Licensing requirements for South African microinsurers

New regulations encourage innovation and transformation in South Africa's insurance industry

David Kirk, FASSA

In an effort to improve financial inclusion and encourage transformation of the insurance industry, the Insurance Act—which came into effect from 1 July 2018—makes explicit provisions for microinsurance products.

Companies are now able to apply for a microinsurance licence, which can include both life and non-life products.

Significantly reduced and less complex minimum capital requirements encourage new entrants into the market, while new licensing rules aim to improve the governance and prudential management of existing informal providers.

Application process

The insurance sector is subject to regulatory oversight by the Prudential Authority (PA) as well as the Financial Sector Conduct Authority (FSCA). Between them, these authorities are responsible for ensuring that insurance companies are managed in a way that is financially sound, and that customers are treated fairly.

As a result, when applying for a microinsurance licence, companies are required to demonstrate *"sufficient operational, human and financial capacity to manage the business to be undertaken, both at the time of application and as a going concern, under both normal circumstances and in stress events."*[1]

Companies must have frameworks in place for ensuring compliance with FSCA rules regarding the fair treatment of customers. Companies must also explain how their business model will promote financial inclusion and must provide evidence of planned corporate social initiatives.

In practice, the application usually involves:

- A preapplication consultation with the PA to discuss the upcoming application, business plan, owners, planned governance structures and application project plan.
- Submission of a detailed application pack, including market feasibility study, details of products, distribution and administration plans, governance structures and a detailed business plan.
- Ongoing requests for clarification or additional documentation and queries before issuing the licence.

How much capital is required?

The initial capital required for a licence to be granted depends on a number of factors, such as:

- Expected sales numbers and average premium size
- Amount and timing of acquisition costs
- Mix of fixed versus variable expenses, which is impacted by outsourcing arrangements and the fee basis for these arrangements
- Product profit margins
- Amount and type of reinsurance
- Structure of the business (for example independent microinsurance company, subsidiary of an existing insurance group, cell captive)
- Whether there will be an inwards transfer of existing policies or not

This amount will not usually be less than the ZAR 4 million regulatory minimum, although the PA does have discretion to specify a different amount. In practice, given the need to hold a multiple (e.g., 1.5x or 2.0x) of minimum capital requirements, working capital and expenses to be incurred in the early months and years of the business, this will often be in the range of ZAR 5 million to ZAR 25 million.

The rules for calculating the minimum capital requirement are set out in the Financial Soundness Standards for Microinsurers, published by the PA. These standards also describe the methodology that must be used for the valuation of assets, liabilities and eligible own funds.

The best way to assess the capital required for a specific business plan is to use an actuarial model to project cash flows from tranches of new business over time (while allowing for policy lapses or cancellations and claims), and projecting the income statement, balance sheet and capital requirements under a range of scenarios.

[1] Microinsurance licensing application: https://www.resbank.co.za/en/home/publications/publication-detail-pages/prudential-authority/pa-insurance-act-licensing/2020/10335.

We have used these models to support licence applications, to determine reinsurance requirements and to complete the licence application pack required by the PA.

What types of products can a microinsurer sell?

Microinsurance licences will be granted for one or more specific lines of business. They can cover life and non-life insurance across a range of products. Common examples include:

- Group or individual funeral insurance
- Personal accident cover
- Credit life
- Legal expense insurance
- Consumer credit
- Pet insurance
- Movable property
- Extended warranty

No investment or savings components are allowed. This includes cash back or loyalty benefits.

There are some restrictions on underwriting, waiting periods and the sums assured that can be offered.

Can an existing portfolio of insurance policies be transferred?

Section 50 of the Insurance Act governs transfers of books of insurance between insurers. Transfers are possible, but this can be a complex exercise.

Policies will need to meet the limitations of a microinsurance policy. It will also be necessary to demonstrate that policyholders are not adversely affected, and to go through a thorough process of communicating with policyholders.

Can a microinsurer get reinsurance?

Reinsurance can be an important tool to manage the risk of variable insurance claims within a portfolio, or to reduce the capital required.

There are many different reinsurance structures available, and many reinsurers to choose from. The cost and complexities of reinsurance will need to be balanced against the need for capital and technical support.

Different structures will offer a different mix of advantages and disadvantages. The impact of reinsurance should be modelled in order to determine the optimal structure.

How can a microinsurer invest its assets?

A microinsurer may only invest in cash, cash equivalents and money market funds. A maximum of 25% of the total liability capital, net of reinsurance, can be invested in any one financial institution.

Microinsurers can apply to the PA to change these investment and concentration limits.

Typically, microinsurers will use a money market account to fund a diversified portfolio of low-risk assets to cover capital, and a single bank account for working capital.

What are the governance requirements?

The PA has also published Governance and Operational Standards for Microinsurers. These are less onerous than the equivalent standards for traditional insurers, taking into account the reduced complexity and therefore lower risks associated with microinsurance products.

Applicants are required to demonstrate that appropriate people or firms have been identified to fulfil the following key functions:

- An external auditor with sufficient insurance experience (relevant experience required for PA approval)
- A Head of Actuarial Function with a microinsurance-practising certificate issued by the Actuarial Society of South Africa
- A head of internal audit

What role can outsourcing play?

Many insurers outsource work that does not form part of their core competencies, for example the functions listed above. This improves efficiency by allowing teams to focus their energy on those aspects of the work in which they possess a competitive advantage. Outsourcing certain tasks and functions can also help insurers launch new products or lines of business more quickly, and benefit from the economies of scale and expertise of outsourcing partners who specialise in those tasks.

There are, however, certain risks associated with outsourcing and the PA therefore requires insurers to have clear outsourcing policies and controls in place.

Furthermore, the fee basis for outsourcing can have a material impact on capital requirements and how long it takes for the business to break even. For example, up-front per policy fees for policy onboarding will be more capital-intensive than a fee structure where a percentage of every premium is recovered over time.

As part of the licence application, the PA also requires a detailed description of how policies will be distributed and administered, with a particular focus on communications, claims payment and complaints resolution.

What do the PA and FSCA want to see before granting a licence?

According to the PA's website, all insurance licence applications are assessed against the following minimum criteria:

- Objectives of the PA
- Public interest
- Financial and other resources available to the applicant
- Ownership
- Governance
- Risk management and internal control systems
- Information and accounting systems
- Compliance with the prescribed legal structure of the entity
- Prudential requirements

In addition to the above, microinsurance licence applications must include a clear strategy outlining how the microinsurer intends to contribute to transformation of the insurance sector.

From our experience, the PA also places significant emphasis on the level of insurance expertise within the business, the insurance experience of the external auditor and the application of Treating Customers Fairly principles at all levels of the business.

How long does it take for a licence to be granted?

The PA must grant or refuse an application within 120 days from the date of submission, but incomplete applications can cause significant delays.

Typically the process is at least six months long, and can take longer than a year in some cases.

Professional advisers may be used to help companies complete their applications as quickly and efficiently as possible.

How can Milliman help?

Milliman has experience with all elements of microinsurance licence applications and regulatory applications.

We have helped numerous clients successfully apply for insurance licenses, including microinsurance licenses. We also perform the role of Head of Actuarial Function for microinsurers, life insurers and short-term insurers.

We can assist with all aspects of a microinsurance licence application and ongoing business, including:

The initial capital required for a licence to be granted depends on a number of factors, such as:

- Performing the role of Head of Actuarial Function
- Creating business projections to support a licence application
- Pricing and product design, and modelling the impact of changes to products
- Reinsurance modelling, optimisation and facilitating reinsurance tenders
- Reviewing a licence application pack to improve the chance of success and decreasing time to approval
- Regulatory compliance advice
- Drafting and reviewing risk policies
- Recommending risk and governance structures
- Risk evaluations for outsourced functions

Once a microinsurance licence has been granted, we can offer additional support by:

- Performing the role of Head of Actuarial Function
- Ongoing financial, regulatory and management reporting
- Monitoring claims experience and recommending interventions
- Launching new products and re-pricing existing projects
- Applying for licence extensions or other regulatory approval

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CONTACT

David Kirk

david.kirk@milliman.com

Alicia Gounden

alicia.gounden@milliman.com