.

Approval required for inwards retrocession from other insurers that are part of the same insurance group: Commentators argued that the SAM financial soundness requirements adequately address intragroup reinsurance and therefore no further restrictions are required. Commentators also requested clarity on whether approval would be required on a contract-by-contract basis and if existing intragroup arrangements would also be subject to approval.

Cell captive insurers may not conduct any reinsurance business: A number of commentators misunderstood the proposal to mean that cell captive insurers would not be able to make use of outwards reinsurance to reinsure the risks to which they are exposed. Other commentators were concerned that the proposal would not allow cell captive insurers to accept risks from other countries, where under the prevailing legislative framework in that country, risks are required to be issued to an insurer based in that country before it may be insured outside of that country.

Microinsurers will not be authorised to conduct any reinsurance business: Commentators argued that microinsurers should be authorised to conduct reinsurance business provided that the reinsurance business only relates to microinsurance.

The FSB remains of the view that the proposed reforms will:

- Ensure that only direct insurers that have the necessary skills, expertise and financial resources conduct reinsurance business;
- Mitigate the increasing degree of interconnectedness in the insurance market which poses financial stability risk; and
- Mitigate possible market spirals due to successive rounds of reinsurance and retrocession, which poses prudential and financial stability risk.

The proposed reform that requires specific authorisation to conduct reinsurance business does not prohibit direct insurers from conducting reinsurance business (whether on a
facultative or other basis), but requires that direct insurers be specifically authorised to conduct reinsurance business if they would like to conduct inwards reinsurance business.

The FSB recognises that the SAM financial soundness requirements address intragroup reinsurance, noting that intragroup exposures are excluded from the concentration risk module, but the FSB is of the view that it is important to monitor potential wider risks that may arise due to insurance market spirals. Approvals will be required on a contract-by-contract basis, i.e. per reinsurance arrangement. Existing arrangements will be subject to approval after the commencement of the Insurance Bill.

The FSB would like to clarify that the proposed reform in relation to cell captive insurers did not intend to restrict cell captive insurers placing outwards reinsurance in order to manage risks. The FSB would also not want to restrict cell captive insurers from accepting risks from other countries, where under the legislative framework of that country, risks are required to be placed with an insurer based in that country before it may be insured/reinsured outside of that country.

As the microinsurance framework has been developed through a proportional approach, taking into account the simplified risks to which microinsurers will be exposed, the FSB agrees that microinsurers should be allowed to reinsure microinsurance risk, but only from other microinsurers. However, no automatic authorisation will be given. A microinsurer will have to be specifically authorised to conduct reinsurance business.

**Final reforms:** Local direct insurers will be permitted to conduct inwards reinsurance business, subject to the following limitations, conditions and requirements:

- Specific authorisation as part of the licensing requirements will be required under the Insurance Act to conduct reinsurance business;
- Inwards retrocession from other local direct insurers or foreign insurers that are part of the same insurance group as the local insurer will be subject to approval on a contract-by-contract basis, which approval will be regularly reviewed by the Prudential Authority;
- Cell captive insurers will only be prohibited from insuring the risks associated with the insurance obligations of another insurer licensed in South Africa, i.e. they may reinsure risks from insurers in other countries; and
- Microinsurers will be required to be specifically authorised as part of the licensing requirements under the Insurance Act to conduct microinsurance reinsurance business with other microinsurers.

The reforms will be given effect to in the Insurance Bill, save for bullet 2 (inwards retrocession from other local direct insurers or foreign insurers that are part of the same insurance group as the local insurer) that will be given effect to in the Prudential Standards to be issued under the Insurance Bill.

### 2.3 Branches of foreign reinsurers

The Discussion Paper proposed that branches of foreign reinsurers would be permitted to conduct reinsurance business in South Africa, subject to the following limitations, conditions and requirements:

- Foreign reinsurers will be allowed to conduct reinsurance business only (no direct insurance will be licensed) through a branch established in South Africa;
- The branch will be required to be licensed;
- The same licensing process as for local professional reinsurers will apply. On application, the foreign reinsurer will be required to demonstrate that the laws of the
country under which the foreign reinsurer is authorised and supervised establishes a regulatory framework equivalent to that established by the South African legislative framework;

- Different governance, financial soundness and reporting requirements than those that apply to local professional reinsurers will apply; and
- Reinsurance placed with branches by local direct insurers or local professional reinsurers will be treated differently for purposes of solvency assessment to reinsurance placed with a local professional reinsurer or a local direct insurer.

Some commentators supported the proposed reform that will allow branches of foreign reinsurers to be established in South Africa. Other commentators raised concerns in respect of the potential adverse impact the introduction of branches may have on locally registered reinsurers. Some commentators commented that the proposed requirements for branches are too onerous, and that the introduction of branches should be done in manner that enhances the availability of reinsurance to the local insurance market. Specifically, commentators felt that the determination of equivalence should be the responsibility of the Prudential Authority rather than that of a foreign reinsurer and that reinsurance placed with branches by local direct insurers or local professional reinsurers should for purposes of solvency assessment be treated the same as reinsurance placed with a local professional reinsurer or a local direct insurer.

The FSB is of the view that the final reforms set out below strike the appropriate balance between expanding the reinsurance capacity in the South African market, while maintaining a level playing field between the different providers of reinsurance and addressing prudential risks. The final reforms are also consistent with international practice.

On the assessment of the equivalence of foreign jurisdictions’ laws, and supervisory and information sharing frameworks, the FSB agrees that it may be challenging for reinsurers to demonstrate such equivalence. The FSB has therefore proposed that the Insurance Act authorise the Prudential Authority to determine, from time to time, that the requirements imposed by a foreign jurisdiction meet the objects of the Insurance Act. This will allow the Prudential Authority to establish an initial list of equivalent jurisdictions. A foreign reinsurer, whose jurisdiction is not on the list of equivalent jurisdictions, may approach the Prudential Authority to consider whether that foreign jurisdiction’s laws, supervisory and information sharing frameworks can be regarded as equivalent and therefore considered to be added to the list of equivalent jurisdictions. Also see further discussion on equivalence in paragraph 2.5 below.

On the treatment of reinsurance placed with branches by local direct insurers or local professional reinsurers, the FSB, after careful consideration, is of the view that a combination of the equivalence assessments (outlined above) and an adjustment for the sovereign cap on the credit ratings of locally-incorporated reinsurers (discussed below) will create a sufficiently level playing field and effectively mitigate prudential risks arising from reinsurance arrangements entered into with branches of foreign reinsurers. These risk, in the case of branches, will further be mitigated by enhanced security and reporting requirements.

**Final reforms:** Branches of foreign reinsurers will be permitted to conduct reinsurance business in South Africa, subject to the following limitations, conditions and requirements:

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2 This refers to residual risk that domestic policyholders may not be fully protected from losses in the event of a complex cross-border resolution of (re)insurance groups, and the lack of direct “host” supervisory oversight over the financial soundness and market conduct risks in the foreign (re)insurance groups.
Foreign reinsurers will be allowed to conduct reinsurance business (no direct insurance other than with medical schemes will be licensed) through a branch established in South Africa;
- The branch will be required to be licensed;
- The same licensing process as for locally incorporated professional reinsurers will apply. If, on application, the foreign jurisdiction in which the foreign reinsurer is authorised and supervised has not been determined by the Prudential Authority as equivalent to the regulatory framework established under the Insurance Act, the foreign reinsurer will have to demonstrate that the laws of the country under which it is authorised and supervised establish a regulatory framework equivalent to that established under the Insurance Act;
- Different governance, financial soundness and reporting requirements than those that apply to local professional reinsurers will apply; and
- Reinsurance placed with branches by local direct insurers or local professional reinsurers will be treated the same for purposes of solvency assessment as reinsurance placed with a local professional reinsurer or a local direct insurer.

The reforms referred to in the first 3 bullets will be given effect to in the Insurance Bill. The reforms referred to in the last 2 bullets will be given effect to in the Prudential Standards to be issued under the Insurance Bill.

2.4 Lloyd’s of London

The Discussion Paper proposed that underwriters at Lloyd’s of London (“Lloyd’s”) would be permitted to conduct reinsurance business with insurers in South Africa, subject to the following limitations, conditions and requirements:
- Lloyd’s underwriters through Lloyd’s will be deemed to be licensed to conduct insurance and reinsurance business in South Africa in respect of all non-life classes of insurance and reinsurance business, other than direct and proportional reinsurance of personal lines. For direct and proportional reinsurance of personal lines business, Lloyd’s may apply to the Prudential Authority on a case by case basis to underwrite specialist personal lines coverage in niche and complex risks;
- Different governance, financial soundness and reporting requirements than those that apply to local professional reinsurers will apply;
- Reinsurance placed with Lloyd’s underwriters by local direct insurers or local professional reinsurers through Lloyd’s South African correspondents will be treated in a broadly similar way, for purposes of solvency assessment, as reinsurance placed with a local professional reinsurer or a local direct insurer; and
- Reinsurance placed directly with Lloyd’s underwriters in the London market by local direct insurers or local professional reinsurers will be treated differently for purposes of solvency assessment to reinsurance placed with a local professional reinsurer or a local direct insurer, in a way that is consistent with other forms of cross-border supply of reinsurance.

Lloyd’s raised concerns in respect of the proposed limitation on proportional reinsurance of personal lines and proposals to treat reinsurance placed with Lloyd’s underwriters by local direct insurers or local professional reinsurers differently, for purposes of solvency assessment, from reinsurance placed with a local professional reinsurer of a local direct insurer. Lloyd’s stated that this limitation and treatment will preclude Lloyd’s from providing valuable coverage to the South African market, which will be detrimental to South African insurers and ultimately the policyholder, as reduced access to the Lloyd’s capacity would lead to increases in the costs of reinsurance, reductions in limits and in the choice of products available in the South African market.
Lloyd’s also commented that in a modern regulatory environment, regulators should be able to rely on the supervisory activities performed by a competent regulator with an equivalent supervisory regime in another country in making a determination about the financial strength, the adequacy of reserves and the need for capital deposits of a reinsurer seeking to operate in South Africa. Lloyd’s further commented that it is supervised by the PRA in the UK and that potentially onerous governance requirements should not be placed on the local representative office of Lloyd’s in South Africa.

Other commentators cautioned that the restrictions placed on the classes of business that Lloyd’s is permitted to reinsure, or the types of reinsurance ceded to Lloyd’s, may limit capacity and availability of specific specialty insurance in the local market.

Some commentators expressed the view that Lloyd’s should not be specifically addressed in the regulatory framework and that it must be subject to the same requirements as those that apply to foreign reinsurers wanting to conduct reinsurance business with locally registered insurers.

Lloyd’s of London commented extensively on the aspects of the paper that relate directly to them. In response to their comments, the FSB is engaging closely with Lloyd’s to ensure an appropriate way forward.

The FSB has reconsidered the proposed limitation on proportional reinsurance of personal lines and proposals to treat reinsurance placed with Lloyd’s underwriters by local direct insurers or local professional reinsurers differently for purposes of solvency assessment from reinsurance placed with a local professional reinsurer of a local direct insurer.

The FSB agrees that allowing Lloyd’s to conduct proportional reinsurance of personal lines in South Africa would maintain the existing capacity and choice of products available in the South African market.

The FSB also agrees that equivalence assessments combined with an adjustment for the sovereign cap on the credit ratings of locally-incorporated reinsurers (discussed below) will create a sufficiently level playing field and effectively mitigate prudential risks arising from reinsurance arrangements entered into with branches of foreign reinsurers and Lloyd’s. These risks, in the case of Lloyd’s, will further be mitigated by enhanced security and reporting requirements.

**Final reforms:** Underwriters at Lloyd’s of London will be permitted to conduct insurance business and reinsurance business with insurers in South Africa, subject to the following limitations, conditions and requirements:

- Lloyd’s underwriters through Lloyd’s will be deemed to be licensed to conduct insurance and reinsurance business in South Africa in respect of all non-life classes of insurance and reinsurance business in respect of commercial lines and for reinsurance business in respect of personal lines. For direct insurance of personal lines business, Lloyd’s may apply to the Prudential Authority to underwrite specialist personal lines coverage in niche and complex risks;
- Different governance, financial soundness and reporting requirements than those that apply to local professional reinsurers will apply, as appropriate to the particular business model of Lloyd’s but aimed at achieving equivalent outcomes; and
- Reinsurance placed with Lloyd’s underwriters by local direct insurers or local professional reinsurers, either through Lloyd’s South African correspondents or directly, will be treated the same for purposes of solvency assessment as reinsurance placed with a local professional reinsurer or a local direct insurer.
The reforms referred to in the first bullet will be given effect to in the Insurance Bill. The reform referred to in the second bullet will partly be given effect to in the Insurance Bill and partly in the Prudential Standards to be issued under the Insurance Bill. The reforms referred to in the last bullet will be given effect to in the Prudential Standards to be issued under the Insurance Bill. Financial services providers (or their representatives) that are not binder holders (i.e. Lloyd’s South African correspondents) that place insurance directly with Lloyd’s underwriters, will continue to require the approval of the Prudential Authority prior to placing the insurance. This is a current requirement in the Short-term Insurance Act No. 53 of 1998. This requirement will not be repealed by the Insurance Bill.

2.5 Cross-border supply of reinsurance

The Discussion Paper proposed that:

- Local direct insurers and local professional reinsurers will be allowed to place reinsurance directly with a foreign reinsurer; however, foreign reinsurers will continue to be prohibited from soliciting business in South Africa on a cross-border basis;
- Reinsurance placed directly by local direct insurers or local professional reinsurers with a foreign reinsurer will be treated differently for purposes of solvency assessment to reinsurance placed with a local professional reinsurer, a branch of a foreign reinsurer or a local direct insurer;
- In addition, reinsurance placed directly with a foreign reinsurer that is authorised and supervised under the laws of a country that establishes a regulatory framework equivalent to that established by the South African legislative framework will be treated differently for purposes of solvency assessment to reinsurance placed with a foreign reinsurer that is not authorised and supervised under the laws of a country that establishes a regulatory framework equivalent to that established by the South African legislative framework; and
- In respect of the preceding bullet, local direct insurers or local professional reinsurers that place reinsurance directly with a foreign reinsurer will have to demonstrate that the laws of the country under which the foreign reinsurer is authorised and supervised establishes a regulatory framework equivalent to that established by the South African legislative framework.

In considering whether the laws of a country under which a foreign reinsurer is authorised and supervised establishes a regulatory framework equivalent to that established by the South African legislative framework, the Discussion Paper provided that it is important to establish if the laws provide equivalent policyholder protection and are capable of ensuring stability and fairness in the market. The Discussion Paper specified the criteria to be taken into account in this regard. The Discussion Paper also stated that the Prudential Authority will publish a list of jurisdictions that are deemed to be equivalent, which list will be updated from time to time.

A significant number of commentators supported the proposal that foreign reinsurers should continue to be prohibited from soliciting business in South Africa on a cross-border basis. Commentators, however, were concerned that there is no clear definition of soliciting, and that the provision is difficult to supervise. Commentators also commented that it is not clear whether the placement of cross-border reinsurance through reinsurance brokers would be seen as soliciting or not.

Similarly to equivalence matters relating to branches of foreign reinsurers, commentators felt that the determination of equivalence should be the responsibility of the Prudential Authority, rather than that of local registered insurers.
Commentators requested that reinsurers from jurisdictions that were determined as not equivalent should be allowed to apply for exemption from the requirement of equivalence, alternatively, that such reinsurers are treated as equivalent, subject to additional collateral requirements. There were also requests that intra-group arrangements be treated as equivalent as the holding company would ensure that reinsurance claims are honoured in order to avoid any reputational risk of non-payment within the group. A limited number of commentators commented that BRICS countries should automatically be deemed to be equivalent.

Clarity was sought on whether the status of equivalence would impact on the ability of insurers entering into reinsurance arrangements with cross-border reinsurers, or only on the treatment of the reinsurance contract for solvency purposes.

The FSB agrees that there is no clear definition of soliciting in the current legislation and that the provision is difficult to supervise. The FSB has therefore proposed that the Insurance Bill provide that any person is regarded as conducting insurance business in the Republic if -

(a) The person conducts business similar to insurance business outside the Republic; or
(b) That person or another person, in relation to the business referred to under paragraph (a), directly or indirectly acts in the Republic on behalf of the first mentioned person, including, but not limited to, by rendering a financial service within the meaning of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002), in respect of that business.

This proposal will address unlicensed foreign re/insurers soliciting business in South Africa. The requirement that financial services providers (or their representatives) that are not Lloyd’s South African correspondents that place insurance with a foreign insurer must secure the approval of the Prudential Authority prior to placing the insurance (the current requirement in the Short-term Insurance Act No. 53 of 1998) will also continue to remain in place. This requirement will not be repealed by the Insurance Bill.

In combination, the above measures should mitigate the risk of foreign reinsurers soliciting business in South Africa without being licensed in South Africa. It is recognised that the Prudential Authority’s remedies in respect of such foreign reinsurers may be limited, but the FSB is confident that the supervisory authority of the foreign reinsurer will take appropriate action should it be informed that the foreign reinsurer is acting contrary to South African legislation.

As to the assessment of the equivalence of foreign jurisdictions, the FSB agrees that it may be challenging for locally registered insurers to demonstrate such equivalence. The FSB has therefore proposed that the Insurance Bill authorise the Prudential Authority to determine, from time to time, that the requirements imposed by a foreign jurisdiction meet the objectives of the Insurance Act. This will allow the Prudential Authority to establish an initial list of equivalent jurisdictions. An insurer wishing to place reinsurance with a foreign reinsurer would therefore only have to demonstrate equivalence in instances where the home jurisdiction of that foreign reinsurer has not been identified as equivalent by the Prudential Authority under the Insurance Act.

As to the proposal to treat reinsurance placed directly by local direct insurers or local professional reinsurers with a foreign reinsurer differently for purposes of solvency assessment to reinsurance placed with a local professional reinsurer, a branch of a foreign reinsurer or a local direct insurer, the FSB agrees that equivalence assessments, combined with an adjustment for the sovereign cap on the credit ratings of locally-incorporated reinsurers (discussed below), will create a sufficiently level playing field and effectively
mitigate prudential risks arising from reinsurance arrangements entered into directly with foreign reinsurers.

However, the FSB remains of the view that it is prudent to treat reinsurance placed directly with a foreign reinsurer that is authorised and supervised under the laws of a country determined by the Prudential Authority to be an equivalent jurisdiction differently for purposes of solvency assessment to reinsurance placed with a foreign reinsurer that is authorised and supervised under the laws of a country that is not determined by the Prudential Authority to be an equivalent jurisdiction. The FSB believes that it is critical from a policyholder protection perspective that the Prudential Authority has comfort that a foreign reinsurer with whom locally registered insurers place reinsurance are subject to laws, and supervisory and information sharing frameworks, that are equivalent to those that apply in South Africa. Equivalence mitigates prudential risks to direct insurers arising from placing reinsurance in a foreign jurisdiction. The FSB does not:

- Support any exemptions for jurisdictions that are not determined as equivalent;
- Believe that the holding of collateral is sufficient to address prudential risks to direct insurers arising from placing reinsurance in a non-equivalent jurisdiction;
- Support a different treatment for intragroup counterparties compared to other counterparties; or
- Consider the membership of an international grouping as an appropriate criterion for measuring equivalence.

The equivalence approach is not intended to impact on the ability of insurers to enter into reinsurance arrangements with foreign re/insurers, but rather to determine the treatment of reinsurance contracts for solvency purposes.

It is envisaged that a draft initial list of equivalent jurisdictions will be published shortly.

**Final reforms:**

- Local direct insurers and local professional reinsurers will be allowed to place reinsurance directly with a foreign reinsurer; however, foreign reinsurers will continue to be prohibited from soliciting business in South Africa on a cross-border basis. In addition, the legislative framework will be strengthened to facilitate the enforcement of this prohibition;
- Reinsurance placed directly by local direct insurers or local professional reinsurers with a foreign reinsurer that is authorised and supervised under the laws of a country determined by the Prudential Authority to be an equivalent jurisdiction will be treated the same for purposes of solvency assessment to reinsurance placed with a local professional reinsurer, a branch of a foreign reinsurer or a local direct insurer;
- Reinsurance placed directly by local direct insurers or local professional reinsurers with a foreign reinsurer that is authorised and supervised under the laws of a country that is not determined by the Prudential Authority to be an equivalent jurisdiction will be treated differently for purposes of solvency assessment to reinsurance placed with a local professional reinsurer, a branch of a foreign reinsurer, a local direct insurer, Lloyd’s or a foreign reinsurer that is authorised and supervised under the laws of a country determined by the Prudential Authority to be an equivalent jurisdiction; and
- The Prudential Authority will publish a list of jurisdictions that are deemed to be equivalent, which list will be updated from time to time.

In considering whether the laws of a country under which a foreign reinsurer is authorised and supervised establishes a regulatory framework equivalent to that established by the South African legislative framework, it is important to establish if the laws provide equivalent policyholder protection and are capable of ensuring stability and fairness in the market. In this regard, the Prudential Authority will take into account equivalence assessments
performed by other jurisdictions, or the designation of deemed equivalence, where such other jurisdictions have in place requirements that are deemed equivalent to SAM.

The reforms referred to in the first bullet and the determination of equivalent jurisdictions will be given effect to in and through the Insurance Bill. The reforms referred to in bullets 2, 3 and 4 will be given effect to in the Prudential Standards to be issued under the Insurance Bill. Financial services providers (or their representatives) that are not Lloyd’s correspondents that place insurance with a foreign reinsurer, will continue to require the approval of the Prudential Authority prior to placing the insurance. This is a current requirement in the Short-term Insurance Act No. 53 of 1998. This requirement will not be repealed by the Insurance Bill.

3. CONDUCTING REINSURANCE BUSINESS

3.1 Composite reinsurers

The Discussion Paper proposed that composite reinsurers will not be allowed under the Insurance Bill to ensure an appropriate separation and management of insurance risks. Existing composite reinsurers would be required within a period of two years after the effective date of the Insurance Bill to apply for a licence in accordance with the Insurance Bill and, within a period determined by Prudential Authority, to make arrangements for discharging its obligations under or the orderly resolution of the insurance business that it will no longer be permitted to conduct.

A significant number of commentators disagreed with this proposal, pointing out that the risks highlighted in the Discussion Paper could be avoided by the separation of assets and liabilities of the life and non-life components and managing and reporting on these separately. There was also a question as to how the proposal would apply to branches of foreign reinsurers where the foreign reinsurer operates as a composite insurer in its home jurisdiction.

The FSB agrees that the risks highlighted in the Discussion Paper could be appropriately mitigated. Composite reinsurers will therefore be allowed subject to certain risk mitigation measures.

Final reform:
A reinsurer that is licensed to conduct both life and non-life insurance business may not be licensed to conduct reinsurance business in respect of the investment classes of life insurance business. This minimises the contagion risk to assets backing investments arising from adverse underwriting experience.

The reform will be given effect to in the Insurance Bill.

3.2 Use of reinsurance for purposes other than risk management

The Discussion Paper proposed that the treatment of financial reinsurance\(^3\) within the SAM financial soundness calculation should reflect the economic reality of the reinsurance arrangement. In particular, the Discussion Paper proposed:

\(^3\) The term financial reinsurance (also known in some jurisdictions as “finite reinsurance”, “structured
The valuation of any contingent liabilities raised as a result of entering into the arrangement should be recognised. This contingent liability should then be valued as the expected present value of future cash flows required to settle the contingent liability over the lifetime of that contingent liability, using the basic risk-free interest rate term structure. This is consistent with the approach set out in the Solvency II delegated acts by the European Commission; and

There should be no recognition of the financial reinsurance arrangement within the calculation of the SCR. This is consistent with the final Position Paper 75 (PP75) produced by the SAM Governance Structure.

Given that the SAM framework reflects an economic view of financial reinsurance arrangements, no further proposed reforms are required beyond the planned SAM reforms.

Commentators raised concerns on the lack of a clear definition of financial reinsurance or when a reinsurance contract should be seen as “risk mitigating”. There were also some concerns raised with reference to PP75 in that, what is stated in the Discussion Paper is inconsistent with PP75 as the Discussion Paper requires that financial reinsurance should be disregarded within the calculation of the SCR, while PP75 provides that financial reinsurance should only be disregarded where the financial reinsurance arrangements do not involve any risk transfer.

Commentators made a number of proposals on how “risk mitigation” should be identified, including using the criteria as set out by IFRS and audited by the external auditors, or other technical methods considering the potential downside of the reinsurance contract such as the 10/10 rule and the expected reinsurance deficit method. Some comments requested that the measures used to identify risk transfer should be consistent across all insurers, whereas other comments suggested that the identification of risk transfer should be set out in the insurer’s reinsurance policy and reported on and monitored by the Head of Actuarial Control.

Some commentators supported the use of financial reinsurance by new insurers as this assists them in managing capital strain.

The FSB agrees that further detail should be set out as to when a reinsurance contract involves risk transfer. Although the IFRS option has the advantage of being in place already and being subject to audit by the external auditors, the FSB understands that the application of the IFRS criteria varies from insurer to insurer. The FSB is of the view that it would not be practical to adopt one measure for determining whether a reinsurance contract involves risk transfer, but that it would be more pragmatic for the insurers to specify their view of risk transfer within their reinsurance policy. This then provides a structure whereby the insurer can put in place a control process, including review by the Head of Actuarial Control, to determine whether reinsurance contracts involve effective risk transfer.

The FSB is of the view that the provision of reinsurance without effective risk transfer should be considered “Other Business”4 for purposes of the regulatory framework, subject to prior approval by the Prudential Authority5.

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4 Refer to section 5(4) of the Insurance Bill, 2016.
5 Reinsurance arrangements entered into in relation to linked business could arguably fall into the category of reinsurance without effective risk transfer, but will be excluded from this category at this time until the envisaged comprehensive review of these arrangements has been completed as part of a second phase of SAM framework development, scheduled to begin after the enactment of

reinsurance”, “non-traditional reinsurance” or “loss mitigation reinsurance”) is a generic term used to describe an entire spectrum of reinsurance arrangements that transfer limited risk relative to aggregate premiums that could be charged under the contract.
The FSB further agrees that the proposal as set out in Final PP 75 should be clarified.

The FSB disagrees that any special dispensation should be put in place for new insurers in respect of reinsurance without effective risk transfer.

**Final reforms:** The treatment of financial reinsurance within the SAM financial soundness calculation should reflect the economic reality of the reinsurance arrangement. It is thus important for each insurer to verify that their reinsurance arrangements involve effective risk transfer. The definition of effective risk transfer should be set out in the insurer’s reinsurance policy, and effectively monitored. Only reinsurance arrangements that involve effective risk transfer will be allowed to be taken into account in the calculation of the SCR and technical provisions. Reinsurance arrangements that do not involve effective risk transfer are not invalid or illegal, but cannot be taken into account in the calculation of SCR and technical provisions. Where there is no risk transfer, the arrangement will constitute “other business” for purposes of the Insurance Act and the reinsurer must secure the prior approval of the Prudential Authority to conduct such business. If an insurer enters into financial reinsurance arrangements that do not involve effective risk transfer, these arrangements will be regarded as borrowing of assets and will require the approval of the Prudential Authority prior to entering into such arrangements.

The reform will be given effect in the Prudential Standards to be issued under the Insurance Bill.

### 3.3 Intra-group and related party reinsurance

The Discussion Paper proposed that there are no specific further measures that need to be taken into account with regard to intra-group reinsurance in addition to those inherent in the SAM regime.

No substantial comments were received on this proposed reform.

No specific further measures in relation to intra-group reinsurance form part of the final reforms.

### 3.4 Fronting arrangements

The Discussion Paper proposed the following to address the risk of fronting:

- A licensed direct insurer conducting only direct business will not be allowed to directly or indirectly reinsure more than 75% of the premiums it has underwritten to either a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, a professional reinsurer, or another direct insurer in South Africa;
- A licensed direct insurer conducting reinsurance business or a professional reinsurer will not be allowed to directly or indirectly retrocede more than 75% of the premiums it has underwritten to either a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, or another professional reinsurer or direct insurer in South Africa; and

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6 In accordance with section 5 of the Insurance Act.
In the case of both a licensed direct insurer and professional reinsurer, the limit on the amount that may be reinsured or retroceded is increased to 85% where the counterparty is an entity within the same group.

Commentators had differing views on the proposed reform, with some commentators agreeing with the need for a limit, while others disagreed. Some commentators argued that the limit on placement of reinsurance may hamper effective risk and capital management of insurers, and may increase systemic risk. Other commentators proposed that the limits should be increased, for example from 75% to 90%, and that insurers should be allowed to apply on a case by case basis for exemption from the limitations.

Clarity was requested on whether the limit applied:
- In aggregate or per counterparty;
- For the whole book or by line of business; or
- For the whole book or by reinsurance contract.

Some commentators requested that reinsurance contracts relating to international insurance programmes should be excluded from the proposed reform as these contracts do not relate to fronting.

The FSB would like to clarify that the proposed quantitative limit would apply to reinsurance arrangements with one reinsurer for the whole book of business of the insurer other than a composite insurer. In the case of a composite insurer, the proposed limit would apply in respect of its life insurance business and in respect of its non-life insurance business, respectively. It would therefore be possible for an insurer to reinsure more than 75% of its premium if it is done with multiple reinsurers – e.g. 40% to reinsurer A and 40% to reinsurer B. In light of this clarification, the FSB is of the view that the concerns raised in respect of risk management, capital management and systemic risk are not relevant.

A quantitative limit will not be imposed per class of business; however, insurers will be required not to engage in fronting arrangements in respect of a specific class or sub-class of business. A principle to this effect will be included in the legislation. Whether or not the reinsurance of a specific class or sub-class of business constitutes fronting will be assessed on a case by case basis through supervision.

The FSB agrees that international insurance programmes should be excluded when calculating the limit. However, insurers must clearly demonstrate and evidence to the Prudential Authority that the particular business underwritten is part of a global programme.

The FSB does not believe it appropriate to increase the limit, or to allow applications for the limit to be exceeded.

**Final reforms:** To address the risk of fronting:
- A licensed direct insurer should not engage in fronting arrangements in respect of a specific class or sub-class of insurance business.
- A licensed direct insurer conducting only direct business will not be allowed to directly or indirectly reinsure more than 75% of the premiums it has underwritten to one reinsurer – whether to a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, a professional reinsurer, another microinsurer or another direct insurer in South Africa;
- A licensed microinsurer conducting only direct business will not be allowed to directly or indirectly reinsure more than:
  - 75% of the premiums it has underwritten in respect of its life insurance business to one reinsurer; or
- 75% of the premiums it has underwritten in respect of its non-life insurance business to one reinsurer, whether to a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, a professional reinsurer, a microinsurer or a direct insurer in South Africa;

- A licensed direct insurer conducting reinsurance business will not be allowed to directly or indirectly retrocede more than 75% of the premiums it has underwritten to one reinsurer – whether to a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, a professional reinsurer, or a direct insurer in South Africa;

- A licensed composite reinsurer or microinsurer conducting reinsurance business will not be allowed to directly or indirectly retrocede more than:
  - 75% of the premiums it has underwritten in respect of its life insurance business to one reinsurer; or
  - 75% of the premiums it has underwritten in respect of its non-life insurance business to one reinsurer, whether to a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, a professional reinsurer, a microinsurer or a direct insurer in South Africa;

- In the case of both a licensed direct insurer (including a microinsurer) and a professional reinsurer, the limit on the amount that may be reinsured or retroceded is increased to 85% where the counterparty is an entity within the same group; and

- Reinsurance contracts relating to international insurance programs are excluded from the limitations.

The reforms referred to will be given effect to in the Prudential Standards to be issued under the Insurance Bill.

### 3.5 Reinsuring linked investment business

The Discussion Paper proposed that reinsurers should not be authorised to reinsure linked investment business. This proposed reform would not prohibit linked insurers from making use of insurance to manage their operational risk exposures.

Commentators raised concerns that the reinsurance of linked insurance business facilitates access to funds that are available from a different linked provider.

Subsequent to various engagements with affected insurers and despite the fact that the reinsurance of linked investment business is mainly used to gain access to asset management and administration services, the FSB agrees that the proposed reform should be addressed in a second phase of reforms over the next two years following further technical work and consultation. A term of reference for this research will be consulted on in 2017.

**Final reform:**

- Insurers writing linked business will be permitted to enter into reinsurance arrangements. The purpose and reporting of such arrangements will be subject to further review and consultation.
4. GOVERNANCE, FINANCIAL SOUNDNESS AND REPORTING

As indicated in section 2, specific governance, financial soundness and reporting requirements will apply in respect of licensed branches of foreign reinsurers and Lloyd’s of London. While this reform is looking to create level playing fields between the different providers of reinsurance, it is recognised that different types of providers operate under different structures.

The Discussion Paper proposed that the following requirements will apply in respect of branches of foreign reinsurers and Lloyd’s of London:

- **Governance:**
  - Requirements relating to the composition and governance of the board of directors, roles and responsibilities of the board of directors, duties of directors and structure of the board of directors will not apply;
  - Requirements relating to audit committees as well as other board committees (i.e. risk and remuneration committees) will not apply;
  - A representative office must be established that has appropriate risk management and internal control systems;
  - Duties of representatives will be prescribed;
  - Representatives must comply with prescribed fit and proper requirements and other requirements relating to the appointment and termination of key persons (including executive management and heads of control functions) within the representative office;
  - The representative office will have to undertake an own risk and solvency assessment (ORSA); and
  - An external auditor must be appointed.

The Discussion Paper also made reference to Board Notice 158 of 2014 on Governance and Risk Management Framework for Insurers as published on 19 December 2014, providing more detail on the proposed risk management and internal control requirements that would apply to branches of foreign reinsurers and Lloyd’s.

- **Financial soundness:**
  - Security must be provided in South Africa by a branch of a foreign reinsurer and Lloyd’s on behalf of each Lloyd’s underwriter in respect of the insurance business conducted in South Africa. The security must be held in trust in South Africa;
  - The trust deed must comply with any prescribed requirements and be approved by the Prudential Authority;
  - Requirements relating to the roles, responsibilities and functions of the trustees, and roles, responsibilities and functions of the representative of a branch of a foreign reinsurer or Lloyd’s in respect of the trust may be prescribed;
  - If any trustee of a trust fails to comply with any requirements of the Act or any provision of the trust deed, the Prudential Authority may exercise the powers of the trustees under the trust deed;
  - The security must be invested in accordance with prescribed requirements;
  - The security may not be accessed by a foreign reinsurer or Lloyd’s without the approval of the Prudential Authority;
  - A branch of a foreign reinsurer must at all times maintain its business in a financially sound condition, by providing security in the form of assets valued in accordance with requirements to be prescribed to a trust that is at least equal to the technical provisions for the insurance business conducted by that branch in South Africa, which technical provisions must be calculated in the prescribed manner; and
Lloyd’s must at all times maintain its business in a financially sound condition, by providing security in the form of assets valued in accordance with requirements to be prescribed to the trust that is at least equal to the aggregate of the technical provisions for each Lloyd’s underwriter in respect of the insurance business conducted by that underwriter in South Africa, which technical provisions must be calculated in the prescribed manner.

- **Reporting:**
  - Reporting will be the same as for locally-incorporated licensed insurers, including statutory returns and audited financial statements in respect of business conducted in South Africa; and
  - Branches and Lloyd’s must notify the Prudential Authority of any changes to a law of the country in which the head office of the foreign reinsurer or Lloyd’s is located relating to the governance or supervision of that foreign reinsurer, Lloyd’s or Lloyd’s underwriters, and any actions taken by a regulatory authority in the country in which the head office of a foreign reinsurer or Lloyd’s is located relating to the non-compliance of that foreign reinsurer, Lloyd’s or a Lloyd’s underwriter with the laws that that regulatory authority administers.

Commentators commented that branches of foreign reinsurers should be exempted from conducting an ORSA where the foreign reinsurer conducts an ORSA in its home jurisdiction.

One commentator commented that, in addition to the requirement to hold technical provisions, the branch should be required to hold an MCR. However, another commentator was of the view that the requirement to hold technical provisions may be too onerous, and may act as a deterrent for foreign reinsurers to create branches. There was also a request to clarify whether the requirement to hold technical provisions should be on a net or gross basis.

The FSB is of the view that branches of foreign reinsurers and Lloyd’s should not be exempted from the requirement to conduct an ORSA as the business of a branch of a foreign reinsurer or Lloyd’s may not be significant when compared to the overall business of the foreign reinsurer, which will result in the risks emanating from the branch not being adequately addressed in the ORSA conducted in the home jurisdiction.

The FSB believes that the requirement to hold security in line with the technical provisions and a risk margin is adequate. The FSB, on approval, would allow the technical provisions used to calculate the security to be calculated net of reinsurance.

Lloyd’s of London commented extensively on the aspects of the paper that relate directly to them. In response to their comments, the FSB has been extensively engaging with Lloyd’s to ensure an appropriate way forward. These engagements include:

a) The roles and responsibilities of the Lloyd’s South African Representative Office versus that of the Lloyd’s Corporation;
b) The mapping of the risk management policies and sub-policies as prescribed in Board Notice 158 of 2014 with those already in place at the Lloyd’s Corporation;
c) Qualitative and quantitative reporting requirements;
d) Appointment and establishment of control functions, including the heads of these control functions, and the arrangements between the Lloyd’s South African Representative Office and the Lloyd’s Corporation;
e) Roles and responsibilities of the trustees of the security trust;
f) The wording of the trust deed; and

g) The audit requirements for the reporting by the Lloyd’s South African business.
Final reforms: Governance

- Requirements relating to the composition and governance of the board of directors, roles and responsibilities of the board of directors, duties of directors and structure of the board of directors will not apply, but certain requirements will be made applicable to the representative and/or the foreign reinsurer and Lloyd’s;
- Requirements relating to audit committees as well as other board committees (i.e. risk and remuneration committees) will not apply;
- A representative office must be established that has appropriate risk management and internal control systems;
- Duties of representatives will be prescribed;
- Representatives must comply with prescribed fit and proper requirements and other requirements relating to the appointment and termination of key persons (including executive management and heads of control functions) within the representative office;
- The representative office will have to undertake an own risk and solvency assessment (ORSA); and
- An external auditor within South Africa must be appointed.

The following table provides more detail on the proposed risk management and internal control requirements that will apply, with reference to Board Notice 158 of 2014 (“BN158”):

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>PART 4: RISK MANAGEMENT SYSTEM - requirement to establish a risk management system</td>
<td>The requirements imposed on local registered insurers allow for the proportionate application of the risk management system. The same will apply to branches and to Lloyd’s.</td>
</tr>
<tr>
<td>PART 4: RISK MANAGEMENT SYSTEM - risk management principles</td>
<td>The principle underlying the requirements should be adhered to (i.e. risks addressed both in isolation as well as in aggregate, and risk management embedded in the operations of the branch or Lloyd’s). While risk management supports the board of the parent company, the requirements here should be interpreted so as to adequately support the representative of the branch or Lloyd’s in meeting his or her responsibilities.</td>
</tr>
<tr>
<td>PART 4: RISK MANAGEMENT SYSTEM - elements of the risk management system</td>
<td>All elements are required. These should be applied in a proportionate manner.</td>
</tr>
<tr>
<td>PART 4: RISK MANAGEMENT SYSTEM - review of the risk management system</td>
<td>Ongoing review will be required.</td>
</tr>
<tr>
<td>PART 4: RISK MANAGEMENT SYSTEM - risk management policies</td>
<td>Branches and Lloyd’s should ensure that, where they apply parent policies, the policies meet the prescribed requirements and are appropriate to the business conducted in South Africa. Where the parent policies differ substantially from the prescribed requirements and/or do not cover all risk areas referred to, the branch or Lloyd’s should establish specific policies at the level of the branch or Lloyd’s that meet the requirements.</td>
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</tr>
<tr>
<td>PART 5: INTERNAL CONTROL SYSTEM – requirement to establish an internal control system</td>
<td>The requirements imposed on local entities allow for the proportionate application of the internal control system. The same will apply to branches and to Lloyd’s.</td>
</tr>
<tr>
<td>PART 5: INTERNAL CONTROL SYSTEM - elements of the internal control system</td>
<td>All elements are required. In section 22(2)(d) of BN158, reference is made to a delegation of authority approved by the board. This should be approved by the board of the foreign reinsurer and Lloyd’s, and should specify the authority granted to the representative of the branch or Lloyd’s.</td>
</tr>
</tbody>
</table>
| PART 5: INTERNAL CONTROL SYSTEM - General requirements for control functions | The requirements of BN must be complied with subject to the following amendments:  
* Section 23(3)(a) of BN158: Each control function to have access to the relevant control functions (or similar functions) and the relevant structures of the board of the foreign reinsurer/ Lloyd’s  
* Section 23(5)(c) of BN158: The representative of the branch/Lloyd’s, as well as the relevant control functions (or similar functions) and the relevant structures of the board of the foreign reinsurer/ Lloyd’s, should regularly review the performance of each control function.  
* Section 23(8)(a) of BN158: Conflicts of interest, where they cannot be avoided, should be reported to the representative of the branch/Lloyd’s and, where relevant, the management and appropriate committees of the board of the |
| PART 5: INTERNAL CONTROL SYSTEM – risk management function | The requirements of BN158 must be complied with subject to the following amendments:  
- Section 24(1)(h) of BN 158: Regular reporting should be to the representative of the branch/Lloyd’s, heads of control functions, and the relevant structures of the board of the foreign reinsurer/Lloyd’s.  
- Section 24(2) of BN 158: The risk management function must have access to and report to the relevant structures of the board of the foreign reinsurer/Lloyd’s.  
- Section 24(3) of BN 158: The circumstances referred to should be reported to the relevant structures of the board of the foreign reinsurer/Lloyd’s. |
| PART 5: INTERNAL CONTROL SYSTEM - compliance function | The requirements of BN158 must be complied with subject to the following amendments:  
- Section 25(2) of BN 158: The compliance function must have access to and report to the relevant control functions (or similar functions) and the relevant structures of the board of the foreign reinsurer/Lloyd’s. |
| PART 5: INTERNAL CONTROL SYSTEM - internal audit function | The requirements of BN158 must be complied with subject to the following amendments:  
- Section (2) of BN 158: The internal audit function must have access to and report to the relevant control functions (or similar functions) and the relevant structures of the board of the foreign reinsurer/Lloyd’s. |
| PART 5: INTERNAL CONTROL SYSTEM - actuaria function | The requirements of BN158 must be complied with. |
| PART 5: INTERNAL CONTROL SYSTEM - heads of control functions | The requirements of BN158 must be complied with subject to the following amendments:  
- Section 28(1)(b) and (c) of BN 158: Does not apply. These activities should be conducted by the relevant management and/or structures. |
Section 28(4) of BN 158: Reporting and communication should be with the relevant individuals and structures of the board of the foreign reinsurer and Lloyd’s.

Section 28(5)(a) of BN 158: Reporting in writing should be to the representative of the branch/Lloyd’s and relevant individuals and structures of the board of the foreign reinsurer and Lloyd’s.

Financial Soundness

- Security must be provided in South Africa by a branch of a foreign reinsurer and Lloyd’s on behalf of each Lloyd’s underwriter in respect of the insurance business conducted in South Africa and business/risks originating from South Africa. The security must be held in trust in South Africa;
- The trust deed must comply with any prescribed requirements and be approved by the Prudential Authority;
- The Prudential Authority may direct that an additional trustee must be appointed if the Prudential Authority is satisfied that it is in the public interest, the interests of policyholders or potential policyholders of the insurer, or in the interest of maintaining the security;
- Requirements relating to the roles, responsibilities and functions of the trustees, and roles, responsibilities and functions of the representative of a branch of a foreign reinsurer or Lloyd’s in respect of the trust may be prescribed;
- If any trustee of a trust fails to comply with any requirements of the Act or any provision of the trust deed, the Prudential Authority may exercise the powers of the trustees under the trust deed;
- The security must be invested in accordance with prescribed requirements;
- The security may not be accessed by a foreign reinsurer or Lloyd’s without the approval of the Prudential Authority;
- A branch of a foreign reinsurer must at all times maintain its business in a financially sound condition, by providing security (in the form of assets valued in accordance with requirements to be prescribed) to a trust that is at least equal to the technical provisions for the insurance business conducted by that branch in South Africa, which technical provisions must be calculated in the prescribed manner;
- Lloyd’s must at all times maintain its business in a financially sound condition, by providing security (in the form of assets valued in accordance with requirements to be prescribed) to the trust that is at least equal to the aggregate of the technical provisions for each

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7 Insurance business conducted in South Africa means:
- All risks of South African policyholders underwritten by Lloyd’s underwriters irrespective of where the risks are located (includes direct placements or placements through a South African binder holder); and
- All South African risks underwritten by Lloyd’s underwriters irrespective of who the policyholder is.
Lloyd’s underwriter in respect of the insurance business conducted by that underwriter in South Africa, which technical provisions must be calculated in the prescribed manner;

- Any decision of a trustee or any other person to dissolve a trust must be approved by the Prudential Authority; and
- The Prudential Authority may wind-up a trust if Lloyd’s fails to provide or maintain the security or in the circumstances referred to in section 29(3)(b).

**Reporting**

- Reporting will be the same as for locally-incorporated licensed insurers, including statutory returns and audited financial statements in respect of business conducted in South Africa (adjusted as necessary to take account of the specifics of the Lloyd’s or branch business model); and
- Branches and Lloyd’s must notify the Prudential Authority of any changes to a law of the country in which the head office of the foreign reinsurer or Lloyd’s is located relating to the governance or supervision of that foreign reinsurer, Lloyd’s or Lloyd’s underwriters, and any actions taken by a regulatory authority in the country in which the head office of a foreign reinsurer or Lloyd’s is located relating to the non-compliance of that foreign reinsurer, Lloyd’s or a Lloyd’s underwriter with the laws that that regulatory authority administers.

The reforms referred to will be given effect to in the Insurance Bill and the Prudential Standards that may be issued under the Insurance Bill. To ensure certainty on the extent of risks to be regarded as insurance business conducted in the Republic, the FSB will propose to Parliament (during its deliberations on the Insurance Bill) that the Bill clarifies what constitutes insurance business conducted in the Republic by Lloyd’s and Lloyd’s underwriters (see footnote 5).

**5. TREATMENT OF REINSURANCE FOR SOLVENCY ASSESSMENT OF DIRECT INSURERS**

**5.1 Approved versus non-approved reinsurance**

The Discussion Paper proposed that the concept of “approved” and “non-approved” reinsurance will not be carried through to the SAM framework.

No substantial comments were received on this proposed reform.

**Final reform**: The concept of “approved” and “non-approved” reinsurance will not be carried through to the Insurance Bill or any Prudential Standards that may be made under the Insurance Bill.

**5.2 Impact of credit ratings in the solvency calculations for direct insurers**

The Discussion Paper proposed that the following adjustments will be made to the credit rating of reinsurance providers within the solvency calculation of the user of the reinsurance, as set out below:
Locally registered professional reinsurers
- Locally registered professional reinsurers will be assumed to have a 3-notch upgrade in their credit rating. This upgrade will be subject to review by the Prudential Authority, and may be changed where the sovereign rating is changed;
- If a parental guarantee is in place and this is legally enforceable in the parent’s jurisdiction, the parent’s rating may be used, instead of applying the 3-notch upgrade;
- If a novation agreement is in place with the parent, the parent’s rating may be used, subject to approval by the Prudential Authority, instead of applying the 3-notch upgrade; and
- Where the parent’s rating is used (either due to a parental guarantee or a novation agreement), the 3-notch upgrade will not be applicable.

Local direct insurers
- Local direct insurers conducting reinsurance will be assumed to have a 3-notch upgrade in their credit rating. This upgrade will be subject to review by the Prudential Authority, and may be changed where the sovereign rating is changed.

Branches of foreign reinsurers
- Branches of foreign reinsurers located in jurisdictions with regulatory frameworks equivalent to that of South Africa will be assumed to have a 2-notch downgrade in their credit rating; and
- Branches of foreign reinsurers located in jurisdictions with regulatory frameworks not equivalent to that of South Africa will not be allowed.

Cross-border supply of reinsurance
- Cross-border supply by foreign reinsurers located in jurisdictions with regulatory frameworks equivalent to that of South Africa will be assumed to have a 3-notch downgrade in the credit rating of the foreign reinsurer;
- Cross-border supply by foreign reinsurers located in jurisdictions with regulatory frameworks not equivalent to that of South Africa will not be taken into account in the financial soundness calculation; and
- Where a local insurer or reinsurer uses intra-group reinsurance to retrocede risk to a foreign parent based in a jurisdiction with a regulatory framework equivalent to that of South Africa, the credit rating of the parent may be used with a 2-notch downgrade.

Lloyd’s of London
- Reinsurance business placed with Lloyd’s through the representative office will assume to have a 1-notch downgrade to the Lloyd’s international rating to result in a treatment that is equivalent to that of a locally-incorporated subsidiary; and
- Reinsurance business placed directly with Lloyd’s will be assumed to have a 3-notch downgrade.

Most commentators agreed with the proposed reform relating to the upgrading of the credit rating of local professional reinsurers or direct insurers to create a level playing field. However, concerns were raised regarding:
- The level of the upgrade: Some commentators believed that the level of the upgrade should only be applied to the extent that the credit rating is adjusted for the sovereign cap, or be limited to the level of the parent; and
- To whom the upgrade applies: Some commentators highlighted that the upgrade should only be applied to those reinsurers or insurers who are affected by the sovereign cap.

A question was also raised on whether the use of the parent rating was subject to the parent being based in an equivalent jurisdiction.
Concerns were raised in respect of the proposed reform that would, for solvency calculation purposes, lower credit ratings for Lloyd’s and foreign reinsurers operating on either a cross border or branch basis. Commentators stated that the proposals constrain the freedom of reinsurance and are likely to weaken the strength and competitiveness of the South African insurance market by (1) reducing access to international reinsurance capacity and risk management expertise, (2) creating non-alignment with global regulatory standards and best practices, (3) potentially undermining Solvency II equivalence discussions and on-going negotiations with other international regulators and partners, and (4) compromising financial stability in the face of major catastrophes, where losses may be concentrated in domestic insurers and reinsurers rather than globally distributed. Some alternatives were suggested:

- Applying an additional tax to foreign reinsurers;
- Requiring foreign reinsurers to hold additional reserves in South Africa; and
- Assuming no credit adjustments for foreign reinsurers based in equivalent jurisdictions.

The FSB agrees that the upgrade for local professional reinsurers and direct insurers should only be applied to the extent that the credit rating is adjusted for the sovereign cap.

As to the comments raised relating to the downgrading, for solvency calculation purposes, of the credit rating of foreign reinsurers and Lloyd’s, the FSB agrees that equivalence assessments, combined with an adjustment for the sovereign cap on the credit ratings of locally-incorporated reinsurers, will create a sufficiently level playing field and effectively mitigate prudential risks arising from reinsurance arrangements entered into with branches of foreign reinsurers, Lloyd’s and other foreign insurers. However, the FSB remains of the view that it is prudent to treat reinsurance placed directly with a foreign reinsurer that is authorised and supervised under the laws of a country determined by the Prudential Authority to be an equivalent jurisdiction differently for purposes of solvency assessment to reinsurance placed with a foreign reinsurer that is authorised and supervised under the laws of a country that is not determined by the Prudential Authority to be an equivalent jurisdiction. Also see paragraph 2.5 above.

In line with the latest version of DD111, all references to credit ratings have been changed to credit quality steps.

**Final Reforms:** The relevant credit quality step of reinsurance providers to be used in the solvency calculation of the user of the reinsurance is set out below:

| Locally registered professional reinsurers | • Locally registered professional reinsurers will be assumed to have an upgrade in their credit quality step to the extent that the sovereign cap in place has resulted in a downgrade;   
|                                           | • If a parental guarantee is in place and this is legally enforceable in the parent’s jurisdiction, the parent’s credit quality step may be used, instead of the upgrade referred to above;   
|                                           | • If a novation agreement is in place with the parent, the parent’s credit quality step may be used, subject to approval by the Prudential Authority, instead of applying the upgrade set out above; and   
|                                           | • Where the parent’s credit quality step is used (either due to a parental guarantee or a novation agreement), the upgrade removing the sovereign cap described above will not be applicable. |
The reforms referred to will be given effect to in the Prudential Standards that may be issued under the Insurance Bill.

## 6. REINSURANCE CONTRACTS

The Discussion Paper proposed that, going forward, reinsurance programmes will be subject to more intrusive supervision, specifically in respect of the legal certainty, effectiveness and enforceability of such contracts, to ensure that operational and legal risks are appropriately managed. The Discussion Paper also proposed that the allowance in the prevailing legislative framework for pay-as-paid clauses will be removed.

Some commentators requested clarity on the intrusive supervision approach which will be taken by the Prudential Authority. Some commentators also argued that pay-as-paid clauses should be retained, especially for commercial policyholders.

The more intrusive approach to the supervision of reinsurance contracts is in line with the more general approach to increasing the intensity and intrusiveness of supervision, as envisioned under the Twin Peaks model of regulation. The supervisory framework for reinsurance will be enhanced, and will include at least:

- Thematic reviews;
- Independent reviews, especially in areas where the supervisor may have concerns;
- Review of reinsurance policies, and how these are managed; and
- On-site reviews.

The FSB has also proposed that the Insurance Bill authorise the Prudential Authority to make Prudential Standards in respect of the principles and requirements with which any reinsurance arrangement must comply and the matters that must be included or addressed, or may not be included, in a reinsurance arrangement to ensure that reinsurance contracts are appropriate and in the interests of reinsurers, insurers and ultimately policyholders.

The FSB agrees that in some cases pay-as-paid clauses may be warranted. However, this should only be used for some commercial/corporate policyholders, and those policyholders must be fully aware of the arrangement.
Final reforms:

Supervisory framework: Going forward, reinsurance programmes will be subject to more intrusive supervision, specifically in respect of the legal certainty, effectiveness and enforceability of such contracts, to ensure that operational and legal risks are appropriately managed.

Regulatory framework:

Pay-as-paid clauses: The allowance in the prevailing legislative framework for pay-as-paid clauses for commercial policies will be removed from the Long-term Insurance Act and the Short-term Insurance Act by way of Schedule 1 to the Insurance Bill and addressed in the Policyholder Protection Rules (PPRs) made under the Insurance Act. The PPRs will be amended to provide that these clauses are prohibited for direct insurance policies other than policies where:

- The policyholder is a juristic person whose asset value or annual turnover is in excess of the threshold value determined by the Minister of the Department of Trade and Industry under section 6(1) of the Consumer Protection Act, 2008 (Act no. 68 of 2008); and
- The reinsurer of those policies is locally registered or domiciled in a foreign jurisdiction determined as an equivalent foreign jurisdiction by the Prudential Authority.

Principles and requirements relating to reinsurance arrangements: Principles and requirements relating to the following will be provided for to ensure that reinsurance arrangements are appropriate and in the interests of reinsurers, insurers and ultimately policyholders:

- Due diligence on reinsurers;
- Administration of reinsurance arrangements;
- Documenting of reinsurance arrangements; and
- Terms and conditions of reinsurance arrangements.

Insurers will be allowed to only take reinsurance arrangements into consideration for financial soundness purposes if the reinsurance arrangement:

- Provides for the transfer of significant insurance risk relating to the reinsured portion of the underlying policies to the reinsurer and there is a reasonable probability that the reinsured event will occur;
- Does not contain any unfair terms and conditions or possesses characteristics that may jeopardise the ability of the insurer to meet its policyholder liabilities, such as giving the reinsurer an option to unilaterally alter the terms and conditions of the arrangement or terminate the agreement due to an increased likelihood of the reinsurer experiencing losses under the arrangement; and
- Is entered into with a reinsurer licensed under the Insurance Act or domiciled in a foreign jurisdiction listed in the Prudential Authority’s Determination of Equivalent Foreign Jurisdictions under section 65 of the Insurance Act, 2016.

Criteria for assessing whether insurance arrangements provide for the transfer of significant insurance risk will also be provided for.

The reforms referred to will be given effect to in the Insurance Bill and the Prudential Standards that will be issued under the Insurance Bill.
7. TRANSPARENCY AND ACCESSIBILITY OF INFORMATION

The Discussion Paper provided, given the unique nature and importance of reinsurance to cedants’ risk profiles, and the financial stability of the industry as a whole, that the Prudential Authority will enhance transparency in respect of both inwards and outwards reinsurance by reinsurers and insurers, respectively, through more granular reporting requirements. The Discussion Paper also proposed that a positive obligation should be placed on insurers and reinsurers to:

- Verify the veracity of external models and data sourced from 3rd parties; and
- Make sufficient information available to reinsurers in respect of risks reinsured.

Commentators requested details of the “more granular” reporting requirement that would be imposed. There was also a request to allow sufficient phasing in of such reporting requirements.

Commentators also requested detail on what would be required in respect of the verification of the veracity of external models and data sourced from 3rd parties.

The more granular reporting that is envisaged is already being tested in the SAM Comprehensive Parallel Run. The verification referred to relates to the external models used by insurers to determine, amongst others, the levels and types of reinsurance cover required. The FSB appreciates that it is not possible for all insurers to conduct full quantitative validation of external data and models; the FSB will expect that insurers have a robust process in place to gain comfort with the models and data.

Final Reform:
Given the unique nature and importance of reinsurance to cedants’ risk profiles, and the financial stability of the industry as a whole, the Prudential Authority will enhance transparency in respect of both inwards and outwards reinsurance by reinsurers and insurers, respectively, through more granular reporting requirements. A positive obligation will be placed on insurers and reinsurers to:

- Verify the veracity of external models and data sourced from 3rd parties; and
- Make sufficient information available to reinsurers in respect of risks reinsured.

The reforms referred to will be given effect to in the Prudential Standards that may be issued under and the reporting requirements that may be determined under the Insurance Bill.

8. TAX TREATMENT OF REINSURANCE ARRANGEMENTS AND REINSURERS & IFRS ACCOUNTING

The Discussion Paper proposed, given the various governance and risk management frameworks that will be required of branches, that it is expected that the tax residency of the branch will be South Africa and that financial accounts in accordance with IFRS will need to be filed together with a South African tax return.

No substantial comments were received on this proposed reform.

Final reform: Given the various governance and risk management frameworks that will be required of branches, it is expected that the tax residency of the branch will be South Africa and that financial accounts in accordance with IFRS will need to be filed together with a South African tax return.