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Insurance Industry And Country Risk Assessment: South Africa Property/Casualty

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S&P Global Ratings assesses insurance industry and country risk as moderate in the South African property and casualty (P/C) sector. This reflects our view of country risk as moderate and industry risk as intermediate.

Our expectation is that the P/C insurance sector in South Africa will show constrained real premium growth in the next two years as a result of weak economic growth prospects.

The overall assessment is comparable with other P/C markets such as Brazil, Italy, Morocco, and Turkey. Country risk is a relative weakness due to heightened economic risks within the country. We consider growth prospects to be limited in South Africa's P/C market due to the economic environment and near stagnant GDP growth. We view the balance of industry factors as a relative strength, reflecting our view of the P/C insurance sector's earnings as positive (based on our forecast of industry return on equity [ROE]), barriers to entry as modest, and the regulatory framework as supportive.

Country Risk: Moderate

Our assessment of moderate country risk reflects the economic risks stemming from weak economic growth, relative to that of peers in similar wealth categories, wide income disparities and infrastructure gaps, modest financial system risk, and an acceptable rule of law.

South Africa is one of the largest economies in Sub-Saharan Africa and has a well-developed insurance market. That said, the country's GDP per capita has deteriorated over recent years, which is likely to affect the insurance market's growth prospects. We estimate nominal GDP per capita to be around US\$5,759. Although real GDP per capita on average expanded by 1.0% per year over the past five years, it contracted by 0.5% in 2015. We expect GDP per capita to decline further to US\$4,900 in 2016, which is in part due to the depreciation of the exchange rate. This is largely attributed to restrained household spending, amid rising inflation and interest rates, and the low business confidence of South African corporates.

Our assessment of political risk considers the strong democracy within South Africa, given its independent media and reporting. We believe South Africa will continue to maintain strong institutions such as the Public Protector and the Judiciary, which provide checks and balances. However, the latter have been tested after the executive and ANC-dominated legislature attempted to set aside some of the recommendations of the Public Protector. On a broader basis, South Africa has shown effective policy-making since 1994 that has produced sustainable public finances. That said, the socioeconomic dynamics of race and skewed income distribution have the potential, in our view, to shift policy toward intervention and income redistribution, at the cost of headline GDP growth.

We view the financial system as generally stable, with a strong track record. The South African Reserve Bank has generally been an early adopter of global regulatory best practice. Furthermore, South African banks generally achieve strong and stable returns, resulting from good recurring fee income, generally strong risk controls, and wide interest

margins (a reflection of high base rates and the significant asset liability mismatch). The South African banking sector continues to derive funding predominately from short-term deposits. The financial sector has a neutral external position, with very little external debt and some capital and loans in foreign subsidiaries. We consider domestic capital markets to be moderately broad and deep, with low external debt funding.

We assess the payment culture and rule of law in South Africa as moderate. This view is informed by the country's World Bank rankings for rule of law and control of corruption, as well as Transparency International's Corruption Perceptions index. According to the World Bank's Worldwide Governance Indicators report, South Africa is in the 60th percentile for rule of law. Transparency International places South Africa 61st out of 167 countries in its 2015 Corruption Perception Index. In our view, this adds some uncertainty to the conduct of insurance business in South Africa. We assess South Africa's legal framework as moderately strong, with no government intervention. Court awards are gradually increasing, with consumers becoming more aware of their legal rights.

Industry Risk: Intermediate

We assess industry risk for the South African P/C sector as intermediate, based on our evaluation of five industry-related sub-factors. We see profitability, measured by ROE, as a positive factor; barriers to entry and product risk as neutral factors; and the institutional framework as moderately strong. We view market growth prospects as negative.

Profitability (positive)

We view the historical and prospective profitability of the South African P/C insurance sector as positive as we expect the aggregate ROE to remain above 10% over the medium term, with potential for some short-term volatility. In aggregate, insurers have achieved an annual ROE of above 15% over the past three years. Their aggregate ROE has remained at or above 10% over each of the past five calendar years, edging higher in 2015 due to an absence of natural catastrophe and peril activity. However, we forecast that the sector's profitability will weaken, due to toughening market conditions and weaker underwriting performance. This is a result of a volatile exchange rate environment evidenced in recent years negatively affecting repair costs in the auto insurance segment, large property claims, and a general rise in claims frequency. Investment returns remain supportive of the overall level of ROE, with the prevailing yield environment on average around 7%.

We forecast that the upward pressure on expenses will persist, amid continued currency weakness and rising inflation. In addition, cost pressures will continue, in light of the need to comply with regulatory requirements approaching implementation of Solvency Assessment and Management (SAM) and market conduct rules, as well as IT infrastructure enhancements. We see emerging opportunities for insurers in the outsourcing of claims and process management in seeking to manage cost pressures.

Product risk (neutral)

We assess the potential for product risks to trigger volatility in returns as neutral, as we view the sector's exposure to catastrophe risk and settlement risk as limited.

In our opinion, the South African P/C market has a moderate net exposure to major natural catastrophe events,

relative to comparative countries. The main natural catastrophe exposures are storms, specifically hail and floods, as well as earthquakes. High-risk zones (according to the CRESTA classification [Catastrophe Risk Evaluation and Standardizing Target Accumulations]) within South Africa are concentrated in high density urban areas, with flooding and bushfires traditionally occurring in areas with low insurance density. South African insurers have maintained robust reinsurance protection, which limits their exposure to losses from extreme events as well as accumulation losses.

In our view, the delegated underwriting authority and prevalence of the underwriting managing agency (UMA) model in South Africa has the potential to cause volatility. Operating under a mandate, UMAs have the ability to place insurers on risk. This model generally operates satisfactorily, although we note that, in the absence of appropriate risk controls, there is a higher potential for business to be written outside mandate limits.

We view the absence of motor bodily injury claims and the pricing flexibility of insurers to adjust or cancel most personal lines business on a monthly basis as positive for the industry. With respect to the former, the government runs the Road Accident Fund, which is funded by a motor fuel levy. Accordingly, motor claims are therefore limited to voluntary liability, personal accident, and property damage. We note strong lobbying in the industry to institute compulsory third-party cover.

Insurance fraud, according to the South Africa Insurance Crime Bureau, affects between 30%-35% of claims. We note that the industry has taken strident efforts to reduce fraud. We believe that the industry prices the incidence of fraud into current risks.

Barriers to entry (neutral)

We consider that barriers to entry are neutral. This is supported by our assessment of the forthcoming regulatory changes and moderate operational barriers. Heightened regulation in the form of risk-based regulation under SAM, the shift in both prudential regulation and market conduct authorities, as well as Regulatory Distribution Review, will increase barriers to entry. In addition, insurers must apply for an insurance licence from the regulator, which is a comprehensive process and requires insurers to have a reasonable level of sophistication and resources.

We regard South Africa's non-life insurance market as highly developed, technically sophisticated, and strongly competitive. The industry structure is oligopolistic in structure, with the top-five insurance groups combined commanding less than half of all premiums written. We anticipate some consolidation in the industry, amid intensifying competitive pressures, over the medium term.

Brokers and intermediaries are the main distribution mechanism within South Africa. Given the commoditized nature of many P/C products, direct carriers continue to erode the market share within personal lines and simple commercial lines. We expect this to support an increase in marketing to promote branding, and increased technology expenditure to support the multi-channel offering in the market.

We believe there is limited availability of skilled resources, such as management and staff, which imposes an operational barrier. Recruiting and retaining skilled staff is a constraint within the industry. Although various programs seek to address this skills shortage, it remains a prominent feature within the P/C market.

Market growth prospects (negative)

We view market growth prospects as negative. A combination of soft economic activity, considering tight household income and constrained expenditure within the corporate sector, will constrain overall P/C gross premium growth, in our view. We anticipate modest growth of overall P/C gross premiums, following the selective rate adjustments in recent periods.

P/C insurance penetration rate is relatively high, at 2.7% of GDP, compared with global peer markets. Nevertheless, we believe that negative real rates of growth will emerge for most representative lines of business. We expect only select and niche lines of business to be resilient, with either small increases or flat premium adjustments.

Institutional framework (moderately strong)

We regard the South African institutional framework as moderately strong (3). This reflects our view of the regulatory framework and track record as intermediate. We see no clear deficiencies in governance and transparency.

Currently, the Financial Services Board (FSB) regulates the market, although this will be replaced by a prudential regulator and a dedicated market conduct regulator once the new regulatory and insurance bill is passed in parliament. From that point, the prudential regulation will be overseen by the South African Reserve Bank, and the FSB will be responsible for the market conduct.

Regulatory framework. We view the regulatory framework as intermediate, which reflects our positive view of the sound current framework and introduction of SAM. Currently, insurance entities are operating under dual reporting requirements, namely the current and prospective regime. In addition, further legislative changes are anticipated relating to the Retail Distribution Review. These add to the changes already implemented, namely: changes to binder fees paid by insurers, Consumer Protection Act, Treating Customers Fairly, and the processing of personal information.

The International Monetary Fund and the World Bank's Financial Sector Assessment Programme (FSAP) offer an independent assessment of insurance regulators. They consider the South African regime to be thorough and effective, and the most recent report indicates that insurers observe all 28 insurance core principles (ICP)--although the report highlighted 13 ICPs for further development. The areas for development include enacting legislative change to establish clear priority for policyholders, extending enforcement powers to bar and fine individuals, and extending supervisory oversight in order to cover friendly societies and insurance holding companies. The FSAP also recommends improved guidance for the sector from the FSB regarding its expectations for internal controls, governance, and risk management as well as its approach to solvency level intervention.

We believe the likelihood for greater government intervention in the industry is very low. There has been an increasing pre-occupation of government toward the P/C industry regarding market conduct, financial inclusion, and regulatory reforms. We believe, however, that the government's intention is to encourage industry reform and development and is not evidence of more stringent rules and interference. If a more dogmatic approach was to be taken and it resulted in a greater level of uncertainty in insurers' results, we could lower our assessment.

Regulatory track record. We assess the FSB's track record of oversight and intervention as neutral. Regulated companies have to report financial information quarterly on a range of key measures such as composition of the capital base, asset holdings, and various financial performance metrics. Insurers are currently operating under two parallel systems, ahead of implementation of SAM--which is aligned with aspects of Solvency II--with insurers filing

dual reporting templates to the regulator. Annual regulatory returns also incorporate a number of stress scenarios. The depth of the regulator's oversight has been evidenced over recent periods through reviews of a few small insurers.

Governance and transparency. We regard governance and transparency as supportive for our assessment. Corporate governance is embedded in the King Code and the Companies Act of 2008. The King Code has no legislative backing and is instead based on 75 principles. Adherence to the code is viewed as best practice in the industry. We expect further regulatory guidance in the industry to promote general governance framework and standards, given the focus on fit and proper requirements of management, as well as the structure of internal committees.

South African Generally Accepted Accounting Principles are fully aligned to International Financial Reporting Standards (IFRS), which supports cross-border comparisons and transparency. All listed companies have had to comply with IFRS since Jan. 1, 2005.

We are not aware of any material governance weaknesses across the industry.

Related Criteria And Research

Research criteria

- Insurers: Rating Methodology - May 7, 2013

Related Research

- Research Update: South Africa Ratings Affirmed; Outlook Remains Negative On Weak Growth - June 3, 2016
- Banking Industry Country Risk Assessment: South Africa - December 16, 2015
- Research Update: Outlook On South Africa Revised To Negative On Continued Slow Growth; Ratings Affirmed - December 4, 2015

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