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UMA's in a SAM World

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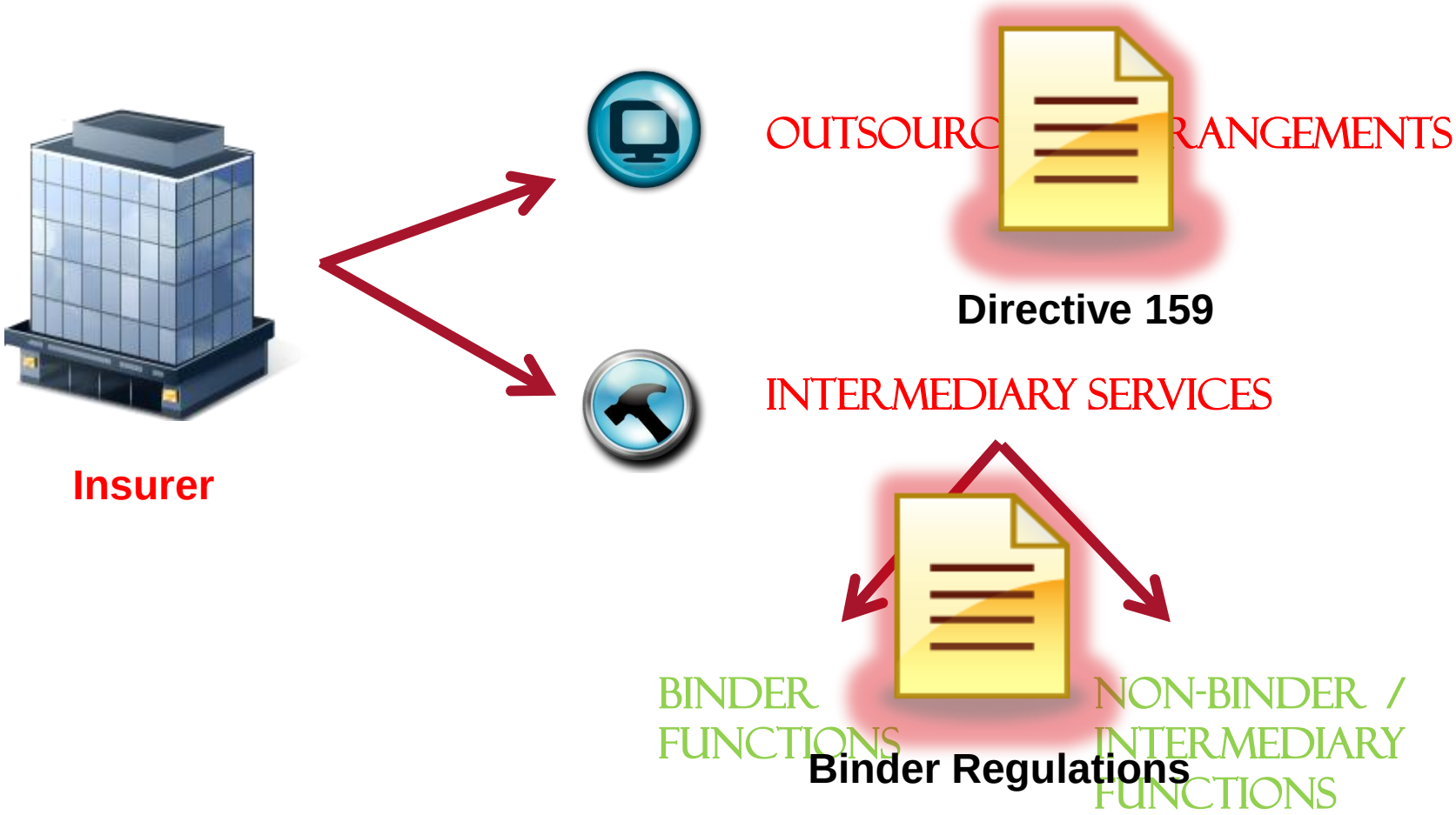
Aims

1. **Background to UMAs**
2. SAM's impact on UMAs
3. SAM's impact on smaller insurers
4. Alternatives/options for smaller insurers

Background - Types of Outsourcing



Background

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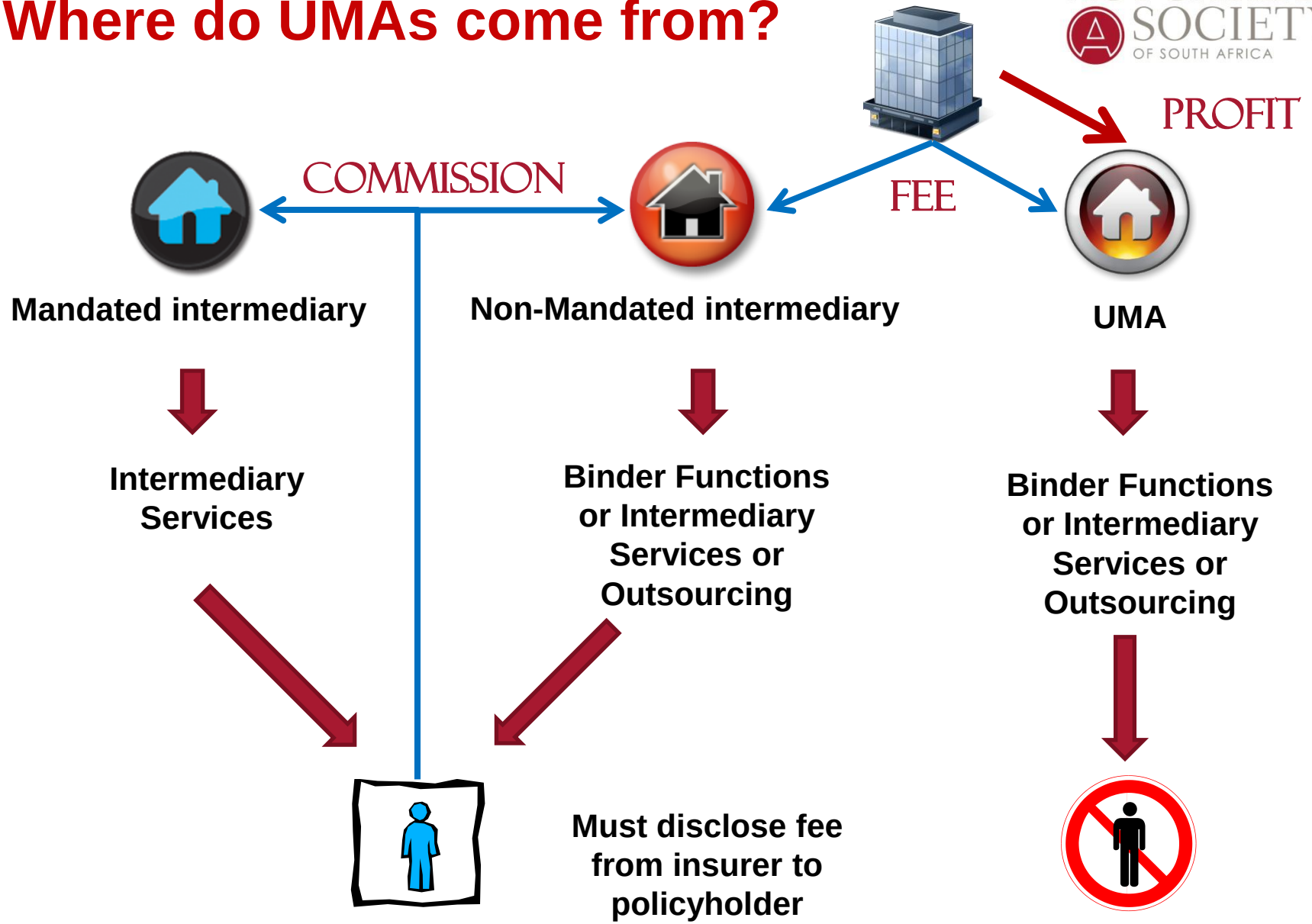
Binder Agreements

- Very specific requirements in terms of contents of binder agreements
- May only be cancelled with 90 days' notice
- Must inform registrar of binder agreement termination date (at least 60 days prior)

Where do UMAs come from?



Background – What is a UMA?

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Who would want to be a UMA?

- Typically experts in a niche field (e.g. engineers with in depth experience of construction projects)
- Understand the risks well
- Understand the industry / field well and can therefore choose the most appropriate distribution channels
- A good network of brokers
- Does not want to be dependent on policyholders / commissions – wants some profit share

Comparison of UMAs with Cells

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- **UMAs:** partake in profit share, which is heavily dependent on reinsurance commission (since heavily reinsured)
- **Cells:** the underwriter/cell owner is able to participate in the cell underwriting result

- **UMAs:** limited to no ability for custom reinsurance arrangements – needs to fall in with the insurer's arrangements
- **Cells:** more flexibility to structure specific/individual arrangements with reinsurers (e.g. non-prop)

- **UMAs:** often small capital requirement – operational risk capital component typically charged for through the fee the insurer takes
- **Cells:** cell owner often needs to put up capital to the extent in which it wants to participate in the underwriting risk

Aims

1. Background to UMAs (regulations & where they fit in)

2. **SAM's impact on UMAs**

3. SAM's impact on smaller insurers

4. Alternatives/options for smaller insurers

UMAs – How are they Impacted

- SAM enforced on insurance licence holder. Not the UMA. But…
  - Insurers will need to put measures in place to give the Board assurance that the organisation is within risk appetite.
  - Especially where UMAs contribute materially to the nature and magnitude of the insurer's risk
  - This is similar to the case where insurers passed on the capital funding requirements (or capital servicing costs) to UMAs.
- We discuss the areas of impact with practical examples next, under the following headings:
  - Pillar I
  - Pillar II
  - Pillar III (Not discussed as still some work to be done here for South Africa)

How are UMAs Impacted

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Pillar I | Pillar II

Data

- Detailed reserving and capital calculations require more detailed data.
- Quality of data will have to improve vs. currently seen.
- Most systems currently used can produce the data required, but some development is needed as they are not set up to record sufficiently detailed historical development patterns.

Example:
Insurer wants to apply for Internal Model approval. It must comply with strict data requirements. Primary source /custodian of data is the UMA. Thus data quality requirements become part of the UMAs operational requirements /responsibilities.

Policy endorsements may have overwritten previously stored records, reflecting only the latest position. In many other cases, the right amount of detail simply has not been captured in the past.

How are UMAs Impacted

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Pillar I | Pillar II

Data

- Typical types of information, often not adequately kept previously:
  - Policy refunds
  - Claims salvages & recoveries
  - Claims handling expenses
  - Commissions & intermediary costs
  - Benefit or cover type splits – both on policy and claim by claim level
  - Reinsurance details – both on policy and claim by claim level

- Data Governance
  - Reconciliation of policy and claims data to financials
  - Broker data validated against system data
  - Currently no off-the-shelf solutions

How are UMAs Impacted

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Pillar I

Pillar II

Measurement

Reserving calculations to follow the underlying risk exposures and length of claim development more closely.

- Short tailed business likely to see some IBNR relief
- Long tailed business could see substantial increases in IBNR (we have seen some niche lines increase by over 200%)
- Contract boundaries could have significant impact on UPP

Capital Requirements become more complex

- UMAs now drawn into dynamic nature of risk-based capital
- Not that easy to determine, communicate and understand
- Source, effect and management options to risk become practical consideration eg
  - The credit quality of debtors and reinsurers can have material impact – manage down receivables
  - Diversified portfolio of business lines gives lower relative level of capital compared to single lines business.

How are UMAs Impacted

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Pillar I

Pillar II

Impacts

- Increased capital injections might be required from some UMAs / reduced profit share pay-outs.
- Sudden once-off impacts on earnings eg change in reserves
- Loss of trust/confidence in the business – not clear how key drivers of capital work
- Increased need for risk management/mitigating actions

How are UMAs Impacted

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Pillar I	**Pillar II**

- Insurers need to show a sound system of governance and convince the regulator their risk management practices are imbedded in the business

- UMAs will therefore have to operate within the guidelines provided by insurers:

Example:
An insurer will not be able to demonstrate that the process for identification of insurance risk during product development and pricing is in line with its stated risk strategy and appetite if the UMA responsible for this aspect of the process does not also operate within this set of boundaries.

- Although not exempt, UMAs could leverage off certain of the Pillar II infrastructure of the Insurer

Small Insurers & SAM

- Cost of QIS and SAM implementation
- **Pillar II - 3 lines of defence model very onerous**
  - Not practical – cost, internal resources, availability of skills in market
  - Uncertainty surrounding proportionality consideration
- Pillar III – requires improved reporting system

Aims

1. Background to UMAs (regulations & where they fit in)

2. SAM's impact on smaller insurers

3. SAM's impact on UMAs

4. **Alternatives/options for smaller insurers**

Alternatives for small Insurers

Mono-line or niche insurers may find it unfeasible to continue business under the proposed SAM regulations, due to the cost of SAM and other regulatory pressures:

- Governance and Risk Management
- Quantification of risk (data systems, capital calculations)
- Sufficient separate lines of defence
- Lack of scale & resources to comply with SAM
- Treating Customers Fairly (TCF)
- FAIS
- Binder Regulations
- Directive on outsourcing

….What are some of the possible alternatives?

Alternatives for small Insurers

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Consolidation - smaller players are bought by larger players (keep insurance licence)

Pros:

- Potentially reduced SAM implementation costs (usage of parent resources and designs/systems/processes)
- Economies of scale: more spread out costs for compliance, reinsurance, administration
- 'Safer option' – parent able to assist in capital shortfalls

Cons:

- Potential loss of identity, business model, key staff, brand value
- Required to move with parent company strategy
- Initial period of increased costs for integration
- Increased capital requirement with no benefit of diversification
- Fate linked to that of parent company's solvency

Alternatives for small Insurers

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Simplified (i.e. ”proportional”) approach to SAM

Pros:

- Potentially reduced SAM implementation costs
- Gain better understanding of risk while being in charge of own future

Cons:

- Regulator might disagree with you view of proportionality
- Potentially having to incur significant costs before deciding to take another route
- Capital requirement could become more onerous under SAM

Alternatives for small Insurers

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Convert to UMA and join another insurer

Pros:

- Lower operating costs - Potentially reduced SAM implementation and regulatory compliance costs
- Able to utilise insurer's actuarial & support staff
- Reduced capital requirements – Operational risk likely to be biggest driver of capital requirements (assuming no underwriting risk retained)

Cons:

- Potential loss of key staff
- Limited by what insurer is willing to take on / approve
- No longer participating directly in underwriting risk, is now via reinsurance commission.
- Still able to use reinsurance, but need to fall in with insurer's overarching arrangements
- If multiple non-related UMAs leave the insurer, your UMA will be impacted.

Alternatives for small Insurers

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Enter into a cell captive arrangement

Pros:

- Lower operating costs - Potentially reduced SAM implementation and regulatory compliance costs
- Able to utilise cell provider's actuarial & support staff
- Reduced capital requirement, depending on the extent to which the cell provider is able to realise diversification between the business written across cells.
- Able to still participate directly in the underwriting profits
- Able to obtain specific reinsurance arrangements for cell exposure.
- No need for insurance licence

Cons:

- No 'protected cells' in South Africa currently
- Exposed to credit risk of cell provider – since cross subsidisation occurs between cells.
- High cost of 'renting' a licence (needs to be weighed against the reduced cost of compliance)

Disclaimers

1. Our interpretation of the current regulations.

2. SAM regulations still under development – requirements might change in future.

Questions?