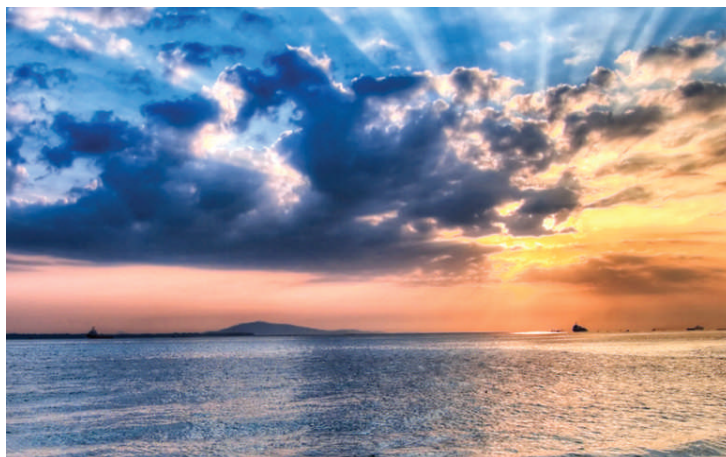


Emerging from the storm:

The day after tomorrow for insurance



The financial crisis will continue to reshape the competitive and regulatory environment within the global insurance industry over the next three to five years. An international team of PricewaterhouseCoopers reinsurance and insurance specialists has defined nine key developments and their strategic implications, revealing that the landscape that emerges in the aftermath of the 'storm' will present both transformational opportunities and significant threats for businesses that fail to anticipate and adapt to the changes ahead.

This document reflects the South African perspective on the nine key developments. It provides an overview of the drivers that are likely to impact the South African insurance industry in the foreseeable future.

Introduction

South Africa has weathered the storm better than most of the developed countries, but even so, the global financial crisis is becoming more of a fact of life for all South Africans. The South African economy has gone into recession for the first time since 1992. Latest statistics show the economic downturn and financial volatility has been tough for local insurers. Insurers' revenues and earnings are declining. They have singled out as some of the reasons, the impact of the slowing economy on claims, persistency and losses on equity. While our local insurance industry faces many challenges and can expect a period of rapid change, this is also a period of opportunity. Local insurance companies should get ready for the new challenges, prospects and opportunities.

1. Organic restructuring

As insurers withdraw from some of their geographical markets and scale back particular lines of business, the market shares and opportunities for those that remain will increase sharply, leading to a significant reconfiguration in the list of leading players.

South African insurers have become more market driven, as they focus on anticipating and responding to customers' rapidly changing demands, to achieve growth.

A big challenge for insurers in the day after tomorrow's environment will be to regain consumer confidence. Insurers will have to focus on improving communication and transparency as well as increasing service, to retain customers.

South African insurers pride themselves in being innovative. As part of their growth and restructuring objectives, they will need to focus on new products, new distribution channels and new geographies.

The rest of Africa continues to be the geography of choice for those South African insurers seeking growth opportunities.

2. The end of innocence for retail investors

What customers demand from savings and investment products and how they want to buy them will take a new direction within many territories, with companies that are slow to catch on becoming increasingly marginalised.

As South African consumer demand profiles change; with crucial implications for product design and distribution - insurers will have to adapt their strategies to more innovative distribution methods and products.

South African insurers face significant marketing, product design and distribution channel battles on two key fronts.

Like their counterparts in the developed world they must rehabilitate and protect their reputation to maintain the trust of their existing client base and historic target market by reacting to changing customer needs.

The continued growth of sophistication and knowledge of these consumers has

resulted in consumers becoming more discerning and able to protect themselves from bad choices and bad advice.

In line with the global trends, we see consumer awareness and informed demands. Also noticeable is the increase in the demand for simpler and more transparent products.

In addition to the above mentioned challenges, local insurers must also address the perceptions of the industry in the low-income market. The challenge for the industry is perhaps greatest in those market segments that have no awareness of insurance or see no benefit in it. Here interventions by the South African insurance industry to educate, inform and reach potential consumers are important.

Even before the financial crisis, the South African insurance industry recognised its obligation to educate and inform consumers of the need for financial services in poorer communities.

Following the shock of the financial crisis and the resulting scepticism, the good news for South African insurers is that the low income market tends to behave in counter-cyclical ways in an economic downturn. This market presents viable opportunities for insurers.

3. Reawakening of M&A

The strong underlying rationale for consolidation and restructuring within many markets means that acquisition activity is set to accelerate rapidly once valuation parameters are stabilised and funding becomes more readily available again.

In South Africa, there are insurance companies of varying size, including large insurers with offices world wide and medium and small companies. In recent years, insurance companies have had to deal with an unprecedented wave of mergers and acquisitions, such as Momentum acquiring the entire issued share capital of Sage; Capital Alliance was acquired by Liberty and Sanlam acquiring the listed assurance company African Life and also acquiring the majority stake in Channel Life.

At present, South African insurance companies prefer the pursuit of growth through product, distribution and geographical diversification.

The key to achieving growth in the current economic environment for South African insurers will come from a greater focus on expanding and diversifying through strategic partnerships and Africa.

4. Another rethink on reporting

Without an industry consensus on a genuinely relevant, intelligible and comparable basis of accounting and disclosure, insurers will find it increasingly difficult to compete for capital.

Share values fail to reflect the true level of wealth created. In South Africa, most insurers shares are traded at a significant discount to embedded value. The lack of a relevant and comparable reporting standard for insurance companies has long been regarded a problem by investors who see reporting by insurers as complex and non-transparent.

International Financial Reporting Standard 4 Phase II ('IFRS 4 Phase II) is on track for a standard on the measurement of insurance contract liabilities towards 2012. The International Accounting Standards Board (IASB) has stated that it would ideally like to eliminate all differences between the accounting principles applied in IFRS 4 and other standards dealing with the measurement of liabilities. This search for consistent financial reporting may be ambitious due to the challenges presented by the unique features of insurance contracts compared with other contracts. The drive for consistency and comparability may impact other projects such as revenue recognition, performance reporting, liability-equity classification, financial instruments and fair value measurement.

Insurers have only just got to grips with the existing International Financial Reporting Standard, and its onerous disclosure requirements. The cost of financial reporting is expected to increase for insurers, as they seek to comply with the proposed new insurance accounting standard.

5. Blurring the lines

The relationship between the public and private sector will change as governments exert a stronger influence over the insurance market as a result of bailouts, regulatory reform and greater control over pensions and health care.

Political awareness and staying in touch with government policy is of particular importance for businesses in the highly regulated financial services industry.

Government proposals can radically change the environment in which financial services businesses operates. The much talked about National Social Security and Retirement Fund Reform and the National Health Insurance Plan are examples of some of the radical changes which will affect local insurers.

The government believes that South Africans are not saving enough for retirement and disability. Government is committed to social security and retirement fund reform. National Social Security and Retirement Fund Reform proposals attempt to achieve mandatory saving, equity, the pooling of risk, administrative cost efficiency and social solidarity.

Government has been working on the reform since 2002. The target date for implementation was initially set for 2010, but indications are that this time frame is not attainable.

Government plans to introduce the National Health Insurance plan for the vast majority who are not covered by the private medical aid insurance service providers.

The broad objective of the Government's proposed National Health Insurance plan is to put in place the necessary funding and health service delivery mechanisms, which will enable the creation of an efficient, equitable and sustainable health system in South Africa. It will be based on the principles of the right to health, social solidarity and universal coverage.

National Health Insurance will be funded through a combination of current sources of government health spending, including the removal of the tax subsidy for medical schemes and modest mandatory or compulsory contributions split equally between employers and employees.

The removal of the tax subsidy may prompt many middle-class consumers to cancel their medical aid membership, opting to use only the government-funded service. In response, many larger medical insurance businesses have already begun to reposition themselves by pursuing opportunities in the African markets rather than in South Africa and by changing models into diversified financial services businesses.

6. Overhaul of rewards

Insurers will base much more of their performance-related pay on risk-adjusted measures, aligned to their business strategy. They will also face tougher regulation over how compensation is governed.

The new King III report gives guidance on the remuneration of directors. The report suggests that the performance of the CEO and executive directors should be reviewed every year. This evaluation will concentrate on the CEO's performance, as a director and as the Chief Executive Officer.

Companies should remunerate fairly and responsibly and remuneration policies should be aligned with the company's strategy. Annual bonuses should be clearly related to performance objectives. Minimum levels of financial performance should be met before executives can be awarded bonuses.

The King III report suggests that directors should be responsible for the process of risk management. The board is expected to exercise duties of care, skill and diligence in identifying, assessing and monitoring risks. It is critical to review the performance of a company against its risk management plan. The intention of this review is to determine whether risk management objectives have been achieved. A considered and systematic approach to risk management underpins the success of a company. It is likely that local insurers will also base much more of their performance-related pay on risk-adjusted measures, aligned to their business strategy.

7. Mounting uncertainty over tax

Amid moves to increase tax revenues and tighten the tax rules on offshore business, the stability of the tax regime will be a key consideration in possible relocation, as will choosing where to domicile and where to do business

As a result of our growing budget deficit, there is increasing focus from our South African Revenue Services on improved tax collections (provisional tax), international tax structures, transfer pricing practices and the financial services industry in general.

8. An uncertain future for Reinsurance

While some believe that reinsurance has strong long-term prospects, others predict that demand will fall away in many developed markets and be concentrated on the more uncertain long tail and high severity risks. This would increase reinsurers' capital requirements and the return expectations of investors within these markets, and ultimately force a rethink of the business model.

A general view in South Africa is that there may be a trend away from reinsurance. Insurance companies believe that, with improved risk management, their appetite to retain more insurance risk can be improved. Through advances in enterprise risk management, insurers are able to choose what risks to retain and what risks to reinsure.

The South African market could become unviable for some of the global reinsurers. We have already seen one or two withdrawals.

9. Tilting the regulatory playing field

Under pressure from governments, supervision will be more intense and regulations will be more subject to national priorities in their interpretation and application.

As a member of the International Association of Insurance Supervisors (IAIS), South Africa has followed the lead of European regulators and as such we would expect an increase in supervision, with additional focus on solvency, governance, consumer protection and risk management.

Recently, we have seen regulatory developments in the form of the Insurance Laws Amendment Act, the Consumer Protection Act, the Companies Act, new Fit and Proper requirements (FAIS), a discussion paper on the future of micro insurance regulation in South Africa and the King III report on governance, to name a few.

Compliance costs have generally increased, as the degree and scope of regulation has intensified in the last few years. Whilst the industry was generally able to absorb these additional costs in a strong economy, it is proving more difficult in a slower economic environment.

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