South Africa: Insurance industry update

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Milliman

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Introduction

This edition of the Insurance Update has a heavy regulatory flavour, covering topic issues such as treatment of vulnerable consumers, climate risk, and current and coming solvency changes. We also include a brief introduction to large language models (LLMs) for insurance, including references to two slightly longer papers for more detail.

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Consumer vulnerability and future conduct regulations

The Financial Sector Conduct Authority (FSCA) is exploring including consumer vulnerability within the Treating Customers Fairly (TCF) framework.

South Africa has experienced events which have increased the levels of consumer vulnerability recently (e.g., COVID-19, cost-of-living crisis) and this could continue to worsen.

Consumer vulnerability impacts insurers through high-lapse experience, additional customer servicing, and challenges at claim stage if products are not well-understood or not fit for purpose.

Insurance can build financial resilience by providing financial support when adversity strikes. However, ongoing research into the 'poverty premium' demonstrates how some of the most vulnerable policyholders often pay higher premiums. While actuarially justified, there is a growing sense that this is not an ideal outcome.

The FSCA is looking to better identify and address the needs of vulnerable consumers through the development of a consumer vulnerability framework applicable to the South African market.

The framework would consider a range of factors across three dimensions:

1. Demographic—e.g., the consumer's digital and financial literacy, age, education, and income level.
2. Resilience—e.g., job security, savings and debt, family support and structure, and the presence of insurance.
3. Life circumstances—e.g., loss of income, bereavement, and relationship breakdown.

The framework could lead to a Consumer Vulnerability Index (CVI) which combines these factors into a vulnerability score.

Some insurers have expressed reservations with the framework, relating to how well a developed world model will fit South Africa, the onerousness of implementation, and the personal nature of private data required to assess vulnerability.

In addition to a global focus on the topic, the FSCA has had related topics on its radar for years, including the impact of large premium increases for existing policies and unilateral termination of policies. The Ombud has expressed similar concerns, including concern for elderly policyholders, who have paid premiums totalling more than the sum assured and who still have to pay premiums to retain coverage. (This frustration is understandable from a policyholder perspective, just as the requirement for at least some policyholders to pay more premiums than benefits is necessary.) The Ombud also pays attention to business rules around missed premiums and reinstatements, and portability of waiting periods.

Given the global and local support for the topic, some form of this will almost certainly be embedded in future market conduct regulations.

Industry engagement is expected to take place over the next couple of years, with a phased rollout thereafter.

For the insurers that already operate most effectively in this space, truly understanding their customer needs and situations has already led to success in sales volumes, persistency, and customer satisfaction.

The release from the FSCA is available here.

Leveraging climate risk management learnings from the UK

Earlier this year our UK Milliman office published a list of the top sustainability items insurers should have on their agenda for 2024. While climate risk management in South Africa may only be at the beginning stages, there is merit in leveraging learnings from other markets which are more developed in this regard. By being aware of the pitfalls and successes in the UK market, South African financial services can accelerate their own efforts enabling them to start at a more mature level on their own journeys.

Priorities in the UK have been based on achieving better **ability**, better **agility,** and better **alignment** with regards to managing climate-related risks and addressing regulations. Below we focus on two of the **ability** priorities and discuss how they relate to the South African market with regard to climate and sustainability considerations.

1. **New climate scenarios:** While no formal regulations have been released by the Prudential Authority (PA), in 2023 the PA published four proposed guidance notices on climate-related risk practices and disclosures for banks and insurers. This focus on climate was again reiterated at the PA Industry Engagement event at the end of February 2024.

   While many boards may wish to wait for formal regulations before making a start on climate risk management, there is merit in getting to grips sooner, with both the risks and opportunities that a changing climate could bring. From our experience in the UK, starting by exploring narrative scenarios (e.g., in the Own risk and solvency assessment (ORSA)) is a good approach to highlighting these risks and opportunities. This could be a helpful catalyst to enable prioritising of climate risk management at the top level.

   Critiques from the UK experience[1] have highlighted shortcomings in the traditional climate scenarios provided by industry bodies like the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). Therefore, the aim here is to start with bespoke decision-useful narrative scenarios which explore risks and opportunities specific to your organisation's unique structure and business offerings. Once this understanding of climate considerations becomes more embedded in your organisation you could then look to align with industry scenarios. By this stage we would also expect that more shorter-term scenarios which address some of the current critiques will emerge from these bodies.

2. **Getting to grips with liability impacts:** Continuing with the critiques of industry scenarios, many of these focus on the assets side of the balance sheet. This has also been the focus of many UK clients who are now being warned by the regulator that liability side risks need to be considered as well. Through the use of narrative scenario explorations, South African financial services therefore have the ability to fast-forward their efforts by considering liability drivers of climate risks and opportunities as well.

   As noted in the UK paper, particular attention should be paid to the potential increases in heterogeneity, particularly in a market with potentially higher levels of climate vulnerable communities and comorbidities, and lower incomes. This requires more care to understand the vulnerability of specific life and health exposures rather than applying broad averages.

   While many financial services in South Africa may wish to wait for regulatory direction before taking action on climate-related risks, globally the attention is slowly shifting to a more holistic perspective on this problem with a focus on risks, but equally opportunities. Those who start considering their exposures sooner rather than later may benefit from these efforts in the long run.

   Adél has recently joined the South African office on an 18-month secondment from our London practice where she has been supporting clients on climate solutions for the past three years. If you would like to speak to Adél about climate and sustainability please send a request to africa@milliman.com.

Leveraging LLMs in insurance

LLMs represent a transformative milestone, offering extensive opportunities for integration into insurance sector business operations. LLMs, with their ability to mimic human language, hold promise in revolutionizing three critical areas:

1. Large-scale textual data analysis
2. Content generation
3. Client interactions

In the realm of data analysis, LLMs streamline the claims process by efficiently classifying unstructured textual data, identifying missing information, and drafting responses, thereby enhancing fraud detection capabilities.

LLMs excel in content generation, summarising interactions and facilitating the creation of documents, contracts, and reports. A key word here is 'facilitation'—LLMs can be

[1] For those interested in these critiques, a recent Milliman paper summarising these is available on request.

confidently wrong. At the moment, they work well for a first draft or recommended adjustments, but are generally not ready for drafting critical documents or contracts without human oversight.

Enhancing client interactions is another possibility for LLMs, as they can craft personalised messages, power chatbots, and offer suggestions to human agents during conversations with clients. However, there are also anecdotal stories of chatbots providing inappropriate responses to customers. The downside damage can be considerable.

For certain tasks, limited context window size creates a significant limitation. LLMs can only work with a certain number of tokens (commonly words, word-parts, or punctuation marks). Greater context windows can be more computational-intensive. Researchers are pushing boundaries on context windows, but with greater computation comes greater expense, energy use, and carbon footprint.

LLMs pose other risks too. Data privacy concerns are paramount, especially with publicly available models, necessitating caution and the use of secure enterprise versions or on-device models. A range of lawsuits are in progress relating to copyright infringement of LLMs having scraped copyrighted works. There are many others risks, including bias and discrimination (especially given the black box nature of the models) and regulatory compliance where LLM progress is orders of magnitude faster than regulations can be developed.

LLMs are not the only machine learning tools relevant for insurers. Given their availability to the public and immediately practical uses without training, they are clearly most in the public eye. It may be that other machine learning algorithms ultimately have a bigger impact on insurance.

As always, new tools and innovation bring opportunities as well as risks. Insurers utilising new approaches must ensure the necessary governance and assurance is in place. A first step is to ensure use of LLMs complies with existing model and data governance procedures. Other necessary steps require involving those with industry context, customer understanding, and the necessary compliance knowledge.

To explore more, read this introductory LLM guide for insurance professionals or this note on the potential of large language models in the insurance sector by Milliman consultants in the US and the Netherlands.

Life IBNR SCR stress and APN116

APN116 was recently issued and is effective for reporting periods starting on or after 31 March 2024. This therefore applies to all South Africa life insurers' quarterly Quantitative Reporting Templates (QRTs) for March and all annual QRTs for those with a March year-end.

It outlines the Actuarial Society's guidance to stress life Incurred But Not Report (IBNR) provisions using the standard life underwriting module for mortality, morbidity, and retrenchment.

The note is most likely to have a meaningful impact for credit life providers (with significant retrenchment risk), group risk and other short-boundary contracts (with large IBNR provisions relative to other liabilities and solvency capital requirements), and reinsurers with significant risk-premium business (for similar reasons to group risk).

PA looking for industry to step up on CQSs

The Prudential Authority (PA) recently published an FSI Technical Supervisory Observation on credit quality steps (CQSs). The key observations raised by the PA include:

DIVERGENCE WITHIN THE INDUSTRY ON CQSS APPLIED TO THE SAME COUNTERPARTY

For counterparties with no published credit rating, this divergence is not too surprising. For material exposures, there are methods available to add some rigour for both listed and unlisted counterparties. In our experience the divergence on rated counterparties is likely due to:

- Using outdated published ratings
- Picking up the incorrect entity (similar name or entities with the same name operating in multiple countries)
- Using local ratings rather than international ratings (see next point)
- Incorrect mapping from credit rating scale to CQS
- Differences across rating agencies (although these are typically within a notch)
- Applying uplift to external ratings due to factors in the public domain which would have been known by the credit rating agency and already factored into the rating

We recommend documenting the justification for internal ratings. Keep in mind the principle of proportionality (e.g., focusing on material exposures). Some insurers may assign conservative CQSs to smaller counterparties, but take care that you don't end up with a material overstatement of the SCR due to a large accumulation of smaller conservatively rated exposures.

It's helpful to have a clear framework of how to select a CQS for an unrated entity to have consistency of approach between counterparties and over time. Different approaches may be appropriate for listed versus unlisted entities given the additional balance sheet information and ability to estimate share price volatility. Initial investment in a robust framework can save significant time down the road.

SETTING A CQS BETTER THAN SOVEREIGN CQS

CQSs must be international scale ratings, and therefore a counterparty's CQS is very rarely better than the sovereign rating. There are exceptions, such as where a significant portion of the entity's assets and operations are outside of South Africa or other credit enhancement strategies are in place. Parental guarantees for local reinsurer subsidiaries are also ubiquitous.

NOT COMPLETING ALL CQS DETAIL IN THE ANNUAL QRT

Insurers need to make sure they are documenting not only the CQS used but also the rating agency (from defined list, or own rating or unrated), the effective date of the CQS and the expiry date of the CQS (i.e., when it will be reviewed).

While this takes effort to populate the QRT, it's also helpful to strengthen the governance on the CQS assumptions, which the Head of Actuarial Function (HAF) and auditors will also appreciate. The log files provide the thresholds for instrument level detailed reporting in the A tabs of the QRT.

REMINDER OF SOME OF THE CQS NUANCES SET OUT IN THE FSIS

The Financial Soundness Standards for Insurers (FSIs) include some nuanced rules, including around concentration risk and unrated reinsurers. Get in touch to explore more of these and confirm your interpretation and application.

Now that the PA has expressed their focus on this area, it will come under increased scrutiny by HAFs and external audit and will come up with the PA during site visits.

Catastrophe calibrations—EIOPA looking at new scenarios

European Insurance and Occupational Pensions Authority (EIOPA) is reassessing natural catastrophe risks for the Solvency II standard formula. The last assessment was six years ago (which is more recent than South Africa's last assessment of the catastrophe calibration of our standard formula.)

As a result of the recent analysis, EIOPA has proposed new risk factors for 25 perils/regions across five perils (flood, hail, earthquake, windstorm, subsidence). Flood risk, for instance, is to be (re)calibrated for 10 countries.

The extent of the changes suggests a similar exercise in South Africa might well result in material changes too. While there has been some discussion of a review of the entire standard formula, it's not clear over what timelines that is planned, when it might start, and from where the capacity to do the review will come.

Increasingly, insurers should be looking to Pillar 2 assessments to gain confidence around current and future catastrophe scenarios.

The risks of outdated catastrophe scenarios are particularly high for insurers which set their reinsurance programme close to the modelled 1 in 200 scenario from the standard formula. Those at a more typical 1 in 400 will be better protected.

How Milliman can help

- Climate risk management support, including the development of decision useful climate scenarios
- Implementation of tried and tested methods for managing complex and emerging risks
- Conversion of Excel spreadsheets into powerful, cloud-based models with all the features of alternative proprietary software using Milliman Mind
- Reinsurance programme assessment for SAM and IFRS17
- Review of market conduct frameworks
- Review of product management (performance, risk, market conduct, and TCF; premium reviews; margins)
- Dealing with regulatory change and approvals
- Solo and group HAF
- ORSA and risk management maturity reviews

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