



The Guardrisk Update

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Incorporating Life Update

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INSURANCE premiums for manufacturers and suppliers are likely to increase, along with certain production costs, once the Consumer Protection Bill is passed into law later this year (*Business Day, 20 Jun*). This is because consumers will have much more legal clout, raising the risk of product liability damages claims.

TYPICAL short-term insurers – those that offered most types of insurance policies – had a net premium growth of 7% to R9,03bn in the three months to March, compared with the same period last year (*Business Day, 6 Jun*). Underwriting profit went up 5,9% to R446m, while underwriting and investment income grew 38,7% to R1,3bn.

THE insurance industry has raised concerns about the manner in which the treasury has attempted to deal with the demarcation of health policies offered by insurance companies and medical schemes (*Business Day, 29 May*). The industry fears that the treasury's proposals could vest too much power in the finance minister.

GROWTH in credit life insurance in SA has been hit by tightening macroeconomic conditions, prompting banks to diversify into noncredit life products (*Business Day, 28 May*). A new survey showed vehicle finance was the worst affected, with growth plunging in the past two years.

THE 3rd King report on corporate governance is set to shake up corporate SA (*Business Day, 30 Jun*). Its recommendations will be mandatory for all public interest companies, parastatals and institutions that fall within financial market regulations. The report will also contain terms for the accountability and responsibility of boards of directors towards shareholders.

The challenge of defining operational risk

Many operational risks – especially the more unusual ones – are those things that companies seldom, if ever, think about. Yet it is precisely these type of risks that can cause a company to fail. Defining operational risk is about as easy as answering the old “how long is a piece of string?” question. And the big problem is that these risks often don't make it onto the radar until they actually become a problem – and by then the damage is inevitably done.

For insurers, the 'old' solvency regime prescribed that companies had to hold 25% of their net written premium as capital and there was no allowance for operational risk outside of traditional insurance risk issues like underwriting risk, reserve and investment risk. Now, under Financial Condition Reporting (FCR) there is a requirement to measure all operational risk and allocate capital to cover it.

Previously, there was a common view that a company could not hold capital for operational risk and that this money should rather be used to prevent the failure in the first place. But now there is a realisation that certain risks cannot be fully prevented, they can only be minimized, and therefore, even in the best managed companies, operational failures will occur.

When it comes to allocating capital to operational risk, the big challenge that companies face is that very often there is no data or experience history to determine how much capital must be allocated for a specific risk.

For starters, companies would benefit by creating registers that record all operational risk failures; and this means anything from fraud, to the company's servers going down for a week. And it's important that the failure is not only recorded but quantified. That's relatively easy to do if it's fraud, but how do you quantify the cost of your servers going down for a week?

The theory behind the register is that once you have enough data, you can assign a probability to the size of each loss and, once you can do that, it's a straightforward exercise to calculate the amount of capital that should be held. No doubt, smaller companies are going to be stretched to come up with sufficient data to enable an accurate quantification of risks.



Companies that can't come up with a probability distribution could benefit if they have a robust enterprise wide risk management (EWRM) programme in place. Information from the EWRM programme can provide a 'first cut' of the company's operational risk but within many companies' EWRM frameworks the cost and probability of operational risks involves a degree of guesswork which merely provides an estimate. The big difficulty facing companies is going to be to put some science behind these numbers.

However, at the end of the day the exact quantum of the capital is not as important as putting a framework in place to produce an accurate calculation. More and more, operational risk is becoming an important issue in the boardroom and the regular revisiting of the issue by senior management in itself will provide a remedy of sorts.

Risk Barometer

LARGE financial institutions have the wherewithal to absorb any losses they suffer in securities litigation related to the subprime mortgage mess despite a lack of commercial insurance and no formal self-insurance mechanism to respond to the losses (*Business Insurance*, 9 Jun). But some experts question the wisdom of financial institutions not establishing some kind of formal self-insurance mechanism to help smooth any hits to their balance sheets and income statements.

COMPANIES are re-evaluating their exposure to environmental risk after ongoing stakeholder pressure, the complexity of business relationships and the threat of climate change have increased (*Insurance Day*, 4 Jun). More attention and resources are being devoted to environmental risk management but many companies are still at the elementary stages of this process.

AN economic slowdown and financial market volatility are at the top of the list of perceived risks for leading chief executives from the insurance and reinsurance worlds, says a new survey (*Insurance Day*, 5 Jun). With respect to developments in financial reporting, mainly concerning IFRS, two-thirds of the respondents were either dissatisfied or very dissatisfied with the overall direction the reforms were taking.

IN the past few months the UK's Financial Services Authority has made it clear that not only is it planning to "beef up" its enforcement operations but it will be taking more action against individuals and will start to use more of its available criminal sanctions (*Insurance Day*, 17 Jun).

REINSURANCE rates are continuing to decline and retention levels are remaining stable during midyear renewals, but observers say there is a "disconnect" as reinsurers exercise greater pricing discipline than their primary counterparts (*Business Insurance*, 30 Jun). Rates overall are dropping 10% to 25%, but "capacity's readily available and there should not be too much difficulty in getting coverage together for the renewals."

Life Update

Life Barometer

THE creation of a pension net for everyone in South Africa has the potential of destroying competition in the retirement industry, as most administrators would be forced to exit this business, says an insurance and retirement fund expert (*Business Report*, 17 Jun). With the suggested maximum level of contributory salary, about 60% to 70% of existing retirement fund members would fail to contribute to their current funds.

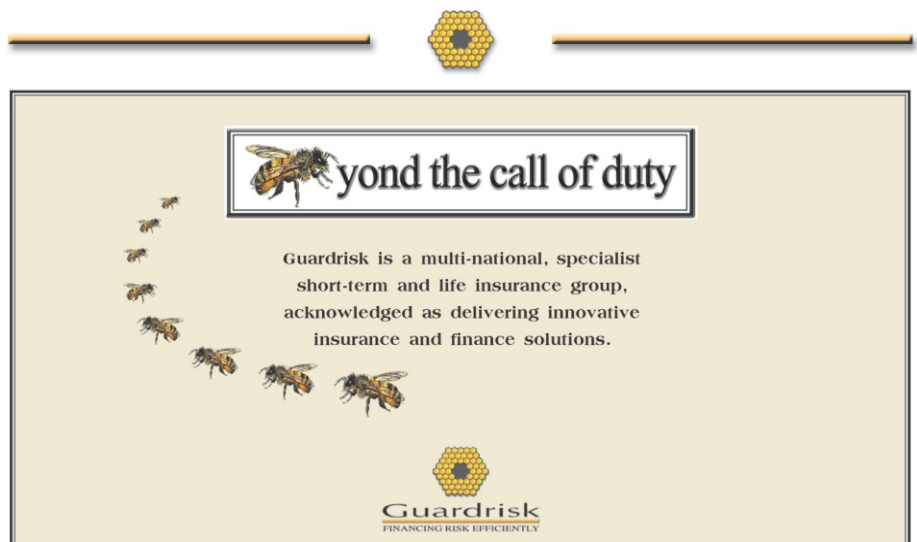
THE past few years have been good for the life insurance market largely because of rising equity markets (*Business Day*, 2 Jun). But global market turmoil and SA's less favourable economic prospects have brought an end to booming investment income earnings. In fact, investment income earnings turned negative in the first quarter, implying declining economic fundamentals. Growth in outflows are also considerably in excess of inflows.

SOME changes to the law in terms of the Financial Services Law Amendment Bill reflect differences in approach between the financial services industry and treasury (*Financial Mail*, 30 May). Of particular concern are the provisions allowing for the immediate claim of retrospective pension benefits that become payable after a divorce. Originally, divorced spouses who were not members of a retirement fund would receive their portion without investment return, and only when the members left the fund. The legislation now ensures non member spouses will get a present-value benefit, accruing at the date of divorce.

LOWER courts should consider an insurer's potential conflict of interest when reviewing a denial of employee benefits in which the insurer both determines and pays the benefits, a divided U.S. Supreme Court ruled last week (*Business Insurance*, 23 Jun).

BUYERS renewing their workers compensation coverage are seeing double-digit rate declines and more competition for their business (*Business Insurance*, 30 Jun). But weakening insurer results and unfavorable investment conditions could make it harder for underwriters to continue cutting prices as steeply as they have. Because of the soft market, there is little incentive for employers with guaranteed-cost contracts to move away from those arrangements. Yet large buyers accustomed to analyzing and controlling their own risks and claims generally are not abandoning loss-sensitive contracts, although some accounts are moving to guaranteed-cost programmes.

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4th floor, Alexander Forbes Place, 90 Rivonia Road, Sandton, 2196
PO Box 786015, Sandton, 2146

Telephone: (+27 11) 669-1000 Fax: (+27 11) 669-1931 Website: www.guardrisk.com