national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

THE FUTURE OF MICRO-INSURANCE REGULATION IN SOUTH AFRICA

DISCUSSION PAPER

7 April 2008

The discussion paper on **THE FUTURE OF MICRO-INSURANCE REGULATION IN SOUTH AFRICA** is hereby released for public comment.

Comments on the discussion document should be furnished by **Thursday, 31 July 2008** in the format indicated in *Appendix 11*. Due to time constraints, it will not be possible to respond individually to comments received. However, receipt of comments submitted in the correct format before the due date will be acknowledged and fully considered by the National Treasury.

Submit comments to Katherine Gibson by email: Katherine.gibson@treasury.gov.za or fax: +27 (0)12 3155206

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EXECUTIVE SUMMARY

This discussion paper proposes that a regulatory space for the provision of micro-insurance products be carved out within the broader regulation of insurance provision in South Africa.

Micro-insurance refers to insurance that is *accessed by or accessible to the low-income population*, provided by a variety of different providers and managed in accordance with generally accepted insurance practices. It does not operate in isolation, but forms part of the broader insurance market, distinguished by its particular market segment focus (which translates into distinct means of distribution and distinctly structured products). Micro-insurance as defined in this paper is intended to catalyse the market provision of risk management tools for poor households. However, given the inherent complexity of insurance and the vulnerability of the target market, there are also risks of potential abuse and misselling. A balance therefore needs to be struck between market development and consumer protection.

Accordingly, the goal of this discussion paper is to develop a coherent and clear regulatory framework that will encourage and facilitate the provision and distribution of good value, low-cost products that are appropriate to the needs of low-income consumers by a variety of market players who compete for the market, treat their policyholders fairly and are able to manage the risks of providing insurance. This is in line with the government's objective to increase access to financial services for the poor and provide a supportive regulatory environment for the implementation of the Financial Sector Charter.

Dedicated micro-insurance license

The discussion paper proposes the creation of -

- a dedicated micro-insurance license,
- available to existing registered long-term insurers, short-term insurers, friendly societies as well as public companies and co-operatives which comply with the registration requirements,
- which will allow the license holder to write both long-term and short-term policies which comply with the product parameters set for micro-insurance products (including a benefit cap of R50 000 and a maximum term of 12 months),
- to which simplified distribution requirements (under the Financial Advisory and Intermediary Services Act - FAIS) will apply;
- as well as a special prudential regime commensurate to the risks applicable to micro-insurance policies.

However, the micro-insurance license will not be the only channel for the provision of market-driven risk mitigation instruments for low income households. This paper also considers the other options that need to be included in an overall regulatory framework for micro-insurance, for example underwriting or the cell captive mechanism.

Why a regulatory framework for micro-insurance?

There are a number of motivations for developing a coherent micro-insurance framework. These reflect both the need to address particular problems and gaps in the current system as well as the need to facilitate the further development of the micro-insurance market:

1. *Create a simplified distribution regime to incentivise market development.* In particular, this will be of interest to existing formal insurers who will be able to harness the distribution benefits in the intermediation of micro-insurance products. The same distribution regime will apply for all categories of insurers offering the micro-insurance products as defined.
2. *Allow the same risk carrier to write micro-insurance products extending across life and property classes of insurance policies.* The current demarcation in insurance legislation combines the differentiation between long-term and short-term as well as life and property categories of insurance. In the proposed micro-insurance regime, the products are defined as short-term in nature to reduce their prudential risk but extend across the delineation in current regulation to include both life and property categories of insurance. This is in line with the risk-based approach to insurance where the regulation needs to be tailored to the overall risk presented by the product, not only one feature of the product, such as the risk event.
3. *Remove unnecessary barriers to entry and operation to facilitate broader participation.* The proposed framework aims to remove unnecessary barriers to entry and operation in this market and facilitate broader participation. This is achieved by scaling the regulatory requirements in proportion to the risk of micro-insurance as defined and involves (1) reducing the capital requirement from that required for long-term and short-term insurers, (2) limiting the operational requirements and (3) allowing additional types of legal persons to operate under the micro-insurance regime. Potential new micro-insurers may come from the ranks of large funeral parlours, microlending organisations, affinity groups, apex bodies and similar organisations. Facilitating the entry of these entities will also support the government's objectives of economic empowerment and black capital formation.
4. *Facilitate effective supervision and enforcement.* By ensuring an optimal regime for entry and operation of businesses wishing to play in the micro-insurance space, government will be able to enforce current regulation vigorously without unnecessarily closing down businesses that are reasonably able to register under the new regime. Having addressed the unnecessary barriers to entry, government can then focus on enforcing insurance regulation on those market segments still operating illegally and presenting particular risks to consumers.

The proposed framework combines a proposed definition of micro-insurance with recommendations on regulatory changes regarding risk carrying and intermediation in this market:

Multiple options to provide micro-insurance.

Micro-insurance of some form or another is currently provided by multiple players, both regulated and unregulated. We propose that the micro-insurance license fit into a wider set of

options for the provision of micro-insurance. Therefore the encompassing regulatory framework for micro-insurance should include approaches to each of the following:

- *Burial societies that do not offer guaranteed benefits:* Where burial societies have fewer than a prescribed number of members (to be actuarially assessed on risk based principles), have an annual income below a prescribed amount (e.g. the current figure of R100 000, but to also be actuarially assessed on risk based principles) and do not offer guaranteed benefits, they should remain exempt from all insurance regulation.[1] Where societies surpass the membership size and annual income thresholds and/or progress to providing guaranteed benefits, the framework will require them to utilise the relevant options available for the formal provision of insurance.
- *Underwriting:* Entities wanting to provide micro-insurance to members or clients, but that are unable to underwrite the risk or conduct the day to day risk management of those products, can obtain underwriting from a formal insurer that is registered under the existing long-term or short-term licenses, or the new micro-insurance license.
- *Cell captives:* Where the entity seeking to offer micro-insurance desires more autonomy (than offered by the underwriting route) in the product design and management process and wants to share in the profit of the risk management, it can buy into a cell captive.
- *A dedicated micro-insurance license*: Based on the particular need to limit the cost of regulation for low-premium products and the reduced risks which can be presented by micro-insurance, we propose a regulatory space for the provision of micro-insurance business under a lighter compliance regime than required for other insurance products.
- *Provision by existing registered insurers:* Existing insurers already provide micro-insurance. The more cost-effective dispensation created by the dedicated micro-insurance license will encourage them to write a substantial amount of their micro-insurance under the new dedicated license. However, not all of the products which they offer to low income households will fall within the product parameters of the micro-insurance license and they will probably continue to market these under their existing long-term or short-term licenses.

The proposed framework includes changes to both underwriting and distribution aspects of insurance taking into account the impacts on prudential risk and consumer protection.

Underwriting under the dedicated micro-insurance license

Product-based definition of micro-insurance. In line with the practice in South African insurance regulation, it is suggested that the definition of micro-insurance should be product-based. The following product parameters are recommended:

(1) the benefits to be paid under a micro-insurance policy must be capped at R50 000 per individual risk per year;
(2) the term of the contract must not exceed 12 months;
(3) limiting the products to risk only, and excluding savings;

[1] In the instance where a burial society has either more than the prescribed number of members or more than the prescribed annual income, the regulatory environment will not distinguish between guaranteed and non-guarantee benefits; all providers will need to comply with the relevant legislation and effecting regulations.

(4) both life and non-life events to be covered, but the risk events need to be relatively predictable for a small insurer, and the financial impact of each event must be relatively small and independent of others (this could include funeral policies, micro-life, personal accident, household structure and content, cell phone and legal insurance, but will exclude investment policy products), and
(5) simple terms and conditions, readily understandable by low-income clients.

Micro-insurers vs micro-insurance. The paper recognises that there may be products which are suitable to lower-income households, but do not fit within the risk criteria and product parameters for the dedicated micro-insurance license. The risk analysis suggests that the product limitations above are necessary to limit the underlying risk, thereby allowing for dedicated micro-insurers to operate under a lighter regulatory regime. Riskier and more complex products targeted at low income clients will continue to require the more onerous regulatory regime currently applied to full insurers. The standards proposed here do not prevent industry standards such as those developed under the Financial Sector Charter to set best and desired practices over and above that which is required by regulation.

Regulation tailored to underlying risk. Insurers that only offer micro-insurance products as defined will operate under a reduced regulatory environment. This is justified as the risks inherent in this business are limited by the product limitations. Key components of the proposed micro-insurance regulation will include:

- Micro-insurers may only offer the micro-insurance products as defined above;
- Initial capital is limited to R3m compared to the de facto R5m currently applied for short-term insurers (and which is likely to rise further under the proposed Financial Condition Reporting Regime) and R10m for long-term insurers (including consideration of tiered capital);
- Reserving will be based on a simplified standard model;
- A minimum set of organisational capabilities, which will have to be proven to the supervisor (as done currently for insurance registrations). These will include the availability of technical expertise and an annual auditing function;
- A minimum set of corporate governance requirements. Apart from demonstrated fit and proper management, this would include requirements around transparency and appropriate expertise of non-executives.
- Legal persons registered under the Companies Act as a Public Company, Friendly Societies Act and the Co-operatives Act will be allowed to register as micro-insurers; and
- Micro-insurers may only invest their funds in a limited set of low-risk and suitably liquid investment instruments.

Insurers registered under the current Long-term or Short-term Acts may also offer these products with limited, if any, further registration or regulatory requirements. Although these insurers will not benefit from the simplified regulation noted above, unless they chose to conduct all their current business under a micro-insurance license, they will benefit from the intermediation space created for micro-insurance outlined below.

Consistent supervision. All micro-insurers need to be under the supervision of the insurance division of the Financial Services Board (FSB).

Friendly societies and co-operatives registered under their respective acts will be allowed to obtain a micro-insurance license if they comply with the requirements. The option of writing insurance under the Friendly Societies Act will be phased out in favour of the micro-insurance regime. That is, friendly societies will no longer be exempted under the Long-term Insurance Act for registration when providing insurance policies not exceeding R5000.[2] It is proposed that a five-year phase-out period is applied. It is also proposed that the tax exemption for friendly societies be removed within one year; an equal tax treatment should apply to friendly societies and co-operatives.

Distribution of micro-insurance

The regulation of the distribution of micro-insurance should remain under the FAIS Act. However, regulatory changes will be necessary to create the space for a broader set of micro-insurance products (beyond funeral insurance) and to provide certainty around the exact requirements for these products.

The lighter distribution requirements will apply to all qualifying micro-insurance products issued by registered micro-insurers and which have been submitted to the FSB (though the FSB will not be required to approve each individual product). The following reduced requirements will apply:

- Intermediaries distributing micro-insurance products will operate under reduced FAIS requirements similar to those currently applying to Category A agents. The distribution of micro-insurance should not be completely excluded from FAIS as there are still risks of abuse and misselling.
- The Category A education requirement must be reduced or done away with, taking into consideration the FSB's current process to develop new Fit and Proper requirements.
- Micro-insurance products may be sold without advice but on condition of simplified and clear language disclosure of key elements of the policy.[3] This does not suggest that the poor do not need advice, but simply that the cost of advice may make it too expensive relative to the premium values of micro-insurance. This does not exempt the intermediary from providing the necessary information on the product required by a client to make an informed decision. Verbal disclosure should be encouraged at the time of sale; moreover, either onsite or offsite verbal product information must be available to the client, through for example a call-centre.
- *Commission levels* on micro-insurers will be *uncapped* but required to be structured on an *as-and-when basis*. This will allow the space for advice and verbal disclosure models.
- *Monitoring and recourse.* It is recognised that there is a risk of misselling. To assess this going forward insurers offering micro-insurance will be required to report key statistics to the FSB (including commission levels and lapse rates) to allow this situation to be monitored. For full long- or short-term insurers selling micro-insurance products under the reduced distribution regulation regime, this will imply reporting separately on the micro-

[2] This figure is currently under review for an inflation related increase, but for the purposes of this paper the existing R5000 amount will be used.

[3] An FSB guidance note should be issued in this regard once the micro-insurance legislation has been gazetted.

insurance product category. In addition, it is important that the legislation ensures *clear and easily accessible recourse, through an insurance provider's customer care facility in addition to an ombudsman's office.*

Other areas requiring adjustment include:

- Facilitating the use of cell captives as a graduation step for entities wanting to move beyond 100% underwriting, but not yet ready to become micro-insurers or full insurers. In particular, the implicit restrictions on friendly societies accessing a cell captive arrangement (via the investment restrictions under the Regulations to the Friendly Societies Act) should be removed.
- The accessing of the cell captive structure by co-operatives must be supported.
- Providing guidance on institutions that are not regulated for FAIS purposes, e.g. group policyholders. Care should be taken that this does not undermine the consumer protection intended by FAIS to the very constituency it was targeted at.

Ongoing areas of consideration and research

While this discussion document does broach the following areas, a more comprehensive strategy may be required for each:

- *Social security reform:* While limited death and disability benefits are included in the envisaged social security system, it is intended that micro-insurance providers in this space will remain (and indeed grow). This assertion is made on the grounds that only those individuals who have been contributing to the social security fund will be covered by the benefits offered, There is furthermore no provision for funeral policies, and the low social security death benefits anticipated suggests that those who can afford it may want to pay for higher benefits via a micro-insurance policy. A related issue for review are abuses noted where deductions are made for funeral policies directly out of social grants.
- *Consumer protection and enforcement:* For abuses in the selling of funeral policies, National Treasury will engage the relevant government stakeholders to ensure enforcement of both legal and illegal operators. As a first step the National Treasury is leading an inter-departmental forum to facilitate increased co-operation amongst national government departments, to be expanded to include enforcement agencies. The enforcement strategy will be underpinned by a consumer awareness campaign targeted at lower income groups, through a combined effort by the National Treasury, FSB and affinity groups. Specific areas examined are improved enforcement co-operation, the role of apex organisations in enforcement, the role of the FSB in supporting regulatory compliance and increased consumer awareness. It is proposed that the process initially focuses on implementation of the micro-insurance regime, with complaints and abuses dealt with by the statutory ombud (when falling outside of the Long-term or Short-Term Ombudsmans' jurisdiction). Over the longer term, the idea of a dedicated micro-insurance ombudsman can be revisited.
- *Tax policy:* The tax treatment of co-operatives, friendly societies and public companies operating under the Long-term and Short-term Insurance Acts will be reviewed to ensure consistency in the approach followed.

Proposed legislation

Although it is technically feasible to introduce the dedicated micro-insurance license through appropriate amendments to current legislation (the Long-term Insurance Act, the Short-term Insurance Act, the Co-operatives Act and the Friendly Societies Act) it is proposed that for the sake of simplicity and a user-friendly set of regulation, a separate micro-insurance act should be created under which micro-insurance products can be written. However, the new legislation should be embedded in a broader micro-insurance framework which should allow for broad participation in this market and the graduation of entities from small, underwritten entities to larger more sophisticated options.

1. INTRODUCTION AND BACKGROUND

1.1. WHAT IS MICRO-INSURANCE AND WHY IS IT IMPORTANT?

Micro-insurance has been defined by the International Association of Insurance Supervisors (IAIS) as insurance that is *accessed by or accessible to the low-income population*, potentially provided by a variety of different providers and managed in accordance with generally accepted insurance practices[4]. It does not operate in isolation, but forms part of the broader insurance market, distinguished by its particular market segment focus (which often translates into distinct means of distribution or distinctly structured products).

Though all members of society face risks that threaten their lives and possessions, the impact of such risks is particularly severe for the poor, as it results in costly interruptions to the difficult process of asset formation. Outside of direct government provision, such risks may be mitigated through savings, informal support networks and semi-formal risk pooling mechanisms. International experience has shown that insurance can play an important role in risk mitigation for the poor. Whereas the individual may not be in a position to accumulate sufficient savings to cover losses when they occur, she or he may be able to pay premiums relating to the risk, should the product be designed so as to be affordable and appropriate to the needs of the poor.

In South Africa, insurance aimed at the low-income market (or largely taken up by the low-income market) is not a new concept. Compared to its peers South Africa has a well-developed commercial micro-insurance industry (primarily funeral insurance). However, this industry is not without its challenges. At the heart of these challenges is the need to reconcile the objectives of *addressing potential abuse* in this market (in respect of prudential and customer protection risk) and *financial inclusion*.

[4] To distinguish micro-insurance from social welfare, it should be funded by premiums and managed based on a generally accepted risk-management principles (IAIS, 2007). Note that this is not a regulatory definition of micro-insurance. One of the aims of this Paper is to develop an operational definition of micro-insurance within regulation in South Africa.

1.2. WHY THIS DISCUSSION PAPER?

Risk of consumer abuse. This discussion paper finds its roots in concerns about consumer abuse in the low-income insurance market which were raised at a parliamentary Portfolio Committee on Finance meeting in August 2003 (and again in September 2005). At this meeting, presentations were made relating to the potential for abuse in the funeral insurance market. In response to these concerns, a regulatory review process was initiated of which this discussion paper and the framework it introduces are the ultimate outcomes.

Opportunities for financial sector development and inclusion. Although concerns about potential abuse were the initial motivation for the regulatory review, it was also established that insurance can provide good value to low-income households, particularly as it is beginning to extend beyond funeral cover to life cover more broadly. Developments in the market have also made it clear that there is potential for expanding the set of products on offer to lower-income households, which will contribute to reducing vulnerability more broadly. This is in line with government's central policy objectives of poverty alleviation.

Unifying framework across diverse policy and regulatory processes. There are numerous regulatory developments that will impact on the provision of micro-insurance. The Financial Advisory and Intermediary Services Act of 2002, the Co-operatives Act of 2005, the proposed move to Financial Condition Reporting in the short-term industry, the processes around social security reform, commission restructuring and the review of outsourcing functions all potentially impact on the provision of micro-insurance. Given these diverse policy processes, it is appropriate for the regulator to periodically review insurance regulation and its place within broader policy processes. In this way a framework is created within which prudential regulation objectives can be reconciled with other government policy objectives such as consumer protection, as well the need to promote access (on the demand-side), going hand in hand with the promotion of BEE and SME development (on the supply-side).

Goal. Accordingly, the goal of this discussion paper is to develop a coherent and clear regulatory framework that will encourage and facilitate the provision and distribution of good value, low-cost products that are appropriate to the needs of low-income consumers by a variety of market players who compete for the market, treat their policyholders fairly and are able to manage the risks of providing insurance. This is also in line with government's objective of providing a supportive regulatory framework for the Financial Sector Charter.

1.3. SCOPE OF THE DISCUSSION PAPER

The focus of this discussion paper is on micro-insurance as defined above. This will include the complete insurance value chain covering re-insurance, insurance, intermediation and policyholders. The paper will commence by developing a more specific and operational definition of micro-insurance that is suitable to the South African context.

Health insurance and savings products excluded. Due to their distinct nature and challenges, long-term savings products and indemnity health insurance[5] have been excluded from the discussion. Personal accident and disability policies as provided under the Long-term and Short-term Insurance Acts are, however, included.

Social assistance excluded. The definition of micro-insurance explicitly focuses on risk management mechanisms managed on accepted insurance principles of contribution and risk pooling. While social welfare seeks to support the poor and does mitigate risks, it is not done on the basis of insurance.

Social security reform referenced. Keeping in mind that a South African social security system at this stage remains in the design phase, its overlap with the envisaged micro-insurance landscape will be contextualised to the extent possible.

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[5] Indemnity health insurance resides under the Medical Schemes Act, 131 of 1998, and cannot be provided under the Long or Short-term Insurance Acts.

1.4. STRUCTURE OF THE DISCUSSION PAPER

A central finding of this document is that micro-insurance risk (prudential and consumer protection[6]) is in the first instance determined by the nature and features of the insurance product written and then by the way in which this complexity is managed by the insurer and the intermediary. As a result the document is presented in seven parts.

- Section 2 introduces the policy objectives pursued by government in the management of the financial sector and principles of good regulation aiming to tailor regulation where it is most required while reducing the cost of imposing such regulations.
- Section 3 provides the context on the current micro-insurance market in South Africa and the current regulatory framework.
- Section 4 then proceeds to develop a definition of micro-insurance suitable to the South African context. This is done by combining the features of the current market (as per Section 3) with an analysis of the product-related risk determinants (Section 4.1).
- Based on this definition, Section 5 outlines the various options for writing micro-insurance in South Africa and identifies the challenges and barriers faced by these. In particular it also develops the basic framework and requirements for a dedicated micro-insurance license. The latter is achieved by applying prudential risk management principles to micro-insurance as defined.
- Section 6 focuses on the intermediation of micro-insurance and, in particular on balancing access with consumer protection. Firstly the section considers the various sources of consumer risk and the extent to which these are addressed by the limitations imposed on the micro-insurance definition. Subsequently, the current regulation of intermediation and the impact this has on the market is considered. Adjustments to current regulation are recommended in order to facilitate micro-insurance intermediation while ensuring consumer protection. Finally, the need for enforcement of illegal operators is highlighted, a strategy for which must be developed to dovetail with an intensive consumer awareness and education campaign (as proposed).
- Section 7 outlines the proposed micro-insurance framework by summarising the recommendations made in the preceding sections.
- Section 8 considers particular impacts of the proposed framework and regulatory changes.
- Section 9 compares the proposed framework to international experience and challenges.
- Section 10 concludes the review and outlines the process ahead.

[6] We note that the ultimate purpose of prudential regulation is also consumer protection, but that this is done by ensuring the viability and stability of the sector. In this document consumer protection refers to the non-prudential aspects of regulation aimed at ensuring consumer protection. This is largely driven by business conduct considerations, which includes intermediation regulation.

2. OBJECTIVES AND PRINCIPLES FOR MICRO-INSURANCE REGULATION

As basis for the rest of this discussion, this section articulates the key policy objectives that the proposed regulatory changes in this document seek to support, including those of other government functions to which this should be aligned. In addition, a set of “principles of good regulation” is introduced to guide the implementation of the proposed framework. Whereas the objectives deal with the overall goals of regulation, the principles seek to provide guidance to the implementation and day-to-day management of the regulatory environment by the supervisor.

2.1. POLICY OBJECTIVES

The proposed micro-insurance framework needs to take account of the multiplicity of policy objectives across government functions which may impact on this market. These policy objectives are not always aligned and may (unintentionally) in some cases be in conflict. It is, therefore, useful to commence the discussion by identifying the policy objectives that are relevant to this process. In doing this, we can explicitly consider how they affect the proposed regulation and where potential conflicts may arise. This, in turn, will facilitate a process whereby the objectives can be differentiated based on priority and conflicts explicitly managed.

Below we highlight (in no particular order) the policy objectives which have been identified as relevant to the current discussion and provide examples to illustrate how they have been taken into account in the proposed framework:

- *Financial Inclusion.* The basic objective of financial inclusion is to extend the number of people that can use a particular product or service which is relevant to their needs. In particular, inclusion seeks to extend such products and services to vulnerable population groups such as the poor. This objective is clearly captured in the Financial Sector Charter. The insurance regulator can support inclusion by removing barriers on the demand-side and supply-side to respectively allow individuals to access the financial services they need and for financial service providers to provide relevant and appropriate products to the broadest market possible. In addition, financial inclusion may also be supported by providing incentives and support on both the supply- and demand-side that will encourage the extension of the formal market. Such support may include a variety of initiatives such as amnesty programmes that facilitate the formalisation of informal and illegal players, consumer education programmes, government ‘approval’ in the form of certification for legitimate providers, and the creation of clear and simplified regulatory regimes that will support legitimate players in conducting their business in the most efficient manner, etc.
- *Competition and market efficiency in order to improve the products and services delivered.* In the context of financial services this may be achieved by encouraging a wide range of financial services providers to provide their products to as wide a market as possible and to compete in the process of doing so. This may include avoiding unnecessary regulatory barriers that prevent the introduction of new business models and technologies (e.g. the use of mobile phone networks for premium collections), avoiding regulations that may unnecessarily increase the cost of delivery for particular models or products, and ensuring a regulatory framework that accommodates varied institutional forms (e.g. co-operatives or

mutual financial service providers). This paper seeks to support competition by limiting regulatory barriers to the minimum risk-management regulatory obligations (balanced with protecting consumer interests). It also seeks to create the space for new types of entrants who can compete in the micro-insurance market, including co-operative insurers. Furthermore, the suggestions on intermediation and disclosure seek to stimulate competition by allowing a broader variety of intermediaries and also to improve the ability of clients to judge the comparative value proposition of different products. It must be noted that the complex nature of insurance products (even where simplified) will weaken competition as a force to ensure efficiency and value.

- *Financial sector development.* This objective recognises that it is not only about extending the coverage of the market (i.e. inclusion), but also facilitating overall development by improving the nature and quality of provision and creating the space for innovation. The insurance regulator can support development by providing clear and unambiguous regulatory frameworks and by visibly supporting market development. In addition, the regulator can support innovation by taking a pro-active and flexible approach to accommodate new models and technologies.
- *Stability.* This traditional objective of financial services regulation seeks to ensure trust in the financial industry by ensuring that financial service providers (FSPs) are appropriately managed and are able to deliver on their commitments to clients. This recognises the fact that individual failures may affect the trust and performance of the system as a whole. While this is may be more immediately obvious in the banking space, it is also true for insurance.
- *Consumer protection.* While this is also the ultimate objective of the drive towards stability, there are other more direct ways in which consumer protection is pursued. This includes regulation of market conduct of intermediaries, consumer education programmes, as well as ensuring easy access to consumer recourse mechanisms. With limited capacity, the benefit of the latter approach is that it allows the regulator to focus capacity on problem areas rather than allocating capacity to all transactions.
- *Empowerment.* This objective impacts at various levels in the financial industry. It relates to empowerment through ownership and employment equity (financial regulation could for example support the development of emerging black enterprises in the form of co-operative insurers, emerging black intermediaries and funeral parlours), but also includes empowerment through the design and delivery of financial products to black households which were not appropriately served in the past.
- *SME development.* Overlapping somewhat with the empowerment agenda, this objective recognises the importance of small business for economic development. Regulation could support this by creating the space for smaller insurers and intermediaries as well as various means through which smaller entities can participate in the insurance sector.

The proposed regulatory framework has to be reconciled with and, as far as possible, support the policy objectives noted above. As noted, these objectives and the processes to achieve them are not always aligned and may even be in conflict. We illustrate the potential conflicts and how this discussion paper seeks to resolve them with two examples:

- *Inclusion and consumer protection.* Current consumer protection regulation has increased the cost of intermediation and has complicated the provision of micro-insurance, which may undermine the objective of inclusion. While this regulation is essential for consumer protection, it is necessary to ensure that it does not impose unnecessary restrictions on

providers and intermediaries. As an alternative, regulatory emphasis on product simplification, simplified disclosure and easy access to recourse, all support consumer protection while minimising the regulatory burden. This is discussed further in Section 6.
- *Empowerment, SME development and consumer protection.* As noted under the objective of stability, illegal insurance provision by, for example, funeral parlours is of concern to the FSB. However, if the current insurance regulation is enforced, many of these funeral parlours may be forced to close as they will be unable to comply with requirements and will face difficulty in legalising their insurance portfolios. While this may be required from stability and consumer protection points of view, these funeral parlours also represent a large number of black-owned SMEs who serve a very large proportion of the funeral insurance market (dominated by lower-income black households). By closing them down, the insurance regulator may undermine the objectives of small enterprise development and black economic empowerment. To reconcile these objectives the enforcement of insurance regulation should be combined with active support for funeral parlours in legalising their operations. As a result, this discussion paper recommends that co-operation with other government departments such as the dti and the Department of Health be sought in order to design such support programmes. This is discussed in Section 2.3 below.

2.2. PRINCIPLES

In addition to the policy objectives, it is also necessary to consider principles of good regulation, as these will guide the practical implementation of legislation. Such principles are often included in the mandate of the supervisory bodies to ensure efficiency in the day-to-day implementation of regulation.

Based on the FSB strategic review for 2004-2007[7] and a review of similar principles adopted in other jurisdictions[8], the following guiding principles of good regulation have been identified against which the new framework should be assessed. It is also suggested that these principles should guide the implementation and management of the proposed framework:

- *Efficiency and economy:* Resources need to be applied in the most efficient and economic manner and the aim should be to minimise the impact of regulation on the regulator (i.t.o. capacity) and on the market. In particular, care should be taken to consider and minimise the administrative burden created by regulation (particularly on smaller entities). Where possible non-regulatory options should be considered, including no regulation.
- *Proportionality:* The restrictions imposed on the industry must be proportionate to the benefits that are expected to result from those restrictions. This principle requires the regulator to take into account the cost of regulation on firms and consumers.
- *International character:* The regulator should facilitate global competitiveness and integration by compliance with international standards and best practices. As far as possible, therefore, regulations should be compatible with relevant international standards

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[7] The FSB Strategic review for 2004-2007 identified its objectives for this period as: Stability and prudential regulation, enhancing competition, encouraging sound governance, ensuring consumer protection, reducing financial crime and, where relevant, complying with international best practices. In addition the FSB strategy recognises that regulation needs to facilitate and support globalisation and needs to be responsive to the principles entrenched in the Financial Sector Charter (i.e. facilitates financial inclusion).

[8] http://www.fsa.gov.uk/pages/About/Aims/Principles/index.shtml, http://www.coag.gov.au/meetings/250604/coagpg04.pdf

and best practices. Compatibility does not necessarily mean uniformity. International standards need to be adapted to suit domestic conditions and constraints.

- *Innovation:* It is desirable for the regulation to facilitate innovation. This involves, for example allowing scope for different means of compliance so as not to unduly restrict market participants from launching new financial products and services. It also requires the regulator to take pro-active and timely steps to ensure that the regulatory space is created for new and innovative business models and entities. Where regulatory frameworks do not currently exist for specific new models, this will require pro-active and flexible efforts from the regulator in order to allow innovation while still managing the potential risks.
- *Competition:* Although competitiveness is not the primary responsibility of the insurance supervisor, care should be taken to minimise the adverse effects of regulation on competition and facilitate competition between regulated firms. In practice this will include avoiding unnecessary barriers to entry and biasing regulation against particular categories of firms.
- *Predictability of outcomes:* In its actions, the regulator should seek to provide regulatory certainty for current and potential players in this market. To provide certainty in a fast-changing environment such as that prevailing in the financial sector will require the articulation of desirable outcomes that will guide individual decisions by the regulator, thereby providing certainty to market players.

The regulatory framework proposed in this document should be evaluated against these principles.

2.3. ALIGNMENT WITH OTHER GOVERNMENT PROCESSES

In addition to the above objectives, the proposed framework also takes account of other financial regulation processes which impact on the insurance and micro-insurance market. Once agreement has been reached on the regulatory framework for micro-insurance, further efforts will be required to ensure alignment with these processes. Some of the relevant processes that have been taken into account are noted below:

- *The Co-operatives Act and the need to align it with insurance regulation*. The Co-operatives Act of 2005 seeks to create the space for co-operative insurers. The legislation distinguishes between guaranteed and non-guaranteed benefits[9], thereby creating the regulatory space for co-operative burial societies offering non-guaranteed products to operate without having to comply with the more onerous requirements of the Long-term Insurance Act. For co-operatives offering guaranteed benefits, the Act establishes the co-operative as a legal entity which can become an insurer under the Long-term or Short-term Insurance Act. Two problems emerge: (i) the Act does not provide any reduction in regulation over full insurers (registration under the Long-term or Short-term Act and all that it entails, including becoming a public company, is still needed)[10]; and (ii) the sub-

[9] Part 3, Chapter 13, Section 94.

[10] Furthermore, the insurance acts exempt friendly societies from insurance registration, should they provide benefits of no more than R5,000, but not co-operatives. Appendix 4 captures the issues surrounding the Co-operatives Act and the unintended disincentives it creates.

regulations governing co-operative insurers have yet to be developed, thereby still leaving a regulatory vacuum.

- *Financial condition reporting* is a recently launched initiative (currently at discussion paper stage, expected to be implemented from 2010) to bring the management of capital requirements in the short-term insurance industry on par with proposed international best practice and to align it with the FSB's risk-based supervision approach. Appendix 5 contains an overview of the proposed system. While desirable over the longer term, the prescribed model as currently proposed may result in increased capital requirements (beyond what the risk portfolio may require) for institutions that are unable to develop internal models. This is a particularly likely scenario for smaller insurers, as well as cell captive insurers, as the prescribed model is calibrated on industry averages. This is clearly of concern to this discussion process where the aim is to minimise the cost of regulation on micro-insurance and avoid unnecessary regulatory barriers. The objective of complying with international standards needs to be carefully balanced against the objective of financial inclusion[11]. This document supports the process of moving to risk-based regulation, but proposes that registered micro-insurers fall beyond its scope (as there is a fixed minimum capital amount that must be held in terms of the micro-insurance license).
- *Social security and retirement fund reform*. The proposed introduction of a comprehensive social security system, coupled with retirement fund reform to introduce mandatory retirement savings (with a concomitant wage subsidy and changes to the retirement fund tax system), is an important aspect currently driving financial sector and social welfare policy in South Africa. It is likely to interact with the micro-insurance market insofar as it may entail death (survivor) and disability benefits for members or their families. The implementation of these reforms will take some years and their scope regarding risk benefits is yet to be fully determined. Furthermore, the proposed social security system aims to provide basic insurance benefits, preserving space for voluntary private micro-insurance provision. In defining micro-insurance and recommending a regulatory scheme appropriate to it, the likely impact of the proposed social security system and the role for private sector provision within this system will need to be taken into account.
- *Commission restructuring*. In March 2006, National Treasury produced a discussion paper that proposed, amongst others, changes to the structure of commission on long-term products. While most of the paper is focused on savings products, risk products are loosely included. Currently, commission on long-term products is paid up front. The paper proposes a move to a hybrid system where part of the commission will be paid up front with the balance paid over the term of the policy on an as-and-when basis. The impacts of this process on micro-insurance risk products need to be monitored and aligned. In 2008 National Treasury expects to start looking into the commission of risk products in both the short-term and long-term insurance space. This process will further inform the micro-insurance debate around commission structuring, and vice versa.
- *Protected Cell Company (PCC) legislation for cell captive*. There is currently no separate regulatory regime for cell captive insurers. Internationally, there is a move towards PCC legislation, a regime that could also be considered for South Africa (but would then be

[11] The schedule proposed for implementation places South Africa ahead of the EU, which only aims to implement "Solvency II", as the process is termed there, by 2010/11. Solvency II can be regarded as the insurance equivalent of the Basle II in terms of banking regulation. The World Bank (Honohan & Beck, 2006) has however discouraged African countries from implementing Basle II too soon due to the strain it places on resources.

classified as company law, rather than financial sector legislation). There are no indications that this will serve to increase the cost of regulation to companies. Rather, consultations with industry indicated that it will formalise what is already practiced and will lead to greater certainty by even more clearly ring-fencing different cells. Should South Africa eventually embark on a process of designing a PCC regime, it needs to consider the impact on the framework proposed in this document.

- *Outsourcing*. The FSB has indicated that the practice by insurance companies of outsourcing certain core business activities to entities such as underwriting management agencies and administrators (also referred to as "white labelling"), is of some concern from a prudential and a market conduct perspective. While inappropriate outsourcing of risk is to be guarded against, it is also noted that the outsourcing of administrative and other functions is core to the provision of insurance to the low-income market. Micro-insurance regulation therefore needs to take into account any developments on this front. Registration should assess the capability of the micro-insurer to manage outsourced functions, as ultimately risk still rests with the registered entity. Again, the process of reviewing this aspect of the insurance market needs to consider the impact on the micro-insurance market.
- *The National Credit Act of 2005 (NCA).* Though not primarily focused on insurance, the new National Credit Act is relevant to the market for (often compulsory) insurance linked to credit purchases. Amongst others, it entrenches the obligation on financiers to provide customers with a choice as to the insurer or policy that they use and not merely to embed a policy in the product without the consumer even being aware of it. This may increase competition within the credit life insurance market. These impacts are supportive of the objectives and proposals in this document. However, developments on the implementation of the NCA should be monitored to ensure that the micro-insurance framework is aligned with that of the NCA and to monitor any unintended impacts on this market.

3. FEATURES OF THE MICRO-INSURANCE LANDSCAPE IN SOUTH AFRICA

This section provides a brief outline of the regulatory and market context for micro-insurance in South Africa as basis for the rest of the discussion.

3.1. REGULATORY CONTEXT

The current regulatory framework for insurance (and hence by implication micro-insurance) consists of five main pieces of legislation:

- The Long-term Insurance Act, no. 52 of 1998
- The Short-term Insurance Act, no. 53 of 1998
- The Friendly Societies Act, no 25 of 1956
- The Financial Advisory and Intermediary Services (FAIS) Act, no. 37 of 2002.
- The Co-operatives Act, no. 14 of 2005

Together these acts govern who may offer insurance products, which products may be offered and what requirements such providers must meet to ensure their soundness, as well as who may act as an intermediary and how intermediation should be conducted.

The Long- and Short-term Insurance Acts. The Long-term and Short-term Insurance Acts define insurance as a contract in terms of which a person, in return for a premium, undertakes to provide contractually defined (and, therefore, guaranteed) policy benefits upon the occurrence of a specifically defined event. Both acts define a number of classes of policies for which a company can register. The long-term insurance classes of policies include benefits payable in the case of a life or disability event, whereas short-term insurance policy classes relevant to micro-insurance include motor and property insurance or personal accident insurance. The Short-term Insurance Act also defines a “miscellaneous” category under which, for example, legal insurance may be underwritten. Both acts include a category of health insurance, which is defined to include capital insurance for health events, but exclude indemnity health products which are regulated under the Medical Schemes Act[12]. Effectively the result is a product category-based regulatory system[13] where the nature of the risk event underlying the product determines the level of risk held by the insurer and therefore the appropriate regulation. Currently different minimum capital requirements apply for long-term (R10m) and short-term insurers (currently a *de facto* minimum of R5m[14]), as well as different reserving formulas. Until recently, the Long-term Act utilised the product-based distinctions to create a reduced regulatory environment for assistance business (including reduced capital

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[12] Act 131 of 1998.

[13] Note that product regulation, where regulation is determined on an individual product basis and where each product has to be approved before launched is *not* applied in South Africa. Rather, the long and short-term demarcation within legislation is done on a product category basis and insurers are licensed, within this demarcation, to provide certain product lines (classes of policies).

[14] The de jure minimum capital required under the Short-term Act and, specifically, Regulation 2 to the Act, is a minimum of R3m or 15% of the previous year’s net premium, whichever is higher. However, the FSB’s Guidance for Registration of Long-term and Short-term Insurers specifies a minimum capital of R5m.

requirements). Increases in regulatory requirements have largely eroded the special regime provided for this category of business but it is still the only category for which commissions are not capped. Commission levels are capped for all other product categories and the cap is differentiated by product category. Both acts give the FSB the authority to reduce the capital requirement for specific insurers or allow them to build up their capital over a period of time. The Short-term Act does not require an insurer to have a statutory actuary (though does requires "appropriate skills" to ensure the sound management of the business are required), while the Long-term Act does. Furthermore, the Long-term Act requires that, where *assistance* policy benefits are paid in kind (for example via the provision of a funeral service), the policyholder is given the right to a monetary benefit; this is not required under the Short-term Act. Apart from these differences the two acts largely mirror each other in terms of compliance and other requirements. Both acts effectively require insurance companies to be *public companies*[15]. No single company is allowed to act as both a long and short-term insurer. Cell captive insurers and re-insurers are treated as normal insurers with special conditions attached to their license.

The FAIS Act limits the provision of intermediary services and advice (as defined in the Act) to authorised FSPs and their representatives. Intermediary services are defined to include any service with the objective to lead a client to enter into a financial transaction, or should it involve collecting premiums or receiving, submitting or processing claims. A representative is classified as any employee, agent or broker of an FSP whose role extends beyond clerical, administrative, or another service in a subordinate capacity, in turn defined as services that do not require judgment and do not lead a client to any specific transaction. In essence, to improve the flow and quality of information in the market and to ensure consumers enjoy full disclosure and protection from unqualified intermediaries, FAIS seeks to ensure that every person authorised to render financial services to a client is sufficiently qualified and "fit and proper" to discharge this responsibility. The Act also stipulates *how* advice is to be provided and structured, though it does not prescribe that advice is required on all transactions. This position is clarified in the FSB guidance note on Intermediary Services and Representatives, where those services not entailing advice or intermediary services are more clearly defined. The result is the emergence of a category of intermediary that is regulated under the FAIS Act, but is not subjected to the process requirements on the provision of advice and does not need to be an authorised financial service provider or representative.

Friendly Societies Act. The Friendly Societies Act provides for the registration of societies built on member-interest as legal persons. In practice, the majority of registered friendly societies are burial societies, many (if not most) of whom provide some form of risk pooling among members via society contributions and pay-outs in event of death. Should such societies wish to contractually guarantee the insured benefits, i.e. provide *insurance*, they are currently

[15] Under the Long-term and Short-term Acts, a registered insurer must either be a public company that has the carrying on of insurance as its main object, or must be "incorporated without a share capital under a law providing specifically for the constitution of a person to carry on long-term insurance business as its main object" (Section 9(3)(a)(ii) of the Long-term Act, mirrored in the same section of the Short-Term Act). Consultations with the FSB revealed that this latter provision does not make room for entities created under a general act, such as co-operatives, but is limited to organisations for which a specific act of parliament has been passed to allow them to register as insurers without being public companies. The most notable example is AVBOB, for which the AVBOB Mutual Assurance Society Incorporation (Private) Act, No. 7 of 1951 was passed.

allowed to do so up to an amount of R5 000 cover under an exemption to registration as an insurer provided for in the Long-term Act.

Co-operatives Act. The Co-operatives Act, no. 14 of 2005, which came into force this year, has taken the first step to create the space for financial services co-operatives (including co-operative burial societies) to provide insurance. Where benefits are contractually guaranteed, the co-operative insurer is required to register under the relevant insurance acts as well, with all the corresponding requirements and institutional implications. The Long-term Act has not yet been adjusted to allow for co-operatives as an institutional form to provide insurance, and regulations regarding the functioning of financial services co-operatives have not been drafted. The result is that it is still effectively impossible for a co-operative to offer insurance under the Long-term or Short-term Insurance Acts. If it wishes to do so, it would have to transform itself into a public company and comply with the full set of regulations applicable to insurers.

Apart from these acts pertaining directly to insurance provision, other areas of regulation may also impact on the provision of micro-insurance. These include the National Credit Act (which could increase competition in the credit-life market) and the initiatives around the access targets set under the Financial Sector Charter. As mentioned in the introduction, there are also a number of current and upcoming regulatory developments, the possible impact of which needs to be provided for to ensure that micro-insurance is part of a coherent financial sector regulatory framework.

Micro-insurance has not developed as a separately defined or regulated market in South Africa. Low-income products such as funeral insurance are provided through mainstream insurers and are therefore regulated as part of the overall insurance regulatory system (as set out above). However, three instances where current regulation does create a lower compliance burden for micro-insurance type of products can be summarised as:

- In the Long-term Insurance Act of 1998, an assistance policy is defined as a life policy of which the aggregate value of the benefit does not exceed R10 000, “or another maximum amount prescribed by the Minister”. Though assistance policies are not given special treatment in the rest of the Act[16], Part 3 of the regulations to the Act, where commission structures are defined, stipulates assistance business to be the only type of long-term policy not to be regulated for commissions (i.e. to enjoy uncapped commissions).
- The FSB’s Board Notice 104 of 2004 makes an exemption regarding the minimum qualifications required of Category A (assistance business insurance) intermediaries of long-term insurance (as defined in the fit and proper determination). This exemption expired on 30 September 2007, but was extended to 31 December 2009.
- The Long-term Insurance Act exempts registered friendly societies from registering under the Long-term Act, provided they do not provide guaranteed benefits in excess of R5 000 per covered life.

[16] Lower capital requirements were in place previously, but this provision was removed with the introduction of the new Long-term Act in the late 1990s.

In all of these instances, the type of insurance to be awarded special treatment was defined in terms of the product provided (funeral insurance), which in turn was defined based on a threshold value of the benefit, rather than the characteristics of the policy holders or the levels of the premium. This document considers whether such special treatment could be extended to an expanded list of micro-insurance products.

3.2. MARKET CONTEXT

This section does not attempt to provide a detailed market review but rather to highlight the salient features relevant to this paper. The discussion focuses on the features of the formal market, but also notes the presence of informal and illegal providers. As micro-insurance has to date not been formally defined in South Africa, we focus the discussion on the products and players that are targeting the lower-income market (including those developed under the various Financial Sector Charter initiatives).

3.2.1. PROVIDERS

Well developed insurance sector. South Africa has one of the highest insurance penetrations in the world when measured in terms of premiums as a percentage of Gross Domestic Product (GDP). Premiums make up slightly less than 14% of GDP, which far exceeds the emerging market average of 3.9% and the industrialised country average of about 9% (SwissRe, 2006). There are 188 (82 long-term and 106 short-term) registered insurance companies in South Africa with collective premiums of R211 billion in 2005 (FSB, 2006).

Comparatively large formal micro-insurance sector. Although still small relative to the rest of the insurance sector, South Africa has a large formal micro-insurance sector compared to its peers. This is dominated by funeral insurance, a market which developed without government pressure and on a completely commercial basis. Unlike other insurance products, the demand for funeral insurance is so strong that the product is said to be "bought rather than sold". A*ssistance business* (as funeral insurance is referred to in regulation), is defined as a line of long-term insurance business with benefits currently limited to R10 000 in value. Such business makes up only 1.3% of the total market in terms of premium (FSB, 2007)[17]. Given the low premiums for this product the total premiums understate the size of the market. Out of the 8.7 million individuals reporting in the FinScope 2006 survey to have some form of formal life cover (including funeral), 60% (5.2m people) have funeral insurance policies only. Currently, there are just four insurers registered for a standalone assistance business license (of which two are in the process of winding down) out of 28 active assistance business providers (FSB, 2006). Over the last decade, the registration conditions for operating as a funeral insurer have

[17] Returns and data are reported to the FSB according to lines of business that an insurer is registered for. Assistance business is one such line, and its reporting is therefore not limited to insurers *only* providing assistance business. There is however no guarantee that data is reported in the correct category. Not all assistance business will necessarily be funeral insurance: it may be that for example credit life policies of less than R10,000 in value are also captured as assistance business. Furthermore, policies of more than R10,000 will not be captured under assistance business, even should they be targeted at the low-income market. The share of assistance business in total net premiums increased significantly in recent years to 2.3% in 2005, before dropping to 1.3% in 2006 (as reported in the FSB's 2007 Annual Report). It is not clear what the reason for this recent drop is.

been increased to be the same as that of a full life insurer and there is, therefore, little incentive to register only as a funeral insurer.

Charter incentivises entry. Although not the only driver, the extension into the low-income market has gained added momentum since the signing of the Financial Sector Charter in 2003 and has extended beyond funeral insurance. In reaction to the Charter, the long-term industry (through the Life Offices Association - LOA) has developed CAT product standards (fair charges, easy access and decent terms) that are applied in the Zimele accreditation programme. A number of products have already obtained the Zimele stamp of approval. The short-term industry, likewise, has developed product standards through its association, South African Insurance Association (SAIA), though the initially planned product has not been launched due to regulatory considerations.

Acquisitions and new entry. Over the last five years, the market for funeral insurance has been characterised by both consolidation and new entry.

- *Acquisitions.* Whereas in 2003, the funeral insurance market was dominated by smaller independent players, a few of these players have since been taken over by large life insurers[18]. The market shares for funeral insurance now more closely resemble that of the overall life insurance market. These acquisitions, combined with a number of recent product launches, suggest a greater awareness among traditional, large insurers of the opportunities offered by the low-income market.
- *New entry.* The formal insurance market is seeing a number of new entrants focusing on funeral insurance. This includes administrators, micro-finance organisations and lower-income groups (for example unions), which traditionally obtained underwriting from registered insurers. In 2005 alone, three new long-term insurers were registered (FSB, 2006). This is driven by the desire for entities to provide their own products on their own terms instead of being dependent on existing insurers. Below we note that there have also been a number of new (non-funeral) low-income products launched by existing players.

Limited presence of formal mutual insurers. Formal mutual insurance is currently limited to a small number of friendly societies providing funeral cover under the exemption to the Long-term Insurance Act (which limits them to sell policies of up to R5 000 cover). Only 5 out of the total 220 registered friendly societies are registered to provide insurance (i.e. guaranteed benefits) and reported a collective premium of R41m in 2005. With the introduction of the Co-operatives Act of 2005, this market could be extended. However, the Co-operatives Act has only recently commenced and the regulatory framework for co-operative insurers still has to be developed. This will include drafting regulations to govern co-operative insurers and making the necessary amendments to the insurance acts to create the space for co-operative insurers. This document gives particular attention to the treatment of these types of entities in the proposed regulatory framework. One other formal mutual insurer in South Africa is AVBOB, a mutual society with more than 700 000 policyholder-owners that is allowed to operate as an

[18] Safrican and African Life were taken over by Sanlam in 2005. Sanlam furthermore acquired a 50% share in Channel Life and transferred its 55% holding in Safrican into Channel Life.

insurer under its own Act[19], and provided for in the Long-term Insurance Act's Section 9(3)(a)(ii). Having a special act passed in parliament is a difficult route to follow and it is unlikely that it will be achievable by a co-operative wishing to become an insurer without transforming to a public company[20].

Illegal and informal providers of funeral cover. Apart from the formal insurers noted above, a significant number of people obtain cover (currently limited to funeral cover) through informal as well as illegal channels:

- *Informal cover through mutual risk pooling mechanisms.* In contrast with the limited number of formal mutual insurers, there are a large number of groups acting as informal providers of risk cover. It is estimated that there are between 80 000 and 100 000 burial societies (each with on average between 50 and 80 members)[21] providing "helping hands" in times of bereavement, as well as, depending on the nature of the burial society, monetary or other benefits. These products are however distinguished from insurance in that pay-outs are not contractually guaranteed and will be limited to the available funds within the burial society (see the discussion in Section 5.1.1).
- *Illegal provision of funeral insurance, often through funeral parlours that self-insure.* Accurate data is not available, but qualitative research suggests that there is a significant number of funeral parlours offering illegal (i.e. not underwritten by a registered insurer) insurance. The take-up discussion below (Section 3.2.4) will indicate that, of all individuals responding that they have life cover, 52% stated that they only have burial society cover. Of the remaining 48% that have some form of formal cover, 58% have a policy with a funeral parlour. Much of the latter could be illegal (Finscope, 2006). This has been noted as an area of concern not only because of the insufficient management of the insurance risk but also due to the potential consumer abuse by operators that do not comply with the consumer protection and insurance legislation.

3.2.2. DISTRIBUTION

Regulation has increased the cost of advice and has contributed to the bifurcation of the market into advice and non-advice intermediation. The FAIS Act was targeted at improving the quality of intermediary services offered and enhancing consumer protection, particularly where financial advice is provided. This has had some unintended consequences. In seeking to improve protection it has also increased the cost of advice (on which the brunt of the regulation focuses) and in effect divided the market into advice and non-advice-based intermediation. The result has been an increase in the use of non-advice and so-called "tick-box"[22] sales models in an attempt to avoid the regulatory cost associated with advice-based intermediation. These

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[19] AVBOB Mutual Assurance Society Incorporation (Private) Act, No. 7 of 1951. A process will need to be agreed to between AVBOB, National Treasury and the FSB in order to align AVBOB with the new micro-insurance regulatory regime.

[20] Sanlam and Old Mutual, likewise, were mutual insurers under the 1943 Insurance Act, but demutualised at about the same time as the introduction of the new insurance regime in 1998 (Sanlam demutualised in 1998, Old Mutual in 1999).

[21] Genesis 2004, quoting FinScope 2003 data.

[22] "Tick-box" or "tick of the box" sales is an informal term used throughout this paper to denote commoditised insurance sales, for example via a retail store where insurance is bought off the shelf. The main characteristic of "tick-box" sales is that it is not actively sold and no advice or even verbal disclosure is given during the sales process. Also, the sales transaction is not conducted by financial service provider representatives, but by administrative/clerical staff.

models are particularly (but not exclusively) applied to the low-income market where they now dominate the intermediation of micro-insurance products. Concerns have been noted about the potential for misselling due to the limited information communicated to the client during the intermediation process.

New distribution models. Parallel to the move to non-advice models in the low-income market, innovative new business models have also emerged where insurers partner with retailers, cell phone air time vendors or other groups to distribute insurance products (e.g. through joint ventures or, more recently, through cell captive arrangements). Not only does this significantly extend the reach of formal insurers, but it also benefits from the often strong low-income brand presence of the distribution partner. These models are still quite new and have yet to prove themselves. Some of the features include:

- *Cell phone technology.* In at least two cases, cell phone technology is used to sign up customers and to communicate premium payments (e.g. made at the retailer by buying a voucher and inserting its number to "top up" insurance cover, similar to loading pre-paid airtime).
- *Cash premiums.* The new distribution models also allow for cash payments of premiums, often through retailer networks.
- *Passive sales.* The retailer models rely on off-the-shelf purchases by the client and the product is not actively sold. While this reduces the cost of intermediation, it is yet to prove its success in achieving take-up, particularly for new non-funeral insurance products. In addition, initial reports are that too many policies are discontinued within a couple of months of purchase (data is therefore also needed to monitor lapsed policies). As noted above, the limited information provided to clients during the intermediation process raises concerns about potential misselling.

3.2.3. PRODUCTS

New products extend beyond funeral insurance. In addition to the entry of new institutions and business models, a number of new low-income products have also been launched. Driven by both Financial Sector Charter pressure and market forces, the products on offer still focus on funeral insurance but increasingly also include legal insurance, personal accident insurance, cell phone insurance and, to a more limited extent, household structure and content insurance. Apart from these standalone products, credit life remains an important product sold to the low-income market. Concerns about the opaque and compulsory nature of credit life insurance bundled with credit purchases are being addressed by the introduction of the new National Credit Act.[23]

The evidence of Financial Sector Charter pressure and increased competition is reflected in the changing features of the products on offer:

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[23] In response to negative media publicity mid-2007 about alleged abuses taking place in the credit insurance sector, SAIA together with the LOA initiated public hearings to unpack the abuse allegations, with the intention of bringing steps to remedy any findings of abuse. The final report of this investigation is expected in the first quarter of 2008. Notably, the alleged abuses identified are for a period preceding the National Credit Act, and so it will prove difficult to consider redress without yet being able to assess the full implication of the new Act.

- *Lower prices.* Although this market is still characterised by wide variation in prices, a number of cheaper products are now available (including family funeral insurance cover of R10 000 for premiums of less than R50 per month).
- *Simplified products.* Driven by the Charter product standards and also the recognition of the needs of the target market, the features of the products on offer are being simplified. Simplified disclosure and communication of essential policy information are also contained as part of the product standards.
- *Flexibility.* Under the Charter product standards, products now allow for some flexibility around defaults, which seeks to cope with the sometimes unpredictable and irregular income flows in the low-income market.

Short-term contracts underwritten on group basis. Another feature of the current low-income insurance market is that policies are written with contract terms of less than 12 months, even those sold under the Long-term Insurance Act. These policies are also underwritten on a group rather than an individual basis, which partly explains the shorter contract terms. Despite group-based underwriting, the products are largely individually sold (through for example direct, agent/broker or retailer marketing using the tick-box model).

Voluntary sales. A feature that distinguishes the South African market from much of the international experience with micro-insurance is that the bulk of the market is based on voluntary (rather than compulsory or embedded) sales. Much of the international market is dominated by compulsory credit life insurance products (typically provided through micro-finance institutions according to the so-called partner-agent model) where the client has no option but to take the insurance product attached to the credit.[24] Voluntary sales are an important feature that regulation will seek to retain and support.

3.2.4. TAKE-UP

Insurance penetration in the low-income market. Figure 1 below (based on FinScope 2006 data) indicates insurance penetration in the low-income market in South Africa. 56% of LSM 10 individuals have some form of formal funeral cover, reducing to about 33% of all LSM 1-5 adults. Burial society membership ranges from 21% in LSM 1-5 to 7% in LSM 10. It is important to note that funeral policies typically also cover the policyholder's family and even extended family. The result is that the level of cover may be higher than the proportion of policyholders noted here. Due to overlapping cover, it is difficult to derive estimates of what that level of cover could be.

52% of LSM10 individuals have life cover other than funeral, versus only 2% of LSM1-5. The contrast is even starker for short-term (general or asset) insurance: 48% of LSM 10 adults indicate that they have some form of general insurance. This is compared to only 0.5% uptake of general insurance in the LSM1-5 market (FinScope, 2006). The following diagram indicates usage of various types of insurance across LSM groups:

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[24] This is not to say that compulsory and embedded products are not prevalent in South Africa, as indeed they are, but that the South African market is unique in its strong market for voluntary insurance products too.

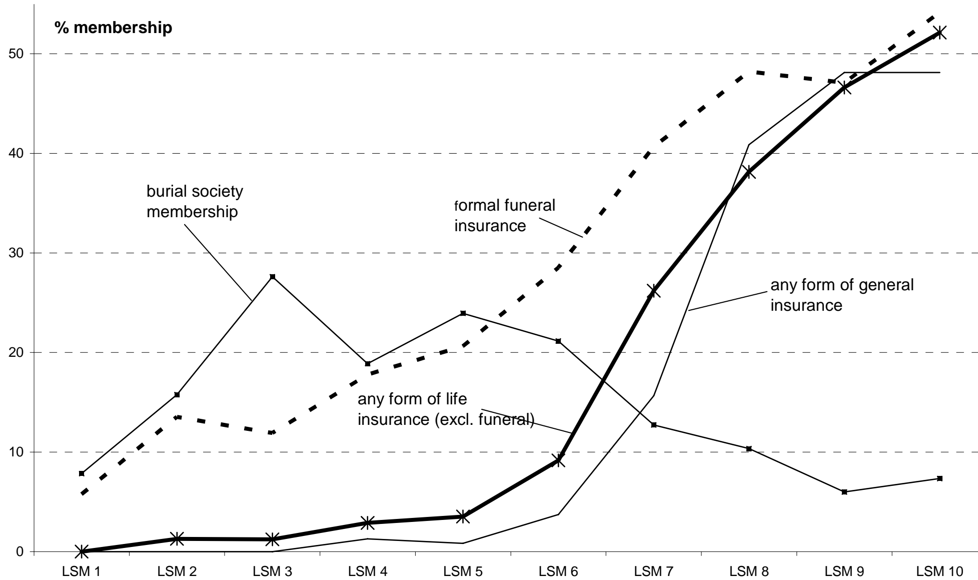

Figure 1. Insurance uptake across LSM groups.

Source: FinScope 2006.

Micro-insurance market dominated by funeral insurance. Despite the entry of non-funeral products, it is clear from Figure 2 below that funeral insurance still dominates products used by the poor and significantly exceeds usage of non-funeral life insurance, credit life insurance and general (otherwise known as short-term) insurance. In fact, the numbers for credit life and general insurance are extrapolated from such a limited number of respondents that they are essentially negligible. It must be noted that the number of people with credit life insurance is most likely underestimated by the survey[25] but the number is probably still lower than that of funeral insurance. Percentages in the figure denote proportion of the total LSM1-5 population:

[25] Due to current opaque sales practices many people will be unaware that they obtained credit life insurance with their loan or credit purchase (most of which will have credit life insurance bundled with it). It is also not possible to estimate the credit life penetration using credit figures as this is also significantly under-reported in the survey (a problem common to surveys).

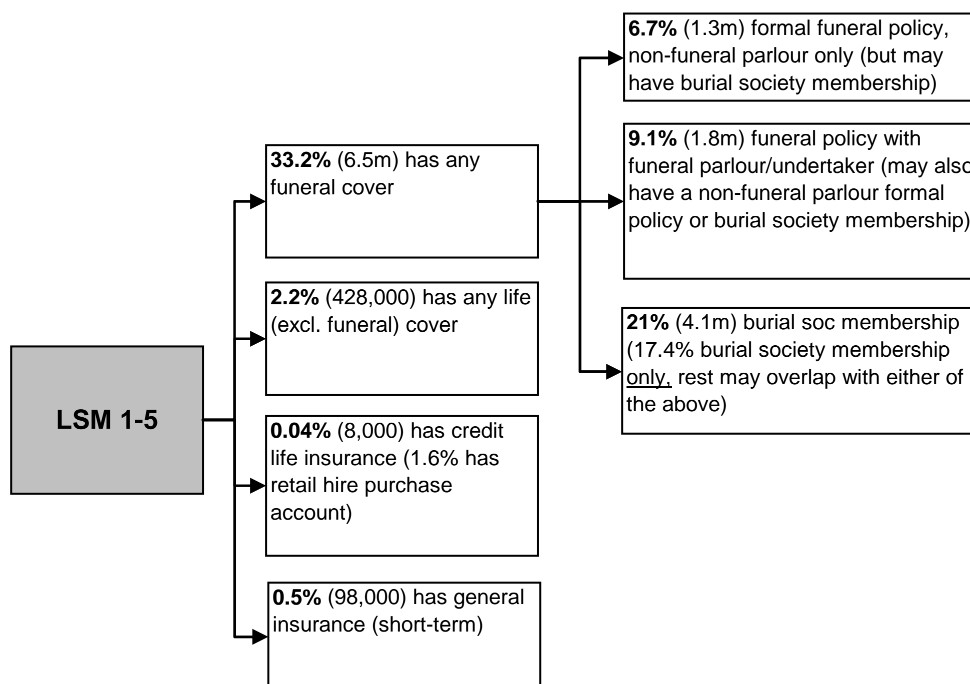

Figure 2. Breakdown of insurance usage among LSM1-5.
Source: Genesis calculations based on FinScope 2006 data[26].

Low-income market penetration on the rise for funeral products. A significant increase in uptake of funeral insurance was also recorded by the FinScope survey with individuals in LSM 1-5 reporting some form of formal funeral cover (formal plus funeral parlour as indicated in Figure 2) increasing from 8% in 2003 to 16% in 2006. Some caution must be taken in comparing FinScope data across years as some of the increase may be due to improvements in the questionnaire. However, data reported to the FSB also indicate a steady increase in the value of assistance business net premiums over this period. In comparison, the take-up of short-term insurance has remained stagnant at less than 1%. It is not possible to comment on trends for other lines of business, as their uptake in the low-income market is too limited or insufficiently recorded in the survey[27].

Of the reported funeral insurance usage, a large proportion is through informal burial societies or potential illegal insurers. Of the 33% (6.5m) of LSM 1-5 individuals that have any form of funeral insurance:

- *Informal.* 63% (4.1m) are members of a burial society and 52% (3.4m) are members of a burial society only (i.e. they do not use any of the other funeral insurance products). Although a proportion of the burial society uptake may actually be referring to formal

[26] Note that the way that the questionnaire is set up allows for overlap between different types of cover. Thus the percentages do not add up to a total.
[27] For example, survey responses tend to under-report on credit usage and due to current opaque sales processes, many individuals who have credit may be unaware of the fact that they also have credit life insurance.

funeral insurance products sold through informal societies, this is a limited phenomenon and is not expected to constitute a large component of the informal product usage.

- *Illegal.* 28% (1.8m) indicated that they obtained funeral cover through a funeral parlour. From previous research (Genesis, 2004) such policies may include policies sold by a funeral parlour that acts as the agent of the formal insurer or by a funeral parlour group registered as an insurer. In many cases, however, this reflects illegal in-house insurance schemes run by funeral parlours without any relationship with a formal insurer. It is not possible to identify illegal insurers through the survey, but anecdotal evidence suggests that it could be significant.

4. DERIVING A MICRO-INSURANCE DEFINITION SUITABLE TO THE SOUTH AFRICAN CONTEXT

At the simplest level, micro-insurance refers to insurance[28] products that are accessible[29] to and/or used by the poor. To operationalise this conceptual definition in the South African context, we propose that the definition of micro-insurance in South Africa should simultaneously achieve a number of specific goals:

- It should reflect the features of products demanded by the low-income market;
- Micro-insurance products as defined should generate sufficiently low prudential risk so that it can safely be provided by a wide range of insurers; and
- It should have features which allow it to be straightforward to distribute, without generating increased consumer protection risk.

The purpose of this section is, therefore, to develop an operational definition of micro-insurance, which meets the needs of the poor but limits the risk in order to justify putting in place a less onerous regulatory framework. We start out by considering the relationship between the product definition and prudential risk. This is then combined with the features of the products currently in the market (as noted in Section 3.2) to derive a micro-insurance definition suitable to the South African market.

4.1. PRODUCT-BASED DRIVERS OF PRUDENTIAL RISK

Guaranteed benefits create prudential risk. Insurance provides guaranteed benefits on a defined risk event in return for premiums which are paid in advance. If benefits were not guaranteed, the liability of the insurer would be limited to its assets rather than to its contractual obligations, as is typically the case with informal burial societies. Guaranteed benefits, therefore, create the risk that the insurer's liabilities in respect of expected future claims at some point in time may exceed the assets they have available to meet those claims.

The exposure for the insurer is driven by features of the risk taken on by the insurer (i.e. the nature of the insurance product sold) as well as by how well this risk is quantified and provided for. The first instance speaks mainly to how product features drive the prudential risk the insurer is exposed to and the second instance to how management and governance also handle this risk.

The product risk, in turn, is driven by two factors: the uncertainty over the claim event and the size of those claims. These are, in turn, directly linked to the nature of the insurance products written. The following product features are key drivers of risk:

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[28] Where insurance is limited to that which is funded by premiums and managed in accordance with generally accepted insurance principles to distinguish it from social welfare and other unfunded government emergency assistance or direct service provision.

[29] The definition of access includes that the product is appropriate to the needs of the poor, is affordable and is physically accessible.

- **Nature of risk event covered.** Some insured events happen with more predictability than others. For example, mortality rates in a given population of large enough size tend to be more predictable than disability or critical illness events, which tend to be less frequent and more subject to claims management and definitional uncertainties. As a result, it is easier for the insurer to predict the overall incidence of death claims and there is thus a reduced risk of underestimating the claims for any specific period. Restricting micro-insurance products to events that are more easily predictable or for which more incidence data is available will reduce prudential risk.
- **Indemnity basis**. Indemnity products (e.g. asset insurance) tend to pay out relative to the value of the loss suffered, rather than a fixed sum assured (e.g. for life and funeral insurance). There is, therefore, less certainty over the total amount of benefit which will be payable under such a policy relative to a simple life insurance policy paying a defined death benefit. This risk could be managed by setting a limit on total value of claims allowed within a specific period. However, this type of product remains more costly to manage and more susceptible to moral hazard (e.g. it can be harder to verify that an actual loss has taken place and to quantify the extent of the loss).
- **Term of the contract**. The term of the contract defines the time span over which the insurer needs to predict the risk experience. The longer the term, the more difficult it becomes to predict the claims and investment experience and the more likely it is that the claims experience will be affected by external factors beyond the control of the insurer. For example, under a 20 year life insurance policy the insurer needs to project two decades worth of mortality experience, investment returns and its own expenses to make sure it has sufficient available funds to pay claims. All other things being equal, under a one year policy there is a reduced chance that the insurer will get their pricing wrong and be unable to meet claims which fall in that year.
- **Benefit value**. Products with a lower benefit value will result in a lower liability to the insurer and will reduce the size of the potential mismatch between the liability that the product creates and the assets held to cover that liability. The fact that micro-insurance products tend to offer lower benefit values, will reduce the prudential risk of writing such products.
- **Product complexity.** Insurance contracts with numerous options and complex features will be harder for the insurer to price correctly and it will be more difficult to set aside appropriate funds to meet future claims. Complex product structures will also be difficult for customers to understand, possibly leading to the purchase of inappropriate products and misunderstandings at the point of claim. It can also increase the chance that there will be legal or operational problems, for example in respect of systems or fraud.
- **Extent of savings component**. Insurance products incorporating a savings component tend to be longer term and introduce additional risks associated with the investment returns achieved, market value fluctuations and liquidity. These products tend to be rare in the low-income market, and the investment risks they generate make them inappropriate for more lightly regulated providers.

Various permutations of the above-mentioned risk drivers are possible within any specific insurance product. The chart below shows how similar levels of risk can be generated by, for example, high claims size risk and low claims frequency risk, or low claims size risk and high claims frequency risk. The horizontal axis shows the impact of claims size on risk and the vertical axis shows the impact of claims frequency. Points along the dotted line indicate a similar level of risk, and the dotted lines further from the origin indicate a higher level of

prudential risk. Note that the diagram is indicative of relativities rather than being an exact quantification of the risks involved.

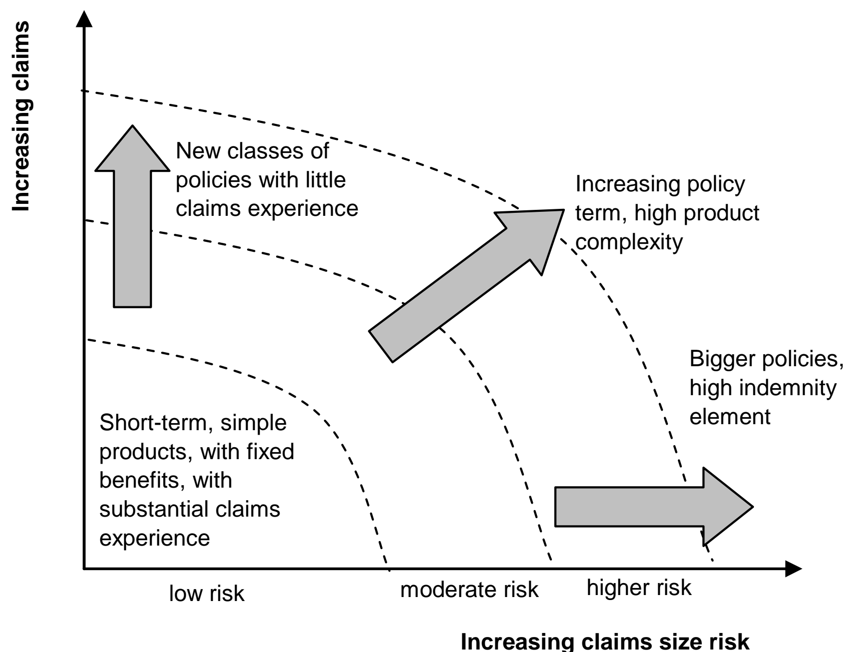

Figure 3. Map of prudential risk drivers

Source: Genesis Analytics.

These risk drivers generate a set of requirements which a regulator imposes on the insurer to control them, particularly around the minimum capacities the organisation needs to have in place to quantify and manage the risk, and the capital base it needs to have to absorb deviations in experience from what it expects. These will be discussed in Section 5.2.2.

4.2. PROPOSED MICRO-INSURANCE DEFINITION

Combining the risk drivers discussed above with the nature of current micro-insurance products in South Africa, as identified in Section 3.2, allows us to limit micro-insurance to a category of products that minimises (as far as possible) the prudential risk while still meeting the needs of the market.

Box 1. Salient features of current insurance products used by or targeting the poor (see Section 3.2 for more details).

- Dominated by life insurance (funeral and credit life) but property insurance products have been introduced (household structure and content, cell phone insurance, etc).
- Simplified. This is partly due to the Financial Sector Charter, but also due to the nature of the client base and their requirements.
- Limited benefits based on the (perceived and actual) cover required by lower-income households.
- Short-term. Most products tend to have short contract periods and are written on a group basis, or at least don't have individual underwriting.

The following definition will therefore limit the risk but still allow the key needs of the low-income market to be served:

- **Type of risk event covered: Allow both life and non-life events to be covered but limit products to risk only.** Based on the current market, it is anticipated that the list of products will include at least micro-life (extending current life insurance beyond just covering funerals), personal accident, household structure and content, cell phone insurance and legal insurance. There are still variations in risk within these categories; for instance, household structure insurance can involve high claim amounts and be subject to more moral hazard than simple funeral insurance. However, this list is intended to reflect a compromise between what are on average low risk products, and what is in demand by the low-income market.

  The key conditions for inclusion in the definition are that there exist sufficient data or claim experience to make the events relatively predictable for a small insurer, and that the financial impact of each event is relatively small and independent of others. For instance, weather insurance, while potentially useful in the low-income market, will not fall into this micro-insurance definition, as events are difficult to predict, their financial impact is high (creating high prudential risk) and they would impact many households in a small area in the same way. This type of insurance should be left to more sophisticated, well resourced and capitalised insurers[30]. In future, additional classes of policies may be added to the definition, should they be demanded by the low-income market and meet the risk criteria for micro-insurance.

- **Term: Contracts should be limited to a maximum term of 12 months[31].** Most (if not all) products targeting lower-income households are written on a short-term basis with contract terms of 12 months or less. This limitation is designed to allow a lighter regulatory regime for dedicated micro-insurers. This is not to say that there are no longer-term products which hold value to lower-income households. However, the increased complexity of these riskier products (and commonly a savings component) requires the more onerous regulatory regime currently applied to full insurers. We are also not proposing that regulation should dictate a minimum term but that insurers need to ensure that the product offers value and meets the expectations of the client. This does not prevent industry standards such as those developed under the Financial Sector Charter to set best and desired practices over and above that which is required by regulation.

- **Complexity: Products need to be simplified based on an agreed standard.** The Financial Sector Charter products have already made significant progress in this regard. We recommend that an agreed set of standards around simplification should be adopted in the regulatory definition of micro-insurance. We recognise that there are limits to the extent to which a legal contract can be simplified in terms of its conditions and features. We are,

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[30] Internationally, there have been efforts to develop parametrically defined weather insurance, e.g. payouts whenever rainfall exceeds or falls below certain thresholds. This kind of insurance however remains complex and parametric weather insurance has not yet developed to the extent that it can readily be provided by a relatively unsophisticated insurer.

[31] That is: the policy contract is valid for a period of 12 months, during which the premium rates are guaranteed, though the premium is payable monthly. Such short-term contracts can be automatically renewed if no party ends it after the 12 months have elapsed.

however, also clear that much of the complexity lies in the manner in which policy information is communicated rather than the policy terms and features themselves. This aspect of the micro-insurance definition should, therefore, be combined with requirements for sufficient but simplified disclosure during the sales process. For example, it is important that micro-insurance policy documents have simple policy document summaries, stated on the first page and clearly indicating the extent of cover, channels of consumer recourse, claiming procedures, exclusions and other main terms of the policy.[32] This is discussed further in Section 6.

- **Benefit levels: Total policy benefits should be limited to R50 000 per individual risk per year.** For instance, in funeral business cover will be limited to R50 000 per individual life on the policy per year. For household structure or contents insurance total claims over the year for a single dwelling will be limited to R50 000. Benefit levels affect both the prudential and consumer protection risks of the product. This R50 000 ceiling is suggested based on the levels of current funeral product offerings in the market, the proposed definition of Charter products and consideration of the prudential safeguards suggested in Section 5.2.2. For the sake of simplicity we recommend that one limit should apply across all product lines, and this limit seems to meet cover requirements in the low income market for most of them. Where different lines of business are bundled together (e.g. funeral and household structure) the limit should apply to each line separately. For lines of business where there is high risk from correlation of claims (household structure and contents is vulnerable to this), the regulator should require reinsurance to be in place as a condition for granting the license.

  In our assessment, the consumer protection considerations (as well as the justification for uncapping commission) require a lower limit than pure prudential considerations may dictate and this has been incorporated into the definition. Extending beyond this level of benefit increases the consumer protection risk, but also weakens the argument for reduced intermediation regulation and the need for uncapped commissions. This limit should be in regulation (rather than the Micro-insurance Act) to allow for adjustment from time to time.

Alignment with the Financial Sector Charter. We recognise that the proposed definition (particularly the limitations on benefit and term) does not include the full spectrum of products developed under the Financial Sector Charter. The intention of the micro-insurance definition is, however, different to that of the Charter in that it also seeks to create a space for micro-insurance providers for which the product definition limits the prudential risk. Insurers will earn Charter points if their products comply with the Charter standards irrespective of such products meeting the proposed micro-insurance standards. However, where it does not meet the micro-insurance standards, they will not benefit from the reduced regulatory regime proposed.

Figure 3 illustrates how the proposed micro-insurance definition relates to the potential market for low-income insurance. The low-income market can be served by products which result in both high and low prudential risk. The Charter definition specifies a subset of both levels of

[32] It is imperative for the policy document format and design requirements to feed into the consumer education strategy outlined in Section 6.

product. Micro-insurance is designed to pick out products which are low-risk from a provider point of view.

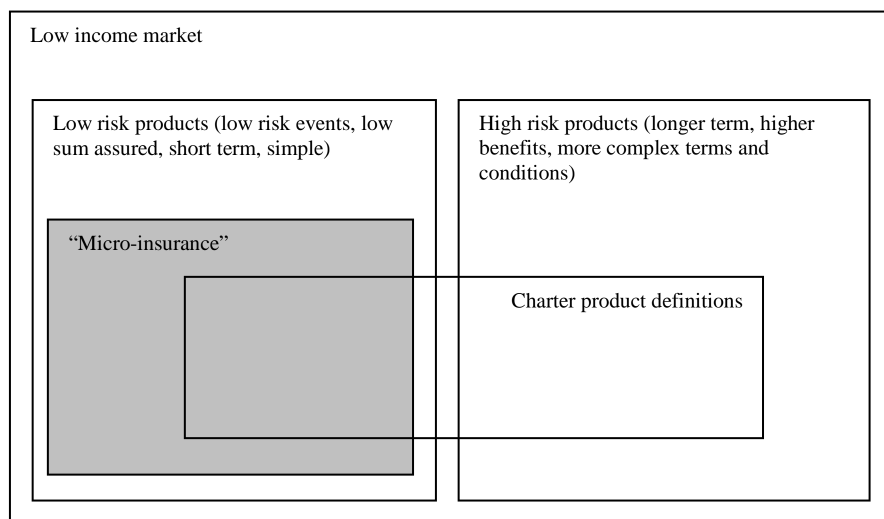

Figure 4. Micro-insurance within the low-income insurance market.
Source: Genesis Analytics

Implications of product-based regulation. A significant implication of the proposed definition is that it will require an extension of the current level of product regulation applied in South Africa. This has to be designed carefully as it increases the work-burden to the regulator, impacting regulatory capacity. The proposal is not that the regulator should pre-approve products prior to its release in the market. The intention is to define the simplest set of rules possible and the least onerous regulatory process based on which an insurer could benefit from the regulatory exemptions and reductions specified in the rest of this document. In Section 8, we explicitly consider what options the regulator has to implement a product regulation system for micro-insurance, and the impact this will have on regulatory burden and therefore capacity.

Sections 2 and 3 have outlined the rationale for creating a regulatory framework for insurance to the low-income market. Building on that, Section 4 developed an operational definition of micro-insurance suitable to the South African context. In the next two sections, a proposed regulatory framework will be developed for micro-insurance provision. In Section 5, we consider the options and regulatory framework for writing micro-insurance, focusing particularly on whether the prudential risk principles allow a reduced regulatory regime for dedicated providers of micro-insurance. In Section 6 we consider the options and regulatory framework for intermediating micro-insurance, focusing particularly on the room to allow lower-cost distribution while ensuring consumer protection.

5. DEVELOPING THE OPTIONS FOR WRITING MICRO-INSURANCE

This section considers the options and institutional framework for writing micro-insurance and whether any changes are required to facilitate the provision of such products. In particular we consider the need for and viability of creating a regulatory space for dedicated micro-insurers.

- The analysis commences by setting out the framework of options currently available for the writing of micro-insurance products.
- Within this framework we then note the position of a potential dedicated micro-insurance license.
- Following this we proceed to consider the feasibility of such a dedicated micro-insurance license. This is based on the finding that current regulation may be too onerous and that the limited definition of micro-insurance creates the space for a lighter regulatory regime without increasing the risk to the sector or consumers. This section concludes with the changes to the regulatory framework that will be required to implement such a license.
- In the final section we also consider some of the challenges faced by the existing options under which micro-insurance can be written.

5.1. FRAMEWORK OF OPTIONS FOR WRITING MICRO-INSURANCE

The low-income market is currently served in a number of ways. In addition to the formal options we also recognise that informal mechanisms support risk management for the poor and need to be recognised in the micro-insurance framework.

5.1.1. BURIAL SOCIETIES AS INFORMAL RISK-POOLING MECHANISMS

Burial societies play an important role in risk management for the poor. Most burial societies do not guarantee benefits to members. These non-guaranteed risk-pooling activities do not qualify as insurance and accordingly fall beyond the scope of insurance regulation. This is recognised in the new Co-operatives Act, which provides an institutional home for burial societies and states that, where they do not provide guaranteed benefits, they do not need to register for insurance provision under the insurance acts. Notwithstanding, recognition is given to the fact as burial societies increase in size, so the risk of improper risk management and fraud increases. Indeed, the technical distinction between guaranteed and non-guaranteed benefits does not assist a member who believes that they are covered for a death event when in fact there are no funds left for distribution.

Fraud risk. Some cases of fraud and theft have been reported but there is no evidence to suggest that this is pervasive. In mind though is that as burial societies increase in member-size so fraud cases become more prevalent, and organisation formalisation more relevant. In any case, combating fraud falls beyond the scope of insurance regulation and within the ambit of general criminal law enforcement. One of the key problems faced by burial societies is that they do not have a clear legal identity (besides that conferred by common law). The new Co-operatives Act seeks to address this by establishing a statutory legal personality that will facilitate their legal actions and recourse.

Burial societies to remain exempted from insurance regulation. It is suggested that the proposed micro-insurance framework should explicitly recognise the role played by burial societies and that, where burial societies have less than a prescribed number of members (to be actuarially assessed on risk based principles), have an annual income below a prescribed amount (e.g. the current figure of R100 000, but to also be actuarially assessed on risk based principles), and do not offer guaranteed benefits, they should remain exempted from all insurance regulation.. Where societies grow in size beyond the membership and annual income thresholds or progress to providing insurance, the framework should allow them to utilise the relevant options available for the formal provision of insurance, as set out below. Burial society associations should ensure that they communicate the non-guaranteed nature of their business clearly to members and also incorporate this into their rules.

5.1.2. SPECTRUM OF FORMAL OPTIONS FOR WRITING MICRO-INSURANCE

There are a number of ways in which formal sector players can currently provide micro-insurance to the low-income market:

- By obtaining underwriting for the products;
- By buying into a cell captive;
- By registering as a Friendly Society offering limited insurance benefits; or
- By registering as a full long or short-term insurer.

In addition, this paper proposes that a future option be added: by becoming a licensed micro-insurer (a new regulatory space below that of a full insurer).

Underwriting. Any entity (including burial societies, affinity groups, sole proprietors, etc.) that wants to provide micro-insurance to its members or clients but that is unable to underwrite the risk or conduct the day to day management of those products itself, can obtain underwriting from a formal insurer. All risk is transferred to the underwriting insurer and the entity effectively acts as an intermediary, but with more input to product design and options for co-branding. The extent of flexibility that the insurer will be willing to offer will depend on the size of the potential client base.

Removes need for capital and skills and provides scale. Underwriting removes the need to have capital and management expertise and allows the organisation to benefit from the scale of the underwriting insurer's risk pool. The insurer can safely underwrite several independent groups which are individually too small to manage risk themselves.

Independent of institutional form and not limited in benefits provided. Essentially any group, regardless of institutional form, can obtain underwriting. For example, a funeral parlour registered as sole proprietor may obtain underwriting in order to offer an insurance product to its clients. The underwriting route then further permits the entity in question to distribute products that do not fit into the micro-insurance definition (e.g. longer term, bigger policies), as long as the underwriting insurer has the license to write these products. As reflected in some cases, the entity may take a bigger role in developing the product for which it obtains underwriting rather than simply on-selling the products of the insurer.

Dependent on existing insurers. For many groups and organisations, underwriting therefore represents a convenient first step into the formal insurance market. It would however imply that the client-facing entity remains dependent on an insurer and that underwriting profits (and losses) are ceded to the underwriting insurer. In the past, some organisations have found it difficult to interest insurers in their client bases and, in particular, to negotiate adjustments to the insurer's policies to meet the needs of their client base. Given Financial Sector Charter pressures and the increased interest in the low-income market, this may now be less of an obstacle.

Cell captives. Where the entity seeking to offer insurance desires more autonomy in the product design and management processes and wants to share in the profit of the risk management, it could buy into a cell captive, thereby in effect renting a part of a formal insurer's insurance license. Even though the entity may share in the underwriting profits, the ultimate risk is still transferred to the cell provider (a registered insurer). As with underwriting, this channel permits the provision of riskier products that extend beyond the proposed definition of micro-insurance.

Cell captive mechanism. A cell captive insurer, also called the "promoter-cell", is a registered long- or short-term insurer that is registered to "sell" individual cells (in the form of separate classes of shares) to groups or organisations that then do not need to obtain a license of their own[33]. The insurer has arrangements in place to ensure that each and every cell is solvent and enters into a "shareholders agreement" with each and every cell-owner to notionally ring-fence cells (as required by the special conditions placed upon its long or short-term license). But in the final instance the cell captive insurer is liable for all prudential risk and other cells may therefore ultimately be affected by losses made in one cell. Reinsurance and the prudent monitoring of cells together can minimise this risk.

Allow provision of insurance while building up skills and capital. Similar to the underwriting option, cell captives have emerged as a way for low-income groups and other entities to offer insurance to their members/clients. This allows them to build up the capital, scale and skills to potentially become an insurer in their own right. The FSB has received the first application for an insurance license from an organisation that is currently a cell owner. This organisation was previously a funeral parlour that opted for the cell captive route as the first step to legalise its insurance business. Other microfinance institutions have also opted for the cell captive route in order to offer insurance to their clients.

Centralised operations reduce cost and minimum capital required. Apart from carrying the prudential risk, the cell captive insurer centralises compliance and reporting, as well as pricing and other skills, thereby reducing operational cost and risk for the cell. The cell captive model works on the principle of internal risk assessment: the cell captive will assess the book of the individual cell and, based on the risk, determine the amount of capital that the cell has to hold with the cell captive to cover contingencies. Only the cell captive insurer is required to hold statutory capital. The individual cell capital holding is determined as part of the shareholder's agreement between cell promoter and cell owner.

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[33] See Appendix 3 for an overview of the regulation of cell captives in South Africa versus internationally.

Flexibility requires a minimum portfolio size. Though a favourable option to facilitate micro-insurance, cell captive models are restricted by the scale required by the cell owner for viability. Thus, not all groups will be able to buy into a cell captive insurer. Current market practices and models differ significantly with some cell providers requiring prospective groups to have premium flows of more than R10m per year whereas others would accept premium flows starting from R1m per year.

FAIS challenges. A current challenge to cell captive insurers is the fact that they are ultimately held accountable under FAIS for interactions with the policy holder. This implies that they need to ensure that no FAIS transgressions take place inside the cell, or even with the representatives or intermediaries servicing the cell. This creates particular challenges for information systems as the cell promoter is required to report regularly on the business conducted throughout all the cells. In many cases, this may mean that the promoter has to extend their own management information systems into each of the cell operations to ensure that integrated reporting is possible. While it may be necessary to ensure consumer protection, it increases the cost and risk of dealing with cell owners. This is particularly the case where the FAIS Act has not yet been fully enforced and, as a result, cell promoters are compelled to deal with unsupervised intermediaries. While improving enforcement across the spectrum of insurance providers and intermediaries (as proposed in this document) will improve this situation, FAIS compliance of cells in a cell captive structure is likely to remain a challenge.

The mis-use of cell captives to evade commission regulation. In the 2007 credit insurance hearings coordinated by the insurance industry associations SAIA and the LOA, evidence was presented alleging that the cell captive structure is employed by insurance intermediaries to share in the profits from the sale of white-labelled insurance products with the insurer, thereby getting returns that would otherwise contravene the insurance commission regulations prescribed under the Long-term and Short-term Acts. Of caution is not to jeopardise a potentially pro-development structure on the grounds of abuses taking place in other parts of the insurance industry. As commissions are currently unregulated for assistance business policies, and are proposed to remain unregulated under the new regime, the question of cell captives being used to avoid commission regulation is irrelevant in this context.

Friendly societies. Under both the Long-term and Short-term Insurance Acts, there are exemptions allowing registered friendly societies to offer insurance products as defined in the Friendly Societies Act[34] and limited to a maximum benefit value of R5 000. Unlike the first three options, the society carries the full risk[35] of its insurance business and must make the necessary provisions to meet its liabilities.

Friendly societies prevented from accessing cell captives. The Annexure to Regulation 29 under the Friendly Societies Act states that no more than 5% of the total assets of a friendly society may be invested in unlisted shares; 10% may be invested in listed shares where the company has a market capitalisation of less than R2000 million, and 15% in shares of listed

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[34] Primarily funeral cover, but also includes products such as short-term cover on the "tools of trade" of a member and unemployment insurance (see Section 2 (1) of the Friendly Societies Act for the objects for which friendly societies may be established).

[35] It may opt to obtain re-insurance, but is not compelled to do so.

companies with a capitalisation exceeding R2000 million. This may imply that some friendly societies cannot buy the share capital needed to acquire a cell, thereby effectively preventing friendly societies from using the cell captive mechanism.

Full insurance license. Of course, it is possible to offer micro-insurance by registering as a full long-term or short-term insurer and meeting all the requirements of the respective acts. These requirements will be relatively onerous given the limited risk of micro-insurance business.

Potential micro-insurance license. In addition to the formal options currently available and described above, this discussion paper considers the option of an explicit regulatory space for dedicated micro-insurers. The intention of such a space will be to reduce some of the regulatory requirements, based on the more limited risk of the micro-insurance products, while extending products and operations beyond those currently allowed for friendly societies and mutual entities. This will allow micro-insurers to compete for micro-insurance business in their own right rather than being dependent on an underwriting insurer. This is discussed further in Section 5.2.

Note on graduation from one option to another. The intention is also for graduation to be allowed from [licensed] micro-insurer to full insurer. So micro-insurers that in time meet the full registration requirements under the Long-Term or Short-Term Insurance Act may then register under either act and be allowed to expand their product offering. (Under the current rules a micro-insurer offering Long and Short-Term business would have to split into two to fulfil the requirements of each Act if it wanted to formalise.) Micro-insurance is a type of intermediate step – less strictly regulated, but with more limited products. Of course, graduation to a full insurer is not mandatory and organisations may choose to remain micro-insurers. Likewise, if an entity cannot yet meet the requirements of becoming a micro-insurer, there are other alternatives that can, in turn, be stepping stones to providing insurance, such as underwriting and buying into a cell captive.

Role of re-insurance. Re-insurance is a means of passing on a contractually specified proportion of insurance risk from one insurer to another insurer in return for a premium. This mechanism plays an important role in the insurance market as it enables pooling of large risks across multiple insurers and jurisdictions. Under the South African insurance legislation, re-insurers are registered as short-term or long-term insurers with their license restricted to offering re-insurance[36]. As a result, they are not allowed to deal directly with policyholders (individual or group), affinity groups or other non-insurer entities. The only exceptions are that they may apply to deal directly with funds, medical schemes and registered friendly societies.

Re-insurance facilitating graduation. The entity obtaining the re-insurance manages all the day-to-day aspects of the insurance business and has a contract with a re-insurer which transfers specifically defined financial risks. Re-insurance is only an option for ceding entities which themselves are capable of carrying some risk. That is, such entities will have to be registered as a risk carrier themselves either as full insurers, friendly societies or, potentially, micro-

[36] Re-insurance arrangements can however be entered into between direct insurers as well.

insurers. In the case of friendly societies and micro-insurers, re-insurance could facilitate their graduation to full insurers.

Practical constraints on re-insuring friendly societies. In practice there are some constraints on friendly societies accessing re-insurance. Currently only one re-insurer is registered to deal with friendly societies but is not doing so. Reasons for not re-insuring friendly societies include limited business opportunities and operational risks presented to the re-insurer by relatively unsophisticated entities. A lack of management skills and proper systems make it difficult for re-insurers to engage with friendly societies.

Potential role to reduce micro-insurance risk and costs. As a stepping stone in the graduation scheme, the re-insurance option therefore seems to be of limited value in the current market. In future, it could potentially fulfil a valuable function if licensed micro-insurers could pass some of their risk directly onto re-insurers. In addition to risk-sharing, re-insurers have also supported smaller insurers in developing and pricing products in return for buying re-insurance on their portfolio. This can be a less expensive alternative to directly employing actuaries or other expertise to do pricing and risk management.

Consideration will also have to be given to the role of the re-insurer with regards to the new category of co-operative insurers under the Co-operatives Act. This relationship has not yet been defined and will depend on whether co-operative insurers will operate under a new micro-insurance regime or operate under the Long-term or Short-term Insurance Acts (or both).

Emerging framework for writing micro-insurance

In this paper, the options described above combine to provide a comprehensive regulatory framework for writing micro-insurance risk and can be represented schematically as shown in Figure 5 below:

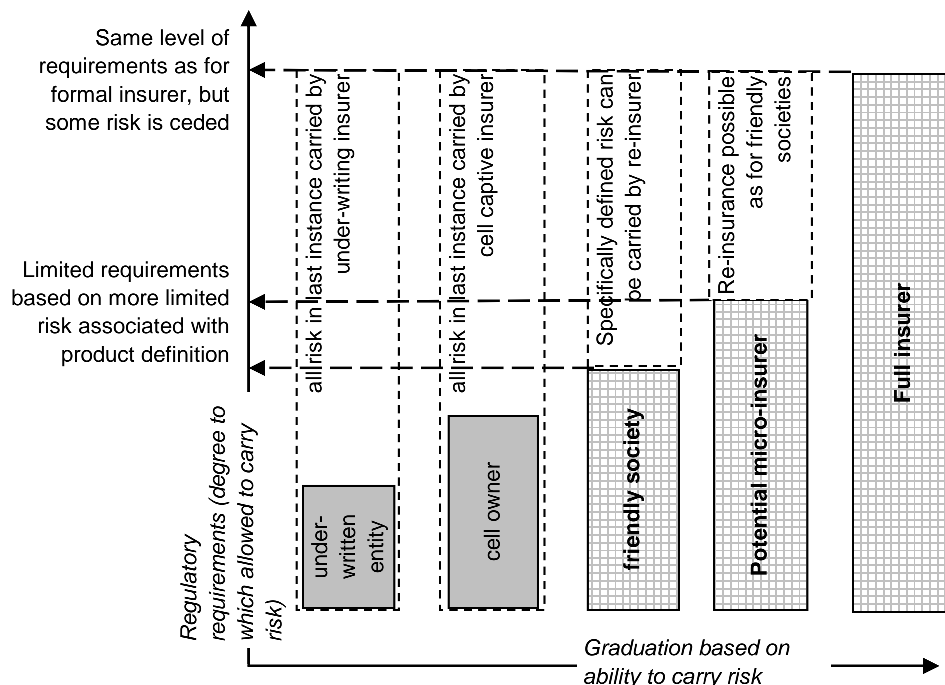

Figure 5. Insurance provision: institutional graduation to becoming a full-fledged insurer.
Source: Genesis Analytics

The following features of the above framework should be noted:

- *Ceding risk.* The first two options are vehicles that cede all risk to fully licensed insurers. As a result the products offered and the extent of risk management could be the same as for the full insurance license. Friendly societies present an intermediate option where the society is allowed to carry some risk in its own capacity but may also access re-insurance.
- *Carrying risk.* Combined with the friendly society option, the next two options carry risk in their own right. In the case of both friendly societies and the proposed micro-insurers, the products allowed to be written (and, therefore, the risk allowed to be carried) are restricted.
- *Graduation.* The different options show a progression or graduation to becoming a full insurer in the final instance. This is not necessarily a simple linear progression as it is shown in the diagram and it is not necessary to progress through all stages to become a full insurer. The entity buying into a cell captive arrangement may, for example, actually carry more risk than is allowed for a friendly society. Furthermore, the cell captive mechanism can be used to grow an insurance portfolio to the point where it can directly transform into a fully registered insurer.
- *Various entry and sustainable points*. Entry can happen at all levels and organisations may choose to remain at a specific level and not progress to become a full insurer. Organisations wanting to provide insurance should consider the full range of available options. It may, for example, initially make more sense to obtain underwriting than to register as a micro-insurer, in order to build up capital and/or skills levels. For a small insurance portfolio, it may also make more sense to use the cell captive option even if requirements for a full license can be met. The small risk pool will make it difficult to cover the fixed costs and also increase the risk charge making it difficult to offer value to clients. If the core function of the organisation is not to offer insurance, it may opt to remain within the underwriting or cell captive options even if it could meet the requirements for the other options. The micro-insurance license should therefore not be regarded in isolation and is not intended to become the only option for writing micro-insurance.
- *Friendly societies interfacing with co-operatives.* A question remains as to the role of friendly societies verses co-operatives as alternative institutional structures for community based organisations. At issue here is the current legislative overlap between the two forms that may facilitate regulatory arbitrage moving forward (particularly with regard to benefits permitted and tax treatment). Argued to be an outdated and ineffectual act, offering insurance type benefits under the Friendly Societies Act (whether guaranteed or not) may be phased out in favour of the co-operatives legislation. Until that time, registration as a co-operative or friendly society will take place with the Companies and Intellectual Property Registration Office (CIPRO) and the FSB respectively, while any co-operative or friendly society that wants to write its own micro-insurance business must register under the envisaged license and be supervised by the FSB.

The focus in the rest of this discussion paper will largely be on creating the space *for a micro-insurance license* as an explicit option within the larger scheme. The proposed micro-insurance license may however not be appropriate or within reach for all organisations, particularly smaller ones. It is, therefore, important to ensure that the alternative options are available and

efficient. These options will help to build smaller entities to the level where they can consider registering as micro-insurers or even full insurers. It will also allow these entities to offer some competition in the low-income market while they are not yet able to compete as full insurers.

5.2. THE OPTION OF A DEDICATED MICRO-INSURANCE LICENSE

Given the risk profile of micro-insurance products defined in Section 4, what should be the minimum institutional requirements placed on micro-insurance? In this section we consider the current requirements on insurers and argue that they may be unnecessarily onerous for the micro-insurance product category as defined. This will be used as grounds to define the regulatory space for a micro-insurance license.

5.2.1. EXISTING REGULATION MAY BE UNNECESSARILY ONEROUS

Insurance regulation is aimed at limiting entry into the market to organisations which are able to manage the insurance risk sustainably. If too strict, such requirements may, however, also prevent entry of possibly capable insurers. There is evidence to suggest that the current requirements may be too strict for the risks presented by micro-insurance (as defined in Section 4). Below, we consider some of the potentially restricting requirements in the current insurance regulation.

Operational capabilities. For insurers writing business explicitly based on death and morbidity events the rules of the Long-term Act apply. Many policies under this Act are in force over several years and often involve the build up of substantial investments. The rules under the Act tend to be more onerous and expensive than those under the Short-term Act, particularly including involvement of a statutory actuary, accessible at all times, to monitor and report on the insurer's ongoing financial soundness. Short-term business is defined under its Act as business relating to other insurance risk, and tends to be written in the form of one year renewable policies. In this sense micro-insurance as defined above is more closely related to Short-term business than Long-term, so the set of capabilities required in the Short-term Act will be more appropriate and the application of Long-term regulation (as is currently the case for assistance business) will be an overly strict regime.

Institutional form. The requirements of the Long-term and Short-term Insurance Acts restrict the provision of insurance to public companies. This does not present a significant barrier to private companies as the cost of transforming into a public company is not significant. However, it does present barriers for entities such as friendly societies and co-operatives where the process of transforming into a public company may be onerous and costly and inconsistent with their member-based structure. It is therefore important to consider whether the public company requirement is necessary. We do that by assessing what the requirement to be a public company contributes to governance and regulation of insurance providers. It entails three main elements:

- *Public reporting*: Public companies are required to submit their financial statements to CIPRO, where they are available for public scrutiny. While this presents a useful additional level of scrutiny, in practice it does not appear to alleviate policyholder risk. Individual policyholders rarely go to the effort to access the reports at CIPRO and institutional investors and market analysts only tend to focus on the largest entities. We suggest that

reporting sufficient information to the regulator for effective supervision is more important and is required by both insurance acts, independent of institutional form. Public reporting could be included as an additional requirement under the envisaged Micro-insurance Act if it is shown to add value.

- *Audit requirement and fit and proper standards for management*: These are requirements of public companies and private companies under the Companies Act, but are also independently required by the Long-term and Short-term Insurance Acts. The requirement of being a public company in the insurance acts, therefore, does not add anything in terms of these requirements.
- *Governance process and structures*: Listed public companies are required by the listing rules of the JSE Securities Exchange to comply with certain requirements in the King Code, but unlisted public companies are not. However, all companies are subject to the corporate governance rules contained in the Companies Act. Non-companies may then require corporate rules in the proposed Micro-Insurance Act to level the playing field.

The requirement to convert into a public company poses significant barriers to co-operatives and friendly societies desiring to provide insurance beyond the limits allowed by the Friendly Societies Act. The result of the above is that whilst recognising the value of the public company form based on the three requirements described, we can ensure a level playing field (and the implied additional protection to policy holders that this offers) across various institutional forms, by building these rules into the micro-insurance requirements. We conclude that as long as the presence of skilled management and skilled non-executive directors is stipulated in functional regulation (e.g. in the envisioned Micro-Insurance Act) and the regulator is able to effectively supervise using audited financial statements, institutional form should not be a key consideration for the micro-insurance framework.

Note on the implications of the Companies Bill, 2007 for the institutional form of micro-insurers. Upon the enactment of the Companies Bill, the traditional categories of companies (public vs private) will fall away and be replaced with[37] not-for-profit companies (to succeed the current Section 21 companies) and for-profit companies. The latter can be classified as either “widely held” or, if not so, then “closely held”. A company qualifies as a widely held company:

(a) If the company’s Memorandum of Incorporation –
(i) permits it to offer any of its shares to the public;
(ii) limits, negates or restricts the pre-emptive right of every shareholder; or
(iii) provides for the unrestricted transferability of any of its shares; or

(b) a majority of its shares are held by another widely held company, or collectively by two or more widely held companies or inter-related persons, any one of which is a widely held company.

[37] Definitions taken directly from a summary of the Companies Bill of 2007 by the South African Institute of Chartered Accountants (SAICA). Available from: https://www.saica.co.za/documents/Main%20Features.pdf

The draft also introduces public interest companies, which have greater responsibility to a wider public from a corporate governance and reporting perspective. A public interest company is defined as:

(a) a widely held company; or
(b) a closely held company, or a not for profit company, that:
(i) is predominately engaged in certain activities, namely taking deposits from the public or ***exercising a public trust***, having a substantial or significant impact on the environment, contributing to public health or supplying or maintaining essential goods, services or infrastructure; or
(ii) satisfies any two of the set three criteria (thresholds are defined in terms of monetary value, annual turnover and number of employees).

It is our view that full licensed insurers and micro-insurers would fall within this definition as captured by "…or exercising a public trust". Accordingly, rules implemented to equalize treatment across institutional forms will need to take these developments into account.

Provisions for corporate governance largely retains the existing regime designed to promote accountability and transparency[38].

Any reference in this Discussion Paper to companies, public companies, etc, will change in line with the Companies Bill, when enacted. Furthermore, in designing the corporate governance standards applicable to micro-insurance the changes proposed in the Companies Bill of 2007 will be considered.

Capital. Insurers are required to hold capital to ensure that they can meet their liabilities with sufficient probability[39]. There is a base level of capital required to meet expected future claims, and an additional layer of capital to allow for the risk that claims are higher than expected. The total capital requirements are currently subject to minima for both Long- (R10m) and Short-term (at a *de facto* level of R5m) business. So insurers will have to hold the minimum level of capital until such time as their base level of capital plus the additional layer exceed this and they have to hold the higher total. (There is a fuller explanation of the rationale behind insurance capital requirements in Appendix 8.)

Minimum levels high even for full insurers. According to the 2005 FSB returns there is a high proportion of insurers holding capital at the minimum, i.e. the capital requirements generated by the volume of in-force business have not yet exceeded the minimum stipulated by legislation. While not an automatic conclusion this can suggest that the minimum may be conservative. In the case of long-term insurers, for example, this suggests that the minimum capital required by regulation exceeds the insurer's own internally calculated base capital and the additional layer calculated with the risk-based stress tests laid out in actuarial guidance notes. The results for both long- and short-term business are given below:

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[38] Explanatory Memorandum to the Companies Bill, 2007. Available from: http://www.thedti.gov.za/ccrdlawreview/-part1companyBill1_145.pdf
[39] The theoretical rationale for these requirements is discussed in Appendix 9.

	Long-term	Short-term
Number of insurers submitting 2005 returns	69	87
Companies actively writing business and not fully reinsured	62	73
Effective level of minimum capital	R10m	R5m
Number holding more than minimum capital	32	50
Number holding minimum capital	25	23
Number holding less than minimum capital*	5	0
% holding more than minimum capital	52%	68%
% holding minimum capital	***40%***	***32%***
% holding less than minimum capital	8%	0%

* companies could hold below minimum capital if they have been permitted by the regulator and are building up to the required level of capital

Table 1. Ranges of capital held by registered insurers.

Source: Genesis calculations based on FSB returns (2005).

Funeral insurance capital the same as all other life insurance. Furthermore, there is no differentiation between the minimum level of regulatory capital that must be held by insurers offering only funeral cover versus insurers offering other types of life cover, despite the former being restricted to policies of no more than R10 000 in benefits.

The above does not prove that the minima are inappropriate, but it suggests that there is a case for revisiting them to ensure that the burden they impose are not unjustifiably excluding players writing less capital intensive business from the market. This will be particularly the case where insurers offer a limited set of low-risk products (e.g. current funeral insurers and the potential dedicated micro-insurer).

Further investigation would be required to determine the precise minimum levels with confidence, though a broad brush calculation is provided in Section 5.2.2.3 to illustrate the point.

In light of this discussion, recent trends to increase minimum capital requirements across the board are concerning. The de facto minimum for short-term insurers has moved to R5m (from the R3m noted in regulation) and there are proposals to increase it to R10m as part of the Financial Condition Reporting process (see Appendix 5 for a discussion of the proposed new regime).

5.2.2. REQUIREMENTS FOR MICRO-INSURANCE PROVISION

Based on the preceding analysis, this section considers the regulatory requirements that will be proportional to the risk posed by micro-insurance. Micro-insurance as defined in Section 4.2 is situated in the low risk region of Figure 3. However, an institution wishing to take on the risk presented by writing even small and simple micro-insurance policies will still attract some insurance regulatory requirements as a result. These can be categorised into *operational capabilities*, quality of *governance* and *minimum capital* to be held.

5.2.2.1. OPERATIONAL CAPABILITIES

As insurance consists of promises being made to honour future claims, it is critical that a micro-insurer is organised in such as way as to fulfil these promises. It needs to understand what kinds of promise it can make in the first place and on what terms and what the possible implications are. For this it needs certain minimum capacities in place.

Capabilities required are proportional to risk and complexity of business. Many of the skills required by a micro-insurer offering limited, low-risk products, will be similar qualitatively to those required by a conventional insurer. However, the level of capability will be lower (and, therefore less expensive) than that required for a full insurer due to the restricted product offering. The minimum capacities it needs to have or to have access to are, in approximate order of importance to managing prudential risk:

- *Fit and proper management* are required to coordinate all of the capacities described below, and maintain a viable business plan which projects the organization's operation into the future. Without governing structures that understand the risks presented by writing insurance business it will be impossible to detect if the micro-insurer is falling short in any of the capacities described and take appropriate action.

- A base of technical skills (possibly but not necessarily an actuary or similar) is needed to conduct *pricing* of even the simplest insurance business, and should be appropriately experienced for that type of business. Use needs to be made of mortality or other claim event tables or data with appropriate adjustments. Actual claims experience needs to be compared to that expected in the pricing in order to make ongoing adjustments to the pricing. Allowances need to be made in premiums so that income covers fixed and variable expenses. Even for the simplest micro-insurance business, repricing should be done at least annually. No statutory actuary is required.

- Furthermore, these skills will be needed to determine the *reserves* which need to be held to provide for future claims. Even if statutory reserve calculations are largely formula driven rather than relying on complex internal models, some expertise will be required to aggregate the correct data and apply the formula. For the very simplest short-term products, access to these technical skills would be required at least every year to review pricing and experience. Errors can drastically increase prudential risk as they can lock an insurer into commitments that it did not expect for a particular period.

- The institution needs an ability to manage a basic *product development* process, to identify customer needs, devise a product to meet them, and specify the appropriate policy terms and conditions. If a product is poorly designed and terms and conditions are badly specified, this can create risk for the insurer in that they have to pay claims they didn't expect to when they priced the product. This process could be done every few years if the micro-insurer is content to provide a line of standard, simple products.

- Insurers also need *claims management*, verification and payment procedures which are clearly set out and justifiable. This is to ensure that policyholders are treated fairly, and claim payouts are precisely in accordance with policy literature (neither above nor below), and to check that claims are in accordance with the assumptions used in pricing the policy.

While the policy and structures need to be set up once, they obviously need to be operational on a continuous basis and monitored frequently to check that they are not being compromised by changes in experience or fraud.

- *Accounting and auditing* functions are required to ensure sound financial management. This includes internal documentation of various procedures and processes, ability to report on cash flows and financial position, and provide required disclosure to regulators. This is necessary to ensure that cash flows are emerging as expected and alert management promptly to any prudential problems which may arise and require attention. As a result, a full time accounting function is required, with at least an annual audit to provide further security.

- *Reliable systems* must be in place for collecting, storing and analysing data records, so that the required technical analysis can be done. These systems will need to provide a basic level of data protection and integrity. Other required capabilities (e.g. technical, accounting) rely on these systems for their data and so the reliability of these systems is imperative to reduce prudential risk. There will be a relatively high set up cost, but also a need for ongoing monitoring. Product changes and re-pricing will generate requirements to change the systems too.

- The organisation also needs *new business processes* in place to process applications, issue policy documents and collect premiums. If there are errors in policy documents, the insurer could be legally liable for claims it hasn't priced for, and if premium collection is erratic, the micro-insurer could encounter cash flow problems which threaten solvency. A process can be put in place at start up but again needs to be staffed continuously and monitored fairly frequently to ensure that it is running as expected.

- A *compliance* officer must be appointed to ensure that legislation and regulations are being observed, including competence in interpreting the insurance acts and rules, FAIS, Policyholder Protection Rules, information confidentiality rules, etc. They could also be responsible for statutory disclosures.

Furthermore, a micro-insurer may want to *underwrite* products on behalf of another entity, i.e. carry the risk on white labelled products, but effectively outsource distribution to a third party provider. In its license application such a micro-insurer will have to demonstrate its ability to manage these relationships and the additional risk they create.

If any of these functions are *outsourced* (e.g. to a third party administrator or systems provider), the micro-insurer will need to have the appropriate expertise in place to negotiate, implement and monitor the contracts. Ultimately it is the insurer that will bear responsibility for mismanagement or errors made by the entities charged to perform these functions. The level of skill required will depend on which functions are outsourced.

Minimum levels and principles required for micro-insurance. As a result, the capability requirements on micro-insurers should be specified as fairly high level principles in micro-insurance regulation. The responsibility will be on the supervisor (where it currently rests with respect to short- and long-term insurers) to verify that a registered insurer or applicant for a license has the necessary operational capabilities for the specific products and business model

it is proposing. The minimum requirements outlined above constitute a base on which further, detailed guidelines can be built for more specific types of micro-insurance, e.g. systems specification requirements, etc.

Note on re-insurance. The micro-insurance license should be restricted to exclude re-insurance activities by micro-insurers (e.g. by a secondary co-operative micro-insurer to a primary co-operative micro-insurer), as the activity of re-insurance is considered as too complex to maintain the low risk-levels desired of micro-insurance. Full insurers registered under the Long or Short-term Insurance Acts may however re-insure part of the risk of a micro-insurer.

5.2.2.2. GOVERNANCE

To offer micro-insurance (or any type of insurance for that matter) all institutions would need to satisfy a minimum level of corporate governance. Corporate governance refers to the set of relationships between an organisation's management, board, shareholders/members and other stakeholders through which the organisation's objectives (as well as the strategy for obtaining them) are set and performance is monitored (OECD, 2004). Accordingly, corporate governance holds management accountable to the overarching goals of the organisation and ensures that, where needed, remedial action is taken. In a public company, such requirements exist to secure the interests of shareholders and policyholders, and in other entities such as mutuals, to secure the interests of policyholders as members. In South Africa corporate governance standards are set in institutional legislation such as the Companies Act, Co-operatives Act and Friendly Societies Act. In addition, the King Code of corporate governance is mandatory for listed companies and voluntary for other institutions.

At a minimum level, corporate governance typically requires:

Transparency. This can be achieved by adhering to the following requirements:

- Financial results need to be audited by an independent body.
- The audited financial results need to be submitted to the insurance supervisor and, once submitted, could be made public to allow for additional scrutiny.

Skilled non-executive supervision. This could include the following:

- Management needs to be supervised by a board or committee representing the interests of shareholders or policyholders. The members of this board need to have the appropriate expertise to enable them to evaluate the performance of management and the running of the insurance business effectively.
- There needs to be appropriately skilled non-executive/ independent members present on the supervisory board or committee. The fit-and-proper requirements that apply to non-executive directors should not only be stipulated in terms of what they should <u>not</u> be (i.e. their negative attributes), but also set minimum skills levels. The requirement for non-executive directors may be in conflict with the usual modus operandi of co-operative organisations, where the members perform governance. This needs to be taken into account in finalising the appropriate micro-insurance regime.
- If at all possible, the independent non-executive directors should comprise the majority of the board or committee.

These principles have a number of implications for micro-insurance:

- *Minimum corporate governance required.* The nature of insurance products and the complexity of risk management require minimum corporate governance standards to be adhered to. These standards are primarily designed not for the protection of the owners of the underwriting institution, but for the protection of policy holders. All institutions providing micro-insurance, irrespective of their legal form, should thus be subject to similar corporate governance requirements which should be calibrated to the level of risk management required.

- *Micro-insurance does not need to be limited to public companies*. Provided that the necessary operational capabilities are present and that minimum corporate governance standards are met, there is nothing inherent in the company structure that makes it more suitable for the provision of micro-insurance than other legal form. In fact, South African law already provides friendly societies to write a limited form of micro-insurance. We therefore propose that micro-insurance be written by a number of legal forms – public, companies, co-operatives and friendly societies – all of which will have to comply with the specific functional requirements imposed on micro-insurers.

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Box 2: Degrees of freedom for mutual institutions[40]?

There are certain minimum requirements relating to the way the business is conducted and the capital that needs to be held for an organisation to qualify as an insurer. New entrants in the micro-insurance sphere could include mutual organisations such as co-operatives or friendly societies and it is important to consider what mutuality entails for these requirements. Put differently, can mutual organisations, by nature of the way that they are constituted and governed, be treated any less strictly from a regulatory point of view? This question relates to three aspects: (i) the business skills and systems required, (ii) the capital required, and (iii) the corporate governance required. Governance is of particular interest in the case of mutual organisations.

Organisational capabilities. The systems and level of skills required relate to the business conducted, rather than to the institutional form of the insurer. Thus it would seem that, regardless of mutuality, the same level of skills needs to be present. Member ownership implies that members have direct control over decision-making and gives them a special interest in the health of the organisation. In comparison to normal shareholders, they are considered to be “closer to and more familiar with, and often themselves are, the target market” Qureshi (2006). However, this does not imply that the necessary management skills are present to ensure the most desirable outcome for the organisation. According to Qureshi (2006), financial co-operatives and other popularly based organisations often struggle or even go under due to a lack of management skills. Accordingly, regulation needs to ensure that these skills and systems are put in place as it is not guaranteed by the mutual form.

Capital requirements. A similar argument could be applied to capital requirements, which are defined by the riskiness of the business written. Thus a mutual writing one year assistance policies should be expected to hold the same capital as a formal insurer writing the same policies, assuming the policyholders of the two institutions are to receive the same levels of protection. However, historically mutuals/friendly societies have had lower levels of capital requirements than normal insurers (e.g. Australia applies no capital requirements, UK applies lower capital requirements on friendly societies with an annual turnover of less than £3.5m, Philippines imposes a small guarantee fund requirement far below the capital required for a formal insurer).

The underlying question is whether a mutual insurer’s liabilities can exceed its assets? In the case of Colombia it is

[40] Note that we refer to mutual organisations or institutions as any entities formed on the basis of mutuality, with members rather than shareholders. The term therefore does not necessarily refer to mutual insurers in the traditional sense of the word, but also includes friendly societies and co-operatives.

argued that for such insurers their liabilities are limited to their assets and, therefore, no regulation is required. If they only sell insurance to members, it is these same members who will collectively be responsible to honour the liabilities. In the case of the Philippines, member liability is made explicit in regulation which states that where a mutual benefit association (MBA) runs out of funds, members have to contribute to cover liabilities. It does, therefore, present a risk to members as they may have to stand in for the liabilities of the insurer. Enforcing this responsibility is, however, not a trivial matter. It will be very difficult to convince members to contribute more capital if the viability of the insurer is threatened and they risk losing more money. This suggests that it may be in the interest of mutual and co-operative insurers to follow the same minimum capital and regulatory regimes applied to commercial insurers offering the same products even if they only sell to members.

Corporate governance. It must be noted that the absence of a profit motive in mutual organisations (or more accurately, the absence of a third party shareholder profiting from the services provided to members of the organisation) increases the incentive for the management of the business to act in the interest of its policyholder members. However, while mutuality creates the incentive for members to participate in the organisation's decision-making processes, it will not always lead to the best outcome from a corporate governance perspective.[41] The benefit of mutuality is most likely to be felt in smaller organisations where member oversight is more effective, but is quickly lost in large mutuals where separation of ownership and management occurs. For the complex business area of insurance members are even less likely to have the competencies to supervise the ongoing financial soundness of the institution. Some regulatory mechanism is required to ensure effective corporate governance for mutual or co-operative insurers.

During 2004, Her Majesty's Treasury in the United Kingdom commissioned an in-depth review of the governance of mutual life insurers by John Myners. The Myners Review was commissioned after the discovery of gross management problems (some caused by inappropriate corporate governance arrangements) at a mutual insurer, Equitable Life. The report argues that although the nature of co-operatives or mutual insurers helps to alleviate the principle-agent problem that arises with other financing arrangements (such as public companies), it also creates a number of corporate governance dilemmas (described in more detail in Appendix 6).

Accordingly, the report recommended the adoption of an amended code of corporate governance (currently applicable to listed public companies) by mutuals. During 2005, The Association of Mutual Insurers (AMI) and Association of Friendly Societies (AFS) in the United Kingdom issued the Combined Code on Corporate Governance. Drawing on the Combined Code on Corporate Governance, the annotated version is tailored for special application to mutual insurers and friendly societies. Friendly societies and mutual insurers have been required to comply with the code on a "comply or explain basis". The AMI and the AFS required members to comply with the code from 2005/2006 and from 2007 the associations will start to publish details related to the compliance of their members.

The Code is structured in terms of principles, supporting principles and code provisions. Two key principles are:

- Board balance and independence: "The board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) so that no individual or small group of individuals can dominate the board's decision making (AMI & AFI, 2005: 8)."
- Information and professional development: "The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge (AMI & AFI, 2005: 10)."

The outcome of the above is that, while mutuality offers some benefits from a regulatory point of view, mutuality *per se* does not address all the risks and a minimum level of regulation will be in the interest of members and the sector.

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[41] See the complete argument on the conflicts that can arise within a co-operative setting and how these should be mitigated in Appendix 6.

5.2.2.3. CAPITAL REQUIREMENTS

An insurer's capital base has two elements, firstly, the base reserves to cover expected future claims, and secondly, the capital held on top of this as a buffer.

Base capital[42]. These capital amounts are sums of money that have to be held predominantly in respect of expected liabilities regardless of the type of business being written, whether micro or normal insurance. However if the insurer holds only these amounts, they will be vulnerable to deviations in experience from expected, e.g. if mortality rates are higher than predicted in pricing, if investment returns are lower, etc. As a result, additional capital is required to act as a buffer against this and lower prudential risk (see discussion on additional capital requirements below).

Micro-insurance reserving requirement similar to that of short-term insurance. Given the definition of the product, a micro-insurer will have liabilities very similar in profile to those of a short-term insurer, and the reserves and their calculation methods required under the Short-term Act are, therefore, appropriate for micro-insurance. The Short-term Insurance Act sets out various types of reserves which need to be calculated. They include:

- An Unearned Premium Reserve (UPR) – this is in respect of premiums which have been paid in advance but where the risk period to which they correspond has not yet elapsed. For business paid in monthly premiums, this usually equates to about half a month's premiums.
- An Incurred But Not Reported Reserve (IBNR) – this refers to claims which have occurred in a past risk period but which have not yet been reported to the insurer. It tends to be high for business with long-tail liabilities, but lower for micro-insurance business as defined – comparable to personal lines of short-term insurance.
- An allowance for claims which have been reported but where the final claim amount has not yet been paid. This is usually quite small.
- A contingency reserve of 10% of the last year's premiums.
- An Unexpired Risk Provision – this is a reserve which can be set aside in anticipation of future high claims if the insurer has reason to believe that the business currently in force has premium rates which are insufficient.

These reserves make allowance for expected claims on a basis that generally does not allow for additional conservatism (apart from the modest contingency reserve linked to premium). They therefore define a base capital requirement for micro-insurers. Note that these requirements are in the process of being reformed in the move towards Financial Condition Reporting (FCR), where the aim is for the capital adequacy of each individual insurer to be calculated with more granularity based on the specific risks that the business faces (a more detailed explanation of FCR is contained in Appendix 5). However, it is proposed that FCR as currently specified not be applied to micro-insurance, but that the traditional reserving requirements for short-term insurers be used.

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[42] Also referred to as the technical reserve.

Additional capital requirements. There are arguments to suggest that the lower prudential risk generated by micro-insurance as defined would justify lower additional capital requirements.

Stress tests point to reduced capital requirement for micro-insurance. High-level calculations[43] apply current reserving rules to three different hypothetical micro-insurers writing funeral insurance and with annual premiums of R5m, R10m and R20m respectively. For the base reserves it calculates the standard unearned premium reserve and incurred but not reported reserves as required for similar short-term business. The stress tests outlined in the Prescribed Margins and Capital Adequacy Requirements of the Long-term Act defines a reasonably conservative set of stresses[44] that the micro-insurer should be able to survive and is used to calculate the additional capital on these businesses.

The detail and results of these calculations are shown in Appendix 9 and suggest that the current capital requirement of R10m for funeral insurers is several times higher than is justified by the insurance risks these businesses present. They suggest that the current *de jure* minimum capital requirement of R3m for short-term insurance may be sufficient and even conservative for this type of business.

More detailed actuarial modelling will be required as part of the micro-insurance regulatory-design process to specify the exact minimum capital requirements appropriate for this business. Data and expertise will be required from industry to set these.

Investment restrictions. In addition to setting the level of capital required, regulation also limits the types and amounts of assets that the insurer is allowed to invest the capital in. These ensure that the nature of the assets held matches the nature of the liabilities of the insurer. For example, an insurer with short-term assets will have to hold a significant proportion of low risk, liquid investments to ensure that they can be sold without significant loss of value to meet claims if required. A long-term insurer may hold more risky assets like equities and move into less risky assets as policy term elapses and it becomes more likely that claims are imminent. Given that the micro-insurance definition limits these products to short-term contracts, it will be appropriate to adopt the same restrictions as those which apply to short-term insurers.

5.2.2.4. SUMMARY OF PROPOSED LICENSE CONDITIONS

The proposed conditions for a micro-insurance license are as follows:[45]

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[43] See Appendix 9 for details.

[44] Broadly these imply that the insurer has to hold sufficient capital to cope with: (i) doubling of lapse rates, (ii) worsening of mortality experience equivalent to about 25%, (iii) expenses being 30% higher than expected and (iv) worsening in investment experience of 20% (either through low returns or reductions in asset values).

[45] The parameters described below are to be considered a starting point , to be expanded or narrowed as the debate develops.

Operational capabilities

All micro-insurers must have the following minimum operational capabilities:

- Fit and proper management;
- A base of technical skills (but not necessarily that of a statutory actuary) for pricing and reserves calculation;
- The ability to manage basic product development process;
- The ability to manage claims and other procedures;
- Adequate accounting and auditing functions;
- Reliable information systems;
- Adequate processes to manage new business; and
- A compliance officer.

The FSB must verify that these requirements are satisfied upon licensing and, subsequently, via annual reporting to it.

Minimum corporate governance

Micro-insurers must satisfy a minimum level of corporate governance standards in terms of:

- Transparency
- Skilled (non-executive, where appropriate) supervision of management

These standards must be calibrated to the level of risk management required for underwriting micro-insurance products and can draw on the King Code of corporate governance and the corporate governance provisions contained in the Companies Act and Co-operatives Act. Micro-insurers will be required to meet such standards on a "comply or explain" basis and must report on levels of corporate governance to the supervisor as part of the regular reporting required.

Given these minimum standards, the legal entities allowed to register as micro-insurers can be extended beyond public companies (as is currently the case for insurers) to also include, friendly societies and co-operatives.

Capital requirements

- Base capital reserving requirements for micro-insurers will be similar to that currently expected of short-term insurers.
- An additional capital requirement of no more than R3m will be set (the exact level must however still be subjected to additional actuarial modelling before being finalised).
- Permission should be given to potential license holders to build up to this level of capital over a period of a few years.

Investment restrictions

The same investment restrictions that are currently applied to short-term insurers will pertain to micro-insurers.

Note on tax dispensation. Currently, not all providers of insurance are subject to the same tax regime. For example, tax law makes a distinction between public companies in general (under which short-term insurers will be classified) and long-term insurers. Cell captive insurers will be taxed as either long or short-term insurers. Friendly societies are income tax exempt. Co-

operatives will fall under the tax regime for public companies, with two exceptions: they can apply to be classified as a *small business corporation* (which has certain sliding scales for tax benefits), or as a *public benefit organisation* (Schedule 9), which also has tax benefits in that non-trading income is tax exempt. Which form is applicable will vary from co-operative to co-operative. The tax dispensation will be one of the factors influencing an organisation's choice of which legal entity to register as (as noted, micro-insurers may be public companies, friendly societies or co-operatives).

This discussion paper does not seek to derive a tax policy position on micro-insurance, instead having focused on building a suitable policy framework for effective regulation. However, the tax policy perspective is important, particularly in terms of ensuring a level playing field amongst providers.

Issues to be considered include:

- Do micro-insurance providers warrant a separate tax dispensation from other insurance providers?
- What is the appropriate tax treatment for co-operatives generally (beyond just financial services), to include specifying treatment of the co-operative itself, as well as treatment of the 5% reserve that a co-operative is required to maintain in terms of the Co-operatives Act?
- Should the tax treatment for friendly societies and financial services co-operatives be rendered equivalent, and if so how?
- If friendly societies are no longer tax exempt, what should the window period for compliance be?
- For friendly societies and financial services co-operatives that are registered as micro-insurers, and that want to build reserves (should they for example want to transition to a full long- or short term insurance license), what should be the tax treatment of that reserve?
- Should illegal operators that want to register in terms of the new regime be offered tax amnesty, and if so, what should be the nature of that amnesty?

National Treasury is engaging the Co-operatives Development Unit at the dti on these issues; tax proposals will accompany the follow-up discussion paper.

Note on re-insurance. A micro-insurer may not conduct re-insurance. Hence all re-insurers will still need to be registered under the Long-term or Short-term Insurance Acts (or both – there are currently four composite re-insurers). Registered re-insurers may provide re-insurance to micro-insurers. Registered insurers may also underwrite part of the risk of a micro-insurer, thereby acting as re-insurer. To limit risk, the FSB may decide to compel a micro-insurer to obtain re-insurance on part of its risk as a licensing condition (particularly while it is building up required capital) which can then be phased out over time.

5.2.3. LEGISLATIVE CHANGES REQUIRED FOR IMPLEMENTING THE MICRO-INSURANCE LICENSE

The micro-insurance framework set out above proposes to subject micro-insurance to a more lenient regulatory treatment than is currently applied to registered insurers, with the aim of facilitating the orderly development of the formal micro-insurance market in South Africa. In designing the reduced regulatory framework, the aim is to limit the extent of adjustments required but to ensure a comprehensive and coherent approach. The proposed approach to

micro-insurance must also align with the potential long-term development of insurance regulation.

In order to implement the proposed framework, the implications for a number of areas of legislation need to be considered:

- The Long-term Insurance Act, its regulations and policy-holder protection rules;
- The Short-term Insurance Act, its regulations and policy-holder protection rules;
- The Friendly Societies Act and its regulations; and
- The Co-operatives Act of 2005.

In addition, the proposed framework will need to be reconciled with various regulatory changes currently under discussion. It should also take cognisance of the implications of the National Credit Act of 2005 and the Financial Sector Charter process.

The two main options for incorporating the proposed framework within the existing regulatory framework are (i) to create a separate Micro-insurance Act or (ii) to insert micro-insurance as a product category within the current Long-term and Short-term Insurance Acts. The first option is proposed as the preferred way of developing a micro-insurance regime.

A micro-insurance act

It is proposed that a separate Micro-Insurance Act be created that sets out the parameters of the micro-insurance space and that provides for a dedicated micro-insurance license.

Required amendments and additions to legislation and rules will include:

Allow existing insurers to operate under the Micro-insurance Act. Current insurers, who by definition already meet the requirements to register as a micro-insurer, should be given a streamlined registration option (in the form of a notification submitted to the FSB) under the Micro-insurance Act at limited or no additional cost or effort. The exception will be where current short-term insurers wish to provide life micro-insurance products as well, and vice versa. In such a case, a short-term insurer will for example need to demonstrate its capability to manage death event related business in the same way that a new applicant for the license would. The same would apply for current long-term insurers also wishing to write non-life indemnity-type of insurance under the Micro-Insurance Act.

Create exemption in Long-term and Short-term Insurance Acts for micro-insurers. Amendments will be required to carve out an exemption from the requirements of Long-term or Short-term Insurance Acts for entities registered under the new Micro-insurance Act (similar to the current friendly societies exemption). Consideration must also be given to the Long- and Short-term requirement of a registered entity being a public company; an alternative institutional form - like that of a co-operative - can be explored by adopting a similar approach to that employed in Section 5.2.1, to render a level playing field.

Amend Friendly Societies Act to allow registration as micro-insurers. An amendment will be required to allow Friendly Societies registered under the new Micro-insurance Act to write the permitted business and remove the current product restrictions in the Friendly Societies Act.

An amendment will also be necessary to the investment restrictions placed on friendly societies (under the Appendix to Regulation 29 under the Friendly Societies Act) in order to allow them to buy into a cell captive insurer where appropriate/desired.

Phase out insurance written under Friendly Societies Act. The risk analysis conducted as basis for the suggested regulatory framework also showed that it is not appropriate to allow friendly societies to write insurance on the current terms. Although amendments to the Friendly Societies Act could rectify this, we propose that this should be integrated with the proposed Micro-insurance Act. Friendly societies will, therefore, become one of the legal entities that may register as micro-insurers if they are able to meet the conditions as outlined above. If not, underwriting or cell ownership may still be legitimate options. Hence the current exemption for friendly societies offering benefits of less than R5 000 under the Long- or Short-term Insurance Acts will be phased out over a period of five years after the new micro-insurance regulation has been implemented. Burial societies fitting within the specified limits of size and income and offering non-guaranteed benefits must still register with the FSB but will be exempted from institutional and insurance regulation. In the transition phase, the supervision of Friendly Societies will be enhanced.

Amend Co-operatives Act to allow registration as micro-insurer. An amendment will be required to allow co-operatives registered under the new Micro-insurance Act to write the permitted business. Co-operatives may still opt to write insurance as a fully registered insurer under the Long or Short-term Act.[46]

Arguments in favour of a separate act

Integrated approach requires complex amendments across both Long-term and Short-term Insurance Acts. In introducing micro-insurance as a new product category with risk characteristics distinguishing it from the classes of policies currently provided for in the insurance legislation, and in arguing for a new regulatory approach for micro-insurance, it makes intuitive sense to create a single space where micro-insurance is defined and its regulatory requirements are stipulated. Under an integrated framework, the different legal structures created under each act and the differences between the acts would need to be explicitly accommodated so as to create a consistent micro-insurance space across acts.

A separate act requires fewer changes to existing legislation: instead of bringing about complicated changes to the acts to accommodate micro-insurance, the existing legislation now merely needs to recognise the Micro-insurance Act, which in turn needs to recognise registration under either the Long or Short-term Insurance Act.

Reduce fragmentation. A separate Act reduces the scope for fragmentation across various acts and establishes a unified micro-insurance framework. This avoids confusion on the various requirements for micro-insurance and how it is to be reconciled with provisions under the Long-

[46] Under the current Co-operatives Act, co-operative insurers are currently required to register under the Long-term or Short-term Insurance Acts. To allow this the Long-term and Short-term Insurance Acts still need to be amended to allow co-operatives to register as insurers. This will only be required if co-operatives want to register as full insurers. These amendments fall beyond the micro-insurance focus of this document.

and Short-term Acts. It also facilitates compliance by institutions with limited capacity to spend on the compliance function.

Facilitate inclusion of non-public companies. In terms of institutional form options for the provision of micro-insurance, a Micro-insurance Act makes it easier to accommodate various options (especially non-public companies), by extending the ability to register as a micro-insurer to various institutional forms. Over the medium term, both the Long- and Short-term Acts would then also need to be amended to allow for co-operative and friendly society insurers to graduate to full insurance licenses if they can comply with the other conditions of the respective acts. Specific care needs to be taken to design the micro-insurance regime in such a manner as to allow graduation.

Facilitate explicit alignment with or exemption from other regulatory changes. Where the provision of micro-insurance is currently or potentially impacted by other legislation, such as the proposed FCR dispensation, the proposed commission restructuring, or the FAIS Act, it will be easier to set out the space for micro-insurance as defined in a separate regulatory space.

Thus, while integration with existing regulation may also be feasible, it will require wide-ranging changes to the Long-term and Short-term Insurance Acts. If a micro-insurance act can allow full integration with existing insurance legislation as suggested above, this will provide the benefit of clear separation that avoids or limits unintended impacts on existing insurers while still ensuring an integrated approach to insurance regulation.

Allow for graduation to full insurer. It will be important to allow for the potential graduation from micro-insurer to full insurer. That is, a micro-insurer will be allowed to register as an insurer under either the Long-term or Short-term insurance acts, should it be able to meet all the requirements. This will allow it to extend its product offering beyond micro-insurance.

5.2.4. OTHER CHALLENGES IN WRITING MICRO-INSURANCE

This section considers the main problems faced by the options outlined in Section 5.1 as well as the regulatory burden on insurers.

Illegal insurance provision

Pervasive illegality a central problem. As explained in the market context section, formalisation is a particular challenge facing the funeral insurance market. A significant proportion of the market is estimated to be served illegally, by funeral parlours that self-insure without an insurance license and who base their business model on in-kind service pay-outs, without providing the option of a monetary pay-out as required under the Long-term Act. In fact, as noted in the introduction, concerns about abuse in this market are what triggered the evaluation of the funeral insurance market (evolving into micro-insurance more broadly) and its regulatory framework in the first place. This problem is not only limited to funeral parlours but also affects administrators. As with funeral parlours, this category of intermediary was for a long time beyond the effective reach of the supervisor. This is slowly changing with the introduction of FAIS, limited by the capacity of the supervisor to enforce the regulation.

Framework for formalisation. One of the aims of the micro-insurance framework is to facilitate formalisation by providing the regulatory space for micro-insurance both as a standalone micro-insurance license and partnership options. Only a small number of institutions are likely to qualify or be able to register as micro-insurers. Not only will this provide the option for some of the larger operations to be legalised, the streamlined regulation suggested also enables the formal sector to better compete with the illegal sector.

The need for enforcement to complement formalisation incentives. The process of facilitating formalisation will occur in parallel with an enforcement campaign to deal with the remaining illegal operators. Once an appropriate regulatory space exists for formal provision, enforcement of illegal activities should be even stricter. A larger enforcement drive will have supervisory capacity implications[47] and will also call for greater inter-governmental co-operation. An enforcement and co-operation strategy will therefore be devised to ensure that the micro-insurance regulatory space is not undermined by sub-optimal enforcement. This strategy will include:

Increased powers of enforcement. As part of the on-going initiative to improve enforcement, regulatory changes have been approved to extend enforcement powers of the FSB and create the necessary tribunal structures to support this. Although this was initially targeted at the investment sectors, the proposal is to utilise these structures to support enforcement in the risk sectors and, in particular, in the funeral parlour environment.

Inter-departmental forum to coordinate enforcement and support with other government functions such as dti, Department of Health, South African Police Service (SAPS) and the South African Revenue Service (SARS). National Treasury recognises the crucial role to be played by other government departments and has already taken steps to strengthen these relationships. As a first step, National Treasury has convened an inter-departmental forum on funeral insurance, which held its first meeting earlier this year. These meetings will continue on a regular basis to allow for coordination in shared areas of regulation.

Shared enforcement strategies. On the enforcement side areas of co-operation that will be considered include:

- Supporting the improvement of the funeral parlour register under the Department of Health that could also be shared with the FSB and other supervisors. This should include consideration of incentives for registration such as the certificate system developed under the MFRC (now the NCA), which would allow registered providers to distinguish themselves from unregistered providers.
- Support for the development and strengthening of legitimate industry associations and apex bodies that could support respective regulators in enforcing the regulation. This will not extend to self-regulation but will look to utilise the networks presented by these entities in a version of delegated regulation.
- Information sharing amongst regulatory bodies (as far as this is legally possible) to correlate with their own information.

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[47] These are considered in Section 8.1.

- Support for the establishment of a central police unit trained in the enforcement of insurance-related transgressions and that could support individual police branches in doing this.
- A joint enforcement campaign by the various agencies that will seek to systematically address this problem as well as to raise awareness of the new regulatory regime created and the support provided. This will include an awareness campaign to inform consumers of the risk of dealing with illegal operators (see section 7).

Shared support strategies. Recognising that 1) illegal insurance provision by funeral parlours is not always with criminal intent, 2) these businesses service a large proportion of the target market for micro-insurance and 3) represent a significant group of black SMEs, enforcement of insurance regulation needs to be combined with support for the formalisation and legalisation of these businesses. Shared support strategies that will be considered will include:

- Amnesty arrangements for operators that have operated illegally. This will include tax and health regulation amnesties as many of these players would also not have been registered for tax and health regulation purposes.
- Active support to comply with the registration processes. This should link with the dti's business development initiatives as the funeral parlour market in particular represents a large and existing market of black SMEs. This component will also include support for registration and compliance with FAIS.
- Support to strengthen legitimate industry associations and apex bodies as a means to direct support to the members of these entities.

Improved recourse. A critical element of the enforcement strategy would be for Treasury to support current programmes to review and improve the recourse environment in financial services. To address the particular issues of the insurance industry, this would require extending recourse mechanisms to also dealing with unregistered/illegal insurers and intermediaries as well as linking closely with (and support for) recourse mechanisms for other areas of regulation such as health. Particular challenges to meet to improve current recourse mechanisms is to make it easier to access these services, to simplify the process of using them and to improve linkages amongst the various ombudsman to avoid consumer being lost in the gaps.

We return to the issue of enforcement in Sections 7 and 8.2, where the debate is considered in the context of designing a holistic consumer protection strategy.

The regulatory position of Friendly Societies

There are two issues to consider for the regulation of friendly societies. The first deals with prudential risk management requirements contained in current regulation and the second with the investment restrictions imposed on friendly societies.

Limited prudential management requirements. Friendly societies providing guaranteed benefits currently operate under an exemption to the Long-term Act that allows them to write benefits of up to R5,000 without registration under the Long-term Act (the same exemption is granted under the Short-term Insurance Act). Such societies are subjected to lower regulatory requirements than full insurers. Current regulation does not stipulate a minimum capital

requirement for friendly societies, reserving rules are not stipulated (relying rather on the internal model of the society) and actuarial assessments are only required every five years.

The analysis of the risk presented by micro-insurance products and the implied institutional and prudential risk management requirements suggest that the lower requirements currently applied to friendly societies may not be appropriate. The mutual nature of such societies also does not compensate for the absence of such requirements (see Section 5.2.2.2 on the degrees of freedom to be awarded to mutual organisations). The result is that the current regime should be revisited. There are a number of alternatives available to deal with this:

- Option 1: Leave the Friendly Society exemption in place but increase the prudential requirements applicable to Friendly Societies (including supervision by insurance division).
- Option 2: Replace the friendly society exemption with a [temporary] micro-insurance exemption thereby requiring friendly societies to migrate to this regime and comply with the recommended requirements for micro-insurers. Where societies are unable to meet the minimum requirements, but still want to provide guaranteed benefits, they would have to follow one of the partnership options noted above (i.e. underwriting or cell captive).

As it stands, the current Co-operative Act does not present a viable alternative framework for friendly societies as the exemption to the requirements placed on fully registered insurers is not extended to co-operatives as well. This is discussed further below.

This paper recommends option 2, i.e. that the friendly society exemption in the Long-term and Short-term acts respectively be replaced with a [temporary] micro-insurance exemption. This will require supporting friendly societies in the process of changing to the new regime, as well as a phasing in of the changes.

Constraints on Friendly Societies accessing cell captives. There are two key constraints to friendly societies utilising the cell captive option. The first (non-regulatory) constraint is the minimum scale required. The annual premium income of four out of the five friendly societies currently offering insurance will be insufficient to meet the minimum premium levels required by current cell captive insurers[48]. The second (regulatory) challenge is the investment restrictions currently placed on friendly societies[49]. Under the current restrictions, it would not be possible for friendly societies to buy the class of shares needed to become a cell owner. Therefore the investment restrictions on friendly societies should be reconsidered so as to facilitate the provision of micro-insurance via the ceding of risk to a cell captive insurer.

Co-operatives Act

The Co-operatives Act (no. 54 of 2005) is much more comprehensive than its 1981 precursor in that it not only focuses on agricultural co-operatives, but makes provision for a number of distinct categories of co-operatives which include that of *co-operative burial society* and of *financial service co-operative*. Though enacted in 2005, the commencement of the Act was

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[48] Calculations based on industry consultations and friendly society premium data obtained from the FSB.

[49] Section 29 of the Regulations to the Friendly Societies Act of 1956.

only proclaimed in May 2007. The Co-operatives Act is of relevance to the proposed micro-insurance regime as it creates one of the institutional forms to be included in the micro-insurance license. However, a number of its provisions would need to be made compatible with the proposed Micro-Insurance Act:

- *Compulsory registration under insurance act*. When a co-operative wishes to provide insurance, the Co-operatives Act (Schedule 1, Part 3, Section 3) holds that "[a] financial services co-operative providing long-term or short-term insurance to its members is required to register in terms of the Long-term Insurance Act, 1998 (Act no. 52 of 1998), or Short-term Insurance Act, 1998 (Act no. 53 of 1998), despite its registration in terms of this Act". Although the intention with the inclusion of financial services co-operatives in the Co-operatives Act was primarily to provide a legal form appropriate for community-based organisations which would deliver products which would fall entirely within the definition of micro-insurance as proposed in this paper, the possibility that a co-operative may wish to underwrite insurance products which fall beyond the limited definition of micro-insurance, cannot be excluded. *This paper therefore proposes that Schedule 1, Part 3, Section 3 of the Co-operatives Act be amended to also allow for the provision of micro-insurance products, requiring financial services co-operatives who wish to write micro-insurance to register under the Micro-Insurance Act..*
- *Exclusion for non-guaranteed benefits*. An exclusion (Part 3, Chapter 13, Section 94) applies, in that the "provisions of the Long-Term Insurance Act, 1998, do not apply to co-operatives in respect of their activities in so far as they relate to a scheme or arrangement in terms of the constitution of the co-operative under which the amount of the benefits afforded by such scheme or arrangement is not guaranteed…". Thus, for example, a burial society that provides benefits to its members of which the value is not guaranteed, does not need to be registered as an insurer. This effectively provides for smaller burial societies that provide a type of cash flow support, rather than insurance in the true sense of the word, to be unregulated on the financial services front, though they will still be regulated as a co-operative. *This paper proposes that a similar provision be included within the micro-insurance regulatory regime, exempting burial societies that fall within member size and annual income limits.*

The Co-operatives Act is not clear on the functional aspects of insurance provision. It is stated that functional regulations are to be drafted in consultation with the FSB (Registrars of Long-term and Short-term Insurance), but this has not yet been done. More details on the provisions of the Co-operatives Act that are of relevance to micro-insurance are contained in Appendix 4.

6. FACILITATING INTERMEDIATION AND CONSUMER PROTECTION

In Section 4, micro-insurance was defined as a simplified set of risk products with terms not exceeding one year and benefit levels not exceeding R50 000. Given these limitations, Section 5 showed that insurers limited to writing only these micro-insurance products, pose lower levels of prudential risk and, therefore, could be subjected to a reduced set of licensing and operational requirements. In this section, we now turn to consider the implications of the limited micro-insurance definition for consumer protection and intermediation regulation. At the heart of this analysis lies the need to reconcile the consumer protection and inclusion objectives of government.

Firstly we consider the drivers of consumer abuse and misselling. Following this we briefly outline the current consumer protection regulation and its impacts on the market. Finally, we propose a number of changes to the current regime which aims to reduce the cost of intermediation while still controlling for consumer protection.

6.1. THE RISK OF CONSUMER ABUSE AND MISSELLING

The risk of (intentional and unintentional) consumer abuse or misselling is driven by a number of characteristics of the insurance product, intermediation process and target market. These characteristics include:

- *The complex nature of the product.* Insurance is a complex product, the true value and quality of which is difficult for consumers to assess on purchase (also referred to as credence goods). The product may only be used years after it is originally purchased by which time significant (and unrecoverable) sums of money may already have been paid in premiums. Intentionally or unintentionally, misselling easily occurs, and given the time elapsed between purchase and claim, there is often little that can be done at the time of claim if problems come to light. Simplified products will reduce (but not remove) the risk of misselling, as consumers are more easily able to understand and compare options.
- *The level of cover provided.* A higher value product will expose the policy holder to a higher risk from misselling as more money will be at stake and the policyholder can suffer potentially more harm.
- *Nature of the sales process.* The way in which insurance products are sold, by whom and the level of disclosure or advice, are important elements to whether or not the consumer buys an appropriate product and is aware of all the intricacies of the product. Misaligned incentives due to the structure of intermediary commission may also impact the risk of harm to the consumer.
- *Nature of the claims process.* Claiming is the core of an insurance contract from the customer's perspective. Whether or not the consumer is disadvantaged by the way in which claims are paid, whether the claim is unfairly refused and whether, in that case, the consumer has adequate recourse and is aware of such recourse channels are all important elements to the level of risk posed to the consumer. In developing micro-insurance products insurers are at risk of focusing only on optimising the sales process and not sufficiently on the claims process. Given that the consumer is tied in by the sales process

and only experience the claims process much later, the incentives to optimise claims are limited.

- *Nature of recourse process*. Should *consumers have easily accessible* consumer recourse channels and be familiar with such channels this will improve consumer protection. While this only provides individual protection after the event, its presence and effectiveness serves *to* reduce risk by raising the cost to financial service providers of harming consumers.
- *Nature of the client*. The level of sophistication of the consumer and the extent of consumer education are important consumer risk issues cutting across the elements highlighted above. More financially literate consumers are able to better assess their own insurance needs, compare products and choose one that fits their need profile.

The micro-insurance product definitions proposed in Section 4.2 impacts on a number of these risk drivers.

- *Product simplification and short-term:* makes the products easier to understand and compare thereby reducing the risk of misselling. If the simplified product features could be appropriately communicated to the client, this may reduce the need for advice.
- *Limited benefit:* Reduce the exposure of the policyholder.
- *Short-term and risk only:* Simplifies the product and enables easier switching without incurring excessive costs.

6.2. CURRENT REGULATORY FRAMEWORK

The primary legislation aimed at addressing consumer protection risk is the FAIS Act of 2002. Apart from the FAIS Act, consumer protection risk is also impacted on by the commission regulations (in terms of structure and levels) as contained in the regulations to the Long- and Short-term Insurance Acts. Consumer education programmes (as required under the Financial Sector Charter and provided by the FSB[50]) may also impact on the level of financial literacy, thereby reducing consumer protection risk. Furthermore, the Consumer Protection Bill of 2007, once enacted, will contribute to the protection of consumers by providing for improved standards of consumer information, prohibiting any unfair marketing and business practices, entrenching the right to disclosure and information, etc.

FAIS regulates the provision of advice and intermediary services and the entities that may provide it. The FAIS Act of 2002, and the fit and proper requirements, code of conduct and exemptions promulgated in terms of it, aims to protect consumers by regulating the institutions or persons selling insurance (financial service providers and their representatives), as well as the way in which insurance products are sold (provisions regarding the contents and structure of any advice given).

[50] Clause 8.4 of the Financial Sector Charter requires all financial institutions to "annually invest a minimum of 0.2% of post tax operating profits in consumer education." Government however also takes direct responsibility for consumer education via the FSB's Consumer Education Department. FAIS registration has been a focus area for the department, as they have encountered many queries by funeral parlours and burial societies about the need for, and procedures to, register as a financial service provider.

Defining advice and intermediary services. Advice is defined as any recommendation, guidance or financial proposal made to a client in respect of the purchase of or investment in any financial product. An intermediary service is in turn defined as: “Any act other than advice, performed by a person for and on behalf of any client or product supplier, the result of which is that the client enters into a transaction.” Thus an intermediary who gives purely factual or administrative information to the client is not giving advice as defined, but as soon as the intermediary starts to offer an opinion or recommendation on the suitability of a financial product for the needs of the client, s/he is providing “advice” as defined in the Act.

Categories of intermediaries. FAIS requires all financial service providers (FSPs) to be registered, should they provide advice or intermediary services. The FSP can have two types of employees/agents: the representative and the administrative employee. Within the category of “representatives”, the so-called Category A representatives are those selling specifically assistance business. From the perspective of micro-insurance, the regulation therefore effectively creates four categories of intermediaries (note that these categories are not explicitly contained in regulation, but are an interpretation of the implications of regulation in practice):

- *Financial Service Provider.* Under FAIS, any organisation or individual providing *advice* or *intermediary services* must register as an authorised financial services provider.
- *Representatives.* In addition, an authorised FSB appoints *representatives* under the FAIS Act. A “representative” is defined as a person who renders a financial service, i.e. gives advice or provides an intermediary service, to a client for or on behalf of a financial service provider, either as employee or as a contractually bound agent of the FSP. A representative may only render advice or intermediary services in terms of his/her contract with the FSP. While they may provide advice, they are not compelled to do so under FAIS. The FSP is at all times remains responsible for the advice or lack of advice that it gives its clients.
- *Category A representative.* Category A is defined as a sub-category of the registered representative that is limited to selling assistance business products. Category A intermediaries may provide advice but are not compelled to do so. This category is defined in the Fit and Proper Determination. They may only provide advice on assistance business policies.
- *Administrative staff/clerks.* Explicitly excluded from the definition of a representative is any clerical, administrative, legal, accounting or other service that does not require judgment, or does not lead a client to any specific transaction in response to general enquiries. In practice, this has created the space for retailer distribution and tick-box selling: the insurer or the joint venture will be registered as an FSP, but staff members selling the product will not be regarded as representatives, as their actions do not require judgment or advice. This category of intermediary is not allowed to provide advice and is not restricted in the types of products they may sell.

The following diagram illustrates the relationship between these intermediary categories:

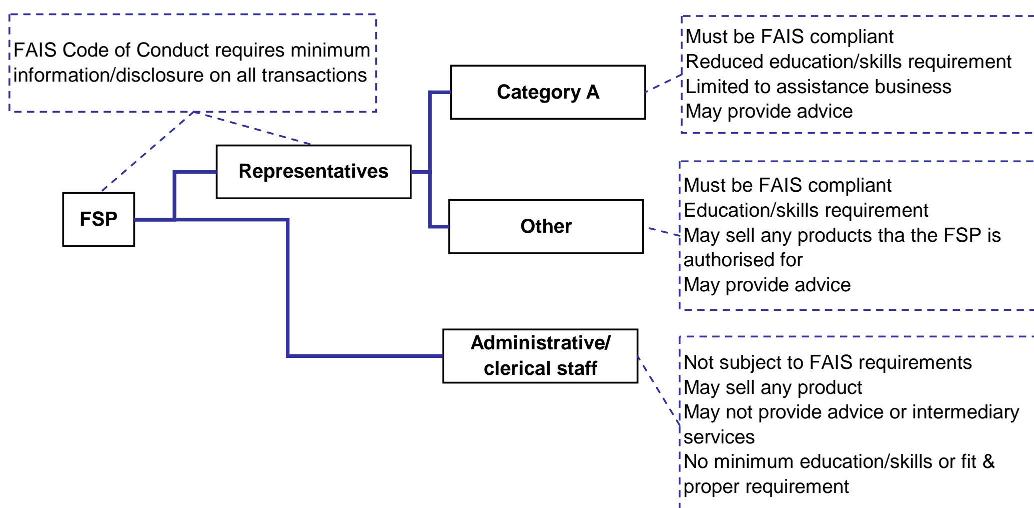

Figure 6. Categories of intermediaries currently under FAIS

Source: Genesis

Advice not required for all transactions. FAIS does not require advice to be provided on all transactions. Should advice however be provided, certain requirements have to be met including:

- A suitability analysis;
- Identification of product appropriateness to the needs of the client;
- Full disclosure of fees, replacement charges, terms, any impact on premiums, etc when advising that an existing product be replaced; and
- Record-keeping of the advice provided.

Disclosure requirements apply to all transactions. While FAIS does not require advice on all transactions, it does require a minimum level of disclosure of fees and product features for all transactions irrespective of whether advice is provided. Under the code of conduct[51] FSPs and representatives are required to provide sufficient information to allow the consumer to make an informed decision[52]. This information should be in "plain language"[53], must be appropriate to the financial service, must take into account the likely level of knowledge of the client[54] and must provide details on the complaints resolution mechanism[55]. The result is that, while sales staff not providing advice are not classified as representatives, the requirement to provide sufficient information still rests on the FSP who has to ensure that such information is included in the transactions.

[51] General Code of Conduct for Authorised Financial Service Providers and Representatives.

[52] Section 7(1)(a).

[53] Section 3(1)(a)(ii).

[54] Section 3(1)(a)(iii).

[55] Section 17(b).

Commission capping. Under the regulations to the Long-term Act, commission on assistance business is uncapped. This is the only line of business under either the Long or Short-term Act that enjoys this treatment. Although not originally intended for consumer protection, the caps on commission levels serve to limit the charges that intermediaries may add to the product. It does, however, not limit the overall cost of the product. Long-term insurance regulation allows for up-front commission structuring while short-term insurance regulation dictates an as-and-when structure. We note, however, that commission structures are currently under review and that a move to a hybrid commission structure has been proposed for life and contractual savings products, as first captured by the National Treasury Discussion Paper on Contractual Savings in the Life Insurance Industry released in March 2006). The recommendations in this document on commission structures will take into account and align with the findings of the commission restructuring process.

Product standards under Financial Sector Charter. Apart from the benefit limit on assistance business, regulation does not dictate specific product features (e.g. simplification). However, in reaction to the Financial Sector Charter, the insurance industry has set about developing common industry standards to ensure fair charges, easy access and decent terms (CAT standards) for all member products. The long-term insurance industry has adopted these CAT standards as the basis for the Zimele product accreditation. These voluntary standards (which however enable insurers to obtain Charter-points) already define appropriate and simplified terms, limited exclusions and simplified “plain-language” disclosure standards, as well as maximum rates to the policy holder[56]. As these standards become entrenched in the market, they could be used as the basis for the development of micro-insurance product requirements in terms of simplicity, flexibility and affordability. The fact that the market is already familiar with the voluntary requirements could simplify the task of implementing such requirements.

6.3. IMPACT OF REGULATION ON THE MARKET

This discussion paper is in support of the need to ensure sufficient consumer protection and will seek to achieve this through various initiatives including incentivising (although not insisting on) advice, insistence on and simplification of disclosure, simplifying the products, improving recourse and extending the category of advice-based intermediaries to also be able to sell non-funeral micro-insurance products.

As noted above, consumer protection to date has primarily focused on controlling the intermediation process. While this is critical, it is also recognised that regulation in its current form may have increased the cost of providing advice and information to the client, thereby unintentionally biasing micro-insurance distribution to non-advice and so-called “tick-box” selling. The FSB has embarked on a number of initiatives to address potential constraints in

[56] It is required that customers must be able to buy the policy, pay a premium or amend a policy at least once a month within 40km of their residence or place of work. It is envisaged that Zimele-accreditation will send a signal to consumers that products are trustworthy and reasonable in terms of pricing and terms. Amongst others, the CAT standards require all products wishing to gain accreditation to fulfil various criteria, with the main goal being the provision of a product that is easily accessible, flexibly, simple and easy to understand. Criteria include that policy documents must use standardised policy terms, simple product descriptions must be provided and that a summary of the policy terms must be available in all 11 official languates. No HIV/AIDS exclusions are allowed. Interrupted contributions must be allowed for with grace periods to make up lost payments. Standardised exclusion wording is required and there are limits on allowable exclusions. Furthermore, minimum and maximum benefits levels are defined.

the market conduct regulation. This discussion paper will align with and is in support of those initiatives. Having said this, it is important to understand how market conduct regulation is impacting on the market and how this will affect the objective of developing a micro-insurance market. The following impacts can be noted.

FAIS may disincentivise advice-based sales in the low-income market. FAIS has increased the per-transaction cost of advice-based sales by stipulating more detailed requirements for the provision of advice. This is contributing to the cost-barrier for such models to operate in low-premium markets which, even before FAIS, implied that advice-based sales were never prominent in this market. In addition to increasing the cost of advice, FAIS unintentionally also disincentivises the provision of verbal information/disclosure in the low-income market. Several of the new low-income models are opting for the approach of using clerical sales staff members, who are not authorised representatives, to conduct sales. This is a more cost-effective way of selling insurance to the low-income market. However, such staff is not authorised to provide advice. It is therefore risky for an insurer or intermediary organisation to allow its clerical agents to provide verbal information to the client as such an agent may overstep the delineation between information and advice. As a result, the firm may incur liability because of inappropriate advice being provided. Given the typical lower education profile of sales staff and their lack of experience in financial services this discourages verbal disclosure to an even greater degree. It must be noted that there are no restrictions on the type of products these models may sell as long as they do not provide advice.

Uncertainty on when advice is required creates risk for insurers. FAIS does not stipulate when advice is required, but only who may provide it and in what manner it should be provided when it is indeed given. As was noted above, FAIS does, however, note that advice is not always required and that it is possible to “sell” a product without providing advice (i.e. communicate factual information on the products on offer without making an explicit recommendation or judgment based on the needs of the potential client). This was made more explicit by a guidance note issued by the FSB, which noted that staff that do not provide intermediary services or advice and act in a clerical or administrative capacity do not have to be authorised representatives even where they collect premiums from clients, as this does not qualify as “intermediary services” as defined. In practice, this has meant that staff members who are, for example, involved in over-the-counter sales at retail stores do not have to register or comply with any of the transactional requirements of FAIS as long as they do not provide advice or intermediary services. However, at the same time, some judgments by the FAIS Ombud have drawn into question the sanction provided to non-advice sales. In particular, judgments have suggested that the need for advice is determined by the need of the client rather than the nature of the product, even where the client has explicitly rejected advice. The FAIS Ombud is governed by the FAIS Act and independent of the FSB. Its judgments will, therefore, overrule the guidance provided by the FSB. Thus risk of an unfavourable Ombud ruling is created for the insurer, should a non-advice model be followed. FAIS Ombudsman rulings must however be read in the context of the complaint and cannot be generalised.

Box 3. An example of a FAIS Ombud ruling relevant to tick-box insurance sales.

In a recent case, the Ombud took what in effect translates into an anti-tick-of-the-box position. The facts were as follows: The complainant purchased a VCR at a furniture store, and discovered later that credit life insurance had been taken out and added to the purchase price. He alleged that he was unaware of the insurance purchase and had not wished to purchase credit insurance. It became apparent that he had, in fact, signed the insurance form, but at the time

no effort had been made to explain to him that he was purchasing credit life insurance or to question whether it was appropriate in the circumstance. The Ombud found that the store's behaviour was in contravention of FAIS and pointed out that the implication is that any sale of insurance, even if bought via tick-of-the-box, must be accompanied by a needs analysis (and hence advice) to clarify at least if the purchaser already has insurance or wishes to purchase insurance. Note that the case in point was resolved without a formal hearing so was not published (It was reported by the Ombud in Cover Magazine, May 2006, Volume 18, Number 12, at page 24). The Ombud has been quoted as saying (Sunday Times, 2 April 2006):

> *"The insurer cannot spend two minutes talking about insurance cover exclusions over the phone — can the consumer really get to grips with the complexity of the product in this time?"* and *"When we ask a complainant if he knows what he has signed off, it becomes clear he didn't in fact know what he was signing off. Making sure the client understands is the way to go."*

Low-income market dominated by tick-box sales. As a result, the improved quality of advice that FAIS seeks to establish is largely to the benefit of the higher-income market, while the poor are being served by non-advice tick-box models where even the most basic information is only communicated on paper. In many cases policy documents have not yet achieved the level of simplicity required by the target market. Some advice-based (and verbal disclosure) models do exist in the low-income market, but this is limited to funeral insurance where uncapped commission allows remuneration of such services.

Educational requirements may be beyond reach of low-income advisors. Category A intermediaries can provide advice in this market, but they are restricted to assistance business policies. Advice-based sales of other insurance products currently have to occur through more expensive intermediary categories that are unlikely to find the remuneration in this market attractive. Category A representatives, as well as those connected with the benefits provided by friendly societies, were exempted from the Grade 10 (or equivalent NQF level 2) educational requirement under the FAIS Fit and Proper Determination until September 2007[57]. However it proved that a significant proportion of Category A intermediaries (at least 42% according to FSB estimates[58]) would not be able to meet this deadline, and it was extended to the end of December 2009. If these intermediaries cannot be accommodated within the regulatory regime, it is likely to further incentivise the trend towards tick-box selling.

Risk of FAIS-non compliance induces reluctance to deal with small intermediaries. FAIS has resulted in the registration of in excess of 13,000 intermediaries. Given the sheer number of FSPs, a risk-based supervision approach is followed as, even with enhanced capacity, the FSB cannot reasonably be expected to visit and pro-actively regulate all registered (let alone the thousands still unregistered) intermediaries. Furthermore, the responsibility is placed on insurers to ensure that they are dealing only with registered intermediaries and to ensure that these intermediaries act in accordance with the law. This has resulted in some reluctance to deal with smaller intermediaries.

The position of burial societies and affinity groups under FAIS. As part of its risk-based supervision approach, the FSB has recognised the challenges faced in registering the large

[57] Board Notice 104 of 2004 – exemption regarding certain minimum qualifications.

[58] According to an FSB article titled "Proposal for addressing Fit and Proper beyond 2009" published on Insurance Times and Investments Online News (www.itinews.co.za) on 30 May 2007.

number of burial societies for FAIS purposes. Underwritten burial societies (i.e. those selling registered insurers' products to members) or affinity groups such as labour unions or church groups distributing policies to their members should technically be classified as intermediaries (and hence should register under FAIS and meet with the necessary requirements). For enforcement purposes, they are however regarded as "group policy-holders" (with their members as sub-policy holders) rather than as financial service providers. Though not explicitly exempted in legislation, they are therefore not supervised for FAIS compliance in practice. Based on the premise that lower-risk areas warrant lower supervisory priority, this is regarded as the most pragmatic solution given the enforcement capacity constraints faced by the supervisor. Though under the proposed new regime all micro-insurers and micro-insurance intermediaries will be subject to the FAIS Act, the FSB will continue to apply a risk-based approach to supervision.

6.4. PROPOSED REGULATORY FRAMEWORK FOR CONSUMER PROTECTION

Recognising that advice-based models may not be affordable to the lower-income market, the proposed framework aims to encourage advice and verbal disclosure while at the same time improving the way in which non-advice models work. The suggested approach is outlined below.

Explicitly remove the requirement to provide advice on the intermediation of micro-insurance products. Given the simplification to be achieved by the proposed product features, we propose that advice should not be required for the intermediation of micro-insurance. This is not necessarily required by current regulation, but we suggest removing any uncertainties created by the Ombud process by explicitly disposing with the need to provide advice as defined in the FAIS Act. The requirement for the disclosure of appropriate and sufficient information will remain in place. While the importance of advice, especially to the low-income market, must be stressed, this proposal is a pragmatic solution based on the trade-off between advice and cost-effectiveness in the low-premium micro-insurance market. Though advice will not be explicitly required, it will still be incentivised through the uncapping of commissions. In a competitive environment, the best possible offer (both in terms of product features and advice) will be provided for the premium and commission paid. Furthermore, insurers must ensure that, should a consumer explicitly request it, they are not denied advice. In a tick-box model, this could for example be achieved through a call centre for which the contact details are provided on the simplified policy document. It must be stressed that the proposal is only to remove the requirement to provide advice. The requirement to ensure that clients are provided sufficient and appropriate information in order to make an informed decision remains in place.

Extend the code of conduct to further simplify disclosure for micro-insurance products. Appropriate disclosure of the key information to facilitate an informed decision is essential. Even though the current code requires "plain language" contracts suitable to the level of knowledge of the target market this still leaves the client with fairly complex contracts and product documentation. In line with the Financial Sector Charter standards, we recommend that micro-insurance regulation should require simplified summaries of key policy information to be included in policy documentation. We recommend that the respective industry associations should facilitate the development of further guidance on the nature and level of simplification required for micro-insurance products. Such guidelines can then be approved by the FSB as

meeting the requirements of the regulation. Simplified disclosure in line with the code of conduct should be ensured across all categories of intermediaries selling micro-insurance.

Extend products intermediated by Category A intermediaries to include all micro-insurance products. Given that the micro-insurance products are required to be simplified products for which the risk of consumer abuse are reduced, this allows the space for it to be intermediated through Category A intermediaries. In doing this, it creates a potential space for advice-based sales in this market. The move towards a second tier of intermediaries is not unprecedented internationally. In a 2002 report based on an extensive research process, the UK's Financial Services Authority (FSA) argues that a two-tiered system should be implemented for independent financial advisers. They propose a lower tier of less qualified advisors that will advise on a limited range of lower risk products (FSA, 2002). Such a move would also be in line with the FSB's risk-based approach to supervision

Investigate alternative education requirements for Category A. As indicated above, almost half of the current Category A intermediaries could not obtain the requisite educational level of Grade 10 or NQF 2 by September 2007 and the exemption has therefore been extended to the end of 2009. It is however not clear that this level of education is necessary, as many intermediaries without the necessary scholastic qualifications have built up years of practical experience. Consideration should be given to using a minimum training (most insurers already provide product-based training to intermediaries) or experience requirement as alternatives[59]. Given the simple nature of the product, it is unlikely that the risk of consumer harm will be impacted, should the size of the benefit and range of products sold by intermediaries not meeting the full education requirements be extended.

Under the micro-insurance regime the proposal is, therefore, that current education requirements be reduced or replaced with more appropriate measures. The FAIS Division of the FSB is currently undertaking a comprehensive review of the Fit and Proper Determination. The FSB has been engaging with industry representatives and representatives of SAQA, INSETA and BANKSETA regarding the development of such a new Determination and has also considered international experience. A system of qualifying examinations, rather than scholastic qualifications, is being considered. However, this process has not been finalised and no decisions thereon have yet been taken. Following the outcome of this process, the relevant Determination could be adopted for micro-insurance, or a further exemption or relaxation could be recommended.

Extend uncapped commissions currently in force for assistance business intermediaries to all micro-insurance products (irrespective of intermediary category) but require that commission be paid on an "as and when" basis. Given the low premiums on micro-insurance products, basic commission amounts required to viably sell such products, though low in absolute terms, are high relative to the value of the premium. An uncapped commission is one of the factors enabling viable business in the funeral insurance market, where players have indicated that it

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[59] An example of such a system is found in India, where micro-insurance intermediaries are required to undergo 25 hours of training (at the insurer's expense), with no subsequent examination, versus the 100 hours of training plus an examination required of other intermediaries (at their own expense, but with recognition of prior learning).

takes on average about 6 months for the insurer and/or the agent/broker to break even. Uncapping commission on the defined micro-insurance product lines will allow some room for advice-based intermediation. In addition, the Charter standards (e.g. the Zimele product accreditation standards developed by the Life Offices Association based on the CAT Standards) will incentivise reasonable all-in prices, which will, in turn, limit commissions. Current industry practices in assistance business also signal that competition will serve to keep commission levels in check.

As-and-when commissions will ensure that churn is not incentivised. It is not expected that mandated as-and-when commission structures will distort the market for micro-insurance. As the policy contract will by definition have a duration of a year or less, it will be difficult to justify upfront structuring and commission and a constant percentage of monthly premium would be more feasible. Short-term insurance is traditionally sold on an as-and-when basis, made viable by the fact that short-term insurance is subject to higher commission caps than long-term insurance. Micro-insurance will be premised on this model, but with the exception that commission levels will be uncapped, as is currently the case for funeral insurance. A significant proportion of the micro-insurance market, namely funeral policies sold on a group-underwritten basis, already operates on this basis of uncapped, as-and-when commissions.

This situation will be monitored for any adverse impacts on consumer protection and National Treasury reserves the right to re-impose commission capping, should abuse be found.

Improve recourse. Improved consumer recourse is a critical component of the strategy to improve enforcement and also for the success of the proposed micro-insurance regime more broadly. Accessible, effective consumer recourse is recognised as an important element of the micro-insurance regime. Especially given the special treatment afforded to micro-insurance intermediation, it is essential that the necessary recourse channels are pointed out to consumers in the sales process, should they feel that they are not granted the right treatment. As part of the implementation of the proposed micro-insurance regime, it is proposed that current recourse mechanisms should be reviewed to ensure that compliant dealing with insurance and micro-insurance are sufficiently dealt with. This issue is dealt with explicitly below.

6.5. PROPOSED REGULATORY FRAMEWORK FOR ENFORCEMENT

No matter how well designed, a regulatory framework is undermined to the extent that the rules cannot be effectively monitored, supervised and enforced. Therefore providing a regulatory space spanning product design, risk management and product distribution in which a micro-insurer can operate is only one side of the reform process. Abuses identified in the funeral insurance sector suggest that many (if not most) providers are not registered, and therefore do not fall under the authority of the FSB. As such, the FSB cannot bring an illegal operator to account; enforcement powers of the FSB and consumer recourse channels through either the FSB or an ombud become meaningless. Moving forward, the challenge is twofold: to align the FSB with the relevant enforcement agencies for co-operation in plugging enforcement gaps, and to increase consumer awareness to the point that consumers “walk-with-their-feet”,

thereby pressurising unregistered players to register with the FSB (and comply with the legal requirements and obligations) or face going out of business.

Improved enforcement co-operation: In recognising that the policy making and regulatory oversight of micro-insurance (particularly funeral insurance) spans the national government departments of at least National Treasury, Health, Trade and Industry and Social Development, in 2007 the National Treasury initiated an inter-departmental forum to ensure a cohesive policy response. National Treasury will continue to actively consult across government departments. Enforcement agencies will be invited to participate in the forum, with the intention of developing a pro-active co-operation and enforcement strategy.

The role of apex organisations: Thought needs to be given to the potential role of apex organisations (as written into the Co-operatives Act) to assist in enforcement and supervision through self-regulation. Of essence here is the value proposition offered by a pervasive network of community based providers who are arguably better positioned to identify abuses taking place, versus the risk of inadequate supervision through weak capacity. An issue to debate therefore is whether the principle of self-regulation is appropriate in this environment, and if so, to what extent and through what mechanisms?

The role of the FSB in supporting regulatory compliance: It may be helpful to conduct an audit to find out the extent of unregistered funeral business in South Africa; the question then is who is best positioned to conduct an audit, and how could it be structured?

It will also be important to understand why insurance providers choose to remain unregistered. The Consumer Education Department in the FSB has suggested that one reason may be that funeral parlours need help to complete registration forms. It also seems that some need information about registration fees, or are unable to afford these. Of course, many choose not to register to avoid regulation.

We should bear in mind that funeral parlours and other informal business in this area have filled a gap that existed in past dispensations in much the same way that the growth of the taxi industry was a response to under-served public transportation needs. In order to bring illegal providers on board and encourage them to be part of our formal systems, their passage into the formally regulated space needs to be facilitated. Informal operators may need support in terms of having access to appropriate well-structured and supervised educational programmes that will enable them to do their jobs properly and to improve their businesses.

A substantial education programme on FAIS and insurance regulation is required for those in the funeral parlour business. This should aim not only to tell funeral parlours why they need to register, but also assist those in the outlying areas to complete the registration forms. The FSB Consumer Education Department is confident that a number of parlours would take advantage of this opportunity to register and comply with the law. The FAIS educational programme could be supported by a widely distributed, template FSB policy wording, to ensure that providers comply with the FAIS code of conduct (requiring a minimum information and disclosure on all transactions, as discussed in Section 6.4 above)

Enforcement unit efforts to penalise entities for non-compliance with the existing and envisaged regulation should go hand-in-hand with efforts to inform and educate informal operators about their rights and responsibilities in this matter.

Improved consumer recourse: In light of the above, consumer recourse is a central part of the proposed enforcement strategy and not an addition to the process. Consumer recourse is an important mechanism to ensure the working of a risk-based regime. It is important to ensure that consumers have (and are aware of) proper channels for complaints, especially should *ex ante* enforcement be constrained by a lack of capacity.

Apart from complaints directly submitted to insurers, insurance clients in South Africa currently have a judicial channel for consumer recourse through complaints submitted to one of the three existing Ombudsmen. Currently only complaints pertaining to assistance business, long-term or short-term products are accommodated by the existing insurance ombud schemes under the Financial Services Ombud Schemes (FSOS) Act. Thought must be given as to whether to make use of these existing dedicated ombuds, employ the statutory ombud established in terms of the FSOS Act, or establish a Micro-insurance ombudsman.

As it stands, in practice indications are that there is consumer uncertainty as to where complaints can be lodged and what the procedures for lodging complaints are. This is also the case for friendly societies for whom there is currently no ombud. Complaints against *registered* friendly societies can be submitted directly to the FSB's friendly society division, which is however of limited size and capacity. They also have limited powers of enforcement. Complaints relating to unregistered burial societies are directed to the FSB's insurance department. Enforcement and capacity for resolving complaints are significant stumbling blocks. It is also linked to the issue of consumer education – as long as consumers are not aware of consumer recourse avenues or do not trust in their effectiveness, it is unlikely that results will be positive.

Furthermore, the Ombud is not mandated to weigh up potentially conflicting policy goals, e.g. consumer protection versus access. Firms may therefore be discouraged from taking increased risks of unfavourable Ombud hearings to improve access to products. Guidelines for the Ombudsmen in this respect could force these tradeoffs to be made explicit at the recourse stage, as well as at the policymaking stage. The establishment of a Micro-insurance Ombudsman under the Micro-insurance Act may also be considered although care should be taken not to contribute to an already fragmented consumer recourse environment.

It is proposed that the process initially focuses on implementation of the micro-insurance regime, with complaints and abuses dealt with by the statutory ombud (when falling outside of the FAIS, Long-term or Short-Term Ombudsmans' jurisdictions). Over the longer term, the idea of a dedicated micro-insurance ombudsman can be revisited. Regardless of the route taken and the avenue of recourse open to the consumer, the simplified policy document should explicitly state the circumstances under which a consumer may lay a complaint, and where this complaint should be directed.

The importance of consumer education alongside recourse. Together with recourse, consumer education is a key support for consumer protection and should be included as a central element of the on-going enforcement and consumer protection strategies. In particular, the

introduction of the new products should coincide with a marketing campaign introducing the products but also informing consumer about the risks and how to access support.

Increased consumer awareness: The FSB and National Treasury are designing a consumer education and awareness strategy to target funeral insurance provision. To be used as a pilot, this plan can be tweaked to accommodate other micro-insurance products. The plan under review is as follows:

- Target potential customers through large affinity and burial society groups (for example, one church group that has agreed to participate in the process reaches approximately 3 million people nation-wide, and has strong alliances with a prominent trade union; its Friendly Society comprises approximately 80 000 members in the Gauteng region).

- Set up an ongoing forum with these groups to initially design the awareness/ educational content, as well as the tools to be used, and then monitor the effectiveness of the campaign on an ongoing basis;

- Train affinity/ burial society representatives to conduct the awareness campaign;

- Make use of available media for both the training of representatives and the awareness campaign itself (for example a video can run through the awareness/ educational content, to include role playing scenarios, and these can be disseminated to affinity and burial society groups).

- One expected deliverable will be a short, easy-to-understand pamphlet that explains what insurance is and why a person might need it, and what dangers there are of taking insurance from an unauthorised provider. The pamphlet should highlight illegal practices (for example not offering a cash benefit, only a benefit in kind), and bullet key questions for a client to ask of any prospective insurance provider (advising also of the required answers). A critical item here would be for the client to request that the provider gives evidence of its Financial Service Provider (FSP) registration number. If the provider has no such number, the client knows not to take insurance from them. If shown the license number, the client can verify the information by sending an SMS to a given toll-free number, which will automatically send back a response saying whether the provider is licensed, and if so, what the registered name and address (to the extent possible) of that provider are.

- A client or registered insurance provider will be able to report any other complaints and concerns of illegal practices to the FSB through a toll-free call-centre. Thought must be given as to how best to use this information. One approach is to disclose illegal operators through localised media or affinity groups on a name and shame basis (as has been done by the Insurance Department at the FSB).

- Alternatively, if a client prefers to speak to someone face-to-face, other avenues can be explored, for example channelling complaints through affinity and burial society networks. Likewise, these networks can also be used to name and shame illegal or unscrupulous operators.

Any consumer education outreach programme should dovetail with enforcement. For example, information on illegal operators disclosed through the FSB's call-centre could be fed through to the relevant enforcement agency.

7. THE EMERGING MICRO-INSURANCE FRAMEWORK

The analysis and recommendations put forth in this Discussion Paper can be summarised as follows:

Establish a specific regulatory space for micro-insurance

Create separate regulatory environment for micro-insurance. Based on the particular need to limit the cost of regulation for low-premium products and the analysis of the risks underlying micro-insurance, we propose that a regulatory space can be created for the provision of micro-insurance under a lighter regulatory regime than required for other insurance products.

Also facilitate alternatives to micro-insurance license. The regulatory framework does not only rests on the entry of dedicated micro-insurers but also proposes to accommodate micro-insurance provision via alternative options to the micro-insurance license, which includes using cell captives, underwriting and provision by existing registered insurers.

Burial societies to remain exempt from insurance regulation. The proposed micro-insurance framework recognises the role played by informal burial societies and that, where burial societies have fewer than a prescribed number of members (to be actuarially assessed on risk based principles), have an annual income below a prescribed amount (e.g. the current figure of R100 000, but to also be actuarially assessed on risk based principles) and do not offer guaranteed benefits, they should remain exempt from all insurance regulation.[60] Where societies grow beyond the limits of effective member governance (proxied by the membership size and annual income thresholds) and/or progress to providing guaranteed benefits the framework will require them to utilise the relevant options available for the formal provision of insurance, as set out below.

The proposed framework includes changes to both underwriting and distribution aspects of insurance taking into account the impacts on prudential risk and consumer protection.

Underwriting

Product-based definition of micro-insurance. It is suggested that this space should be defined based on a product-based definition of micro-insurance, which limits the benefits that may be paid to R50 000, the term of the contract to 12 months, the products to risk only, and requiring the product to be suitably simplified. The product definition will include both long-term and short-term products as defined in the current regulation.

[60] In the instance where a burial society has either more than the prescribed number of members or more than the prescribed annual income, the regulatory environment will not distinguish between guaranteed and non-guarantee benefits; all providers will need to comply with the relevant legislation and effecting regulations.

Micro-insurers vs micro-insurance. We recognise that there may be products, which are suitable to lower-income households, but does not fit within the risk criteria for the micro-insurance license. Our analysis suggests that the limitations above are necessary to limit the underlying risk, thereby allowing for dedicated micro-insurers to operate under a lighter regulatory regime. This is not to say that there may, for example, be longer-term products which could have value to lower-income households, but that the increased complexity of these riskier products requires the more onerous regulatory regime currently applied to full insurers. The standards proposed here do not prevent industry standards such as those developed under the Financial Sector Charter to set best and desired practices over and above that which is required by regulation.

Level playing field but regulation tailored to underlying risk. Insurers that only offer micro-insurance products as defined will operate under a reduced regulatory environment. This is justified as the risks inherent in this business are limited by the product limitations. Key components of the proposed micro-insurance regulation will include:

- Micro-insurers may only offer the micro-insurance products as defined above;
- Initial capital is limited to R3m compared with R5m under Short-term and R10m under long-term (including consideration of tiered capital);
- Reserving will be based on a simplified standard model;
- A minimum set of organisational capabilities, which will have to be proved to the regulator (as done currently for insurance registrations). They will involve certain base requirements for all micro-insurers, including the accessing of technical expertise and an auditing function at least annually;
- A minimum set of corporate governance requirements. Apart from demonstrated fit and proper management, this would include requirements around transparency, and appropriate expertise of non-executives;
- Micro-insurers do not need to be public companies. Friendly societies and co-operatives may also register as micro-insurers; and
- Micro-insurers may only invest their funds in a limited set of low-risk and suitably liquid investment options.

Insurers registered under the current Long-term or Short-term Acts may also offer these products with limited, if any, further registration or regulatory requirements. Although these insurers will not benefit from the simplified regulation noted above, they will benefit from the intermediation space created for micro-insurance products (i.e. those products adhering to the definition of micro-insurance) outlined below.

Consistent supervision. All micro-insurers need to be regulated under the insurance division of the FSB.

Friendly societies and co-operatives registered under their respective acts will be allowed to write insurance under the micro-insurance license if they comply with the requirements of the act. The option of writing insurance under the Friendly Societies Act (as provided for by the exemptions for friendly societies currently contained in the Long-term and Short-term Insurance Acts) will be phased out in favour of the micro-insurance regime.

Distribution

The regulation of distribution should remain under the FAIS Act, but amendments are required to create the space for a broader set of micro-insurance products (beyond funeral insurance) and to provide certainty around the exact requirements for these products.

- *Category A mandate extended to include all micro-insurance products.* Intermediaries distributing micro-insurance products will operate under reduced FAIS requirements similar to those that currently apply to category A agents. The distribution of micro-insurance should not be completely excluded from FAIS as there are still risks of abuse and misselling.
- *Reduce Category A education requirement*. The exact level of education or training requirement will only be determined after the release of the new Fit and Proper Determination by the FSB.
- *Micro-insurance products may be sold without advice but on condition of simplified and clear language disclosure of key elements of the policy*[61] *(as well as access to advice, if requested).* This does not suggest that the poor do not need advice, but simply that the cost of advice (as defined in regulation) makes it too expensive relative to the premium values of micro-insurance. This does not exempt the intermediary from providing the necessary information on the product required by a client to make an informed decision. Although not required by regulation, verbal disclosure should be encouraged at the time of sale; moreover, either onsite or offsite verbal product information must be available to the client, through for example a call-centre.
- *Commission levels* on micro-insurers will be *uncapped* but required to be structured on an *as-and-when basis*. This will allow the space for advice and verbal disclosure models.
- *Monitoring and recourse.* We recognise that there is a risk of mis-selling. To assess this going forward insurers offering micro-insurance will be required to report key statistics to the FSB (including commission levels and lapse rates) to allow this situation to be monitored. For full long- or short-term insurers selling micro-insurance products under the reduced distribution regulation regime, this will imply reporting separately on the micro-insurance product category. In addition, it is important that the legislation ensures *clear and easily accessible recourse, through an insurance provider's customer care facility in addition to an ombudsman's office.* The proposed strategy will include initiatives to improve recourse and consumer education.

Adjust broader insurance and other regulation to facilitate graduation and broader participation in the market.

Other areas requiring adjustment include:

- Facilitating the use of cell captives as a graduation step for entities wanting to move beyond 100% underwriting, but not yet ready to become micro-insurers or full insurers. In particular, the restrictions on friendly societies accessing a cell captive arrangement should be removed.

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[61] An FSB guidance note should be issued in this regard once the micro-insurance legislation has been gazetted.

- Provide guidance on elements of intermediation that are excluded from FAIS. Care should be taken that this does not undermine the consumer protection intended by FAIS to the very constituency it was targeted at.
- The tax treatment of companies, co-operatives, and friendly societies underwriting micro-insurance products should be reviewed to ensure consistency in the approach followed.

Ongoing areas of consideration and research

While this discussion document does broach the following areas, a more comprehensive strategy may be required for each:

- *Social security reform:* While limited death and disability benefits are included in the envisaged social security system, it is intended that micro-insurance providers in this space will remain (and indeed grow). This assertion is made on the grounds that only those individuals who have been contributing to the fund will covered by the benefits offered, there is no provision for funeral policies, and the low social security death benefits anticipated (relative to the benefits wanted) suggests that those who can afford it may want to pay for higher benefits. A related issue for review are abuses noted where deductions are made for funeral policies directly out of social grants.
- *Consumer protection and enforcement:* For abuses in the selling of funeral policies, National Treasury will engage the relevant government stakeholders to ensure enforcement of both legal and illegal operators. As a first step the National Treasury is leading an inter-departmental forum to facilitate increased co-operation amongst national government departments, to be expanded to include enforcement agencies. The enforcement strategy will be underpinned by a consumer awareness campaign targeted at lower income groups, through a combined effort by the National Treasury, FSB and affinity groups. Specific areas examined are improved enforcement cooperation, the role of apex organisations in enforcement, the role of the FSB in supporting regulatory compliance and increased consumer awareness. It is proposed that the process initially focuses on implementation of the micro-insurance regime, with complaints and abuses dealt with by the statutory ombud (when falling outside of the Long-term or Short-Term Ombudsmans' jurisdiction). Over the longer term, the idea of a dedicated micro-insurance ombudsman can be revisited.
- *Tax policy:* The tax treatment of co-operatives, friendly societies and public companies operating under the Long-term and Short-term Insurance Acts will be reviewed to ensure consistency in the approach followed.

Proposed legislation

Separate Micro-Insurance Act. To achieve the above, it is proposed that a separate micro-insurance act should be created under which micro-insurance products can be written. This act should allow for the participation of existing short-term and long-term insurers in this market and facilitate participation of entities that are not public companies (as is required under Long-term and Short-term Acts). A separate act may also make it easier to create the regulatory space without having to reconcile the current requirements of the Long-term and Short-term acts. The act should also ensure a suitable governance regime for micro-insurers including the governance of mutual insurers and friendly societies. However, this act should be embedded in

a broader micro-insurance framework which should allow for broad participation in this market and the graduation of entities from small, underwritten entities to larger more sophisticated options.

8. EXPECTED IMPACT OF PROPOSED FRAMEWORK

This section considers some of the potential impacts of adopting the proposed micro-insurance regulatory framework and the other regulatory changes suggested in this document. In particular we consider the impact on:

- Likelihood of take-up by potential suppliers;
- Regulatory capacity;
- Existing insurers; and
- Existing intermediaries.

8.1. IMPACT ON THE MARKET

It is important that a new regulatory framework, as proposed, is in response to a market need and will be utilised. If not, it will be difficult to justify the costs of designing a new regulatory framework.

Likely take-up among previously-informal entities. It is likely that, initially, the impact of take-up from the bottom up (i.e. formalisation) will be limited. These will take some time to come through the system and will initially serve smaller client bases. Potential however exists for formally unregulated entities to register as micro-insurers, especially as the Micro-Insurance Act becomes better known. Furthermore, the micro-insurance framework will be accompanied by an enforcement plan and a support programme for burial societies and especially funeral parlours, as well as other groups wanting to formalise which will make this more attractive. Once the regulated micro-insurance brand is established as trustworthy and capable of delivering value-for-money products, further incentives for formalisation will be generated by consumer demand.

Likely take-up among existing registered insurers. Industry consultations also indicated interest in the provision of micro-insurance by existing insurers, especially in the quest to reach their Financial Sector Charter targets. For existing insurers, the benefits on intermediation will be of particular interest and value. It is important that the micro-insurance product features do not contradict industry standards developed for Financial Sector Charter products and care has been taken to design the framework to be accommodated within the broader Charter standards framework.

Some specific impacts that are expected include (in no particular order):

- Existing insurers are likely to be the biggest contributors under the new framework. While the space is created for new entrants, this will take some time to come into effect and for new entrants to set themselves up. However, the intermediation benefits provided to existing insurers should provide immediate incentives and opportunity for expansion.
- Existing insurers will take up the opportunity to sell micro-insurance/Charter products through more broadly defined Category A intermediaries. This will particularly include short-term insurers who have been struggling with intermediation to date.

- The number of Category A intermediaries is likely to increase substantially as many of those currently operating as non-advice representatives opt to register for this category and as more intermediaries are able to comply with the reduced entry requirements.
- Some existing insurers may consider moving their micro-insurance business into a separate entity/department that can benefit from the prudential benefits of the micro-insurance license. Large insurance groups may, for example, opt to change one of their licenses to a micro-insurance license.
- Large funeral parlours (or industry associations), micro-lenders, friendly societies and burial society/stokvel associations will at the least investigate registering for micro-insurance licences. Some will pursue the micro-insurance license while others may opt for the cell captive route. It is likely that at least one or two co-operative insurers will proceed with registration.
- Friendly Societies will utilise the link with cell captives in order to grow their book to the size required to register as independent micro-insurer, *or* they may even opt to apply from the beginning for a micro-insurance license with a business plan that proposes growth and accumulation of capital over a period of time.
- Some micro-lenders who recently also obtained insurance licenses, but for their insurance business only operate in the micro-insurance space, may consider downgrading their insurance license.
- Active enforcement against funeral parlours without government offering support to facilitate a migration to regulatory compliance, may result in significant outcries and political battles. However if is the enforcement process is sufficiently backed by consultation with industry associations as well as recognition and support in formalisation (including amnesties), this will be a fringe debate and over a period of 5-10 years most will be registered.
- Once the recourse mechanism has been improved, it is likely that consumer complaints will initially escalate. This will be partly due to improved visibility and recourse and partly due to the fact that there will likely be many new clients who are not used to insurance. If appropriately managed, this will be temporary and complaints should stabilise and reduce over the short term.
- Short-term micro-insurance is likely to remain a problem, as there has been limited expressed demand for short-term micro-insurance products thus far. The new environment is likely to catalyse a number of experiments. Though most are likely not to achieve significant take-up, two or three initiatives may succeed and will thereby set the trend going forward. If no innovative distribution partners/channels are found, growth is likely to be slow for the first few years whereafter it is likely to increase as awareness gradually improves.
- Experiments with retailer, cell phone and other innovative distribution channels are likely to grow in the search for more efficient distribution. If uncapped commissions are adopted, this may stimulate some experimentation with enhanced disclosure or advice-based models. The option of a micro-insurance license is likely to improve the bargaining position of the distribution partners as they can now more easily set up their own insurers (although they are unlikely to want to do so given the additional management burden). This is similar to what was experienced with the development of second tier banking regulation.
- The combination of long-term and short-term products under the micro-insurance license will lead to the emergence of new combinations of products. In particular, short-term insurers will be looking to benefit from packaging their products with more familiar life and funeral products.

- Short-term insurers are likely to quickly take up the opportunity of offering funeral insurance. Given the difficulty of selling short-term products, life insurers are less likely to venture into short-term products initially.
- Retailer-linked insurers are likely to take up the new combination license to offer an increased variety of cover to their clients. If the National Credit Act processes are successful in clamping down on abuse in this space, this will be a positive development.

8.2. REGULATORY AND SUPERVISORY CAPACITY IMPLICATIONS

The impact of product category-based regulation. The introduction of a micro-insurance regime will entail an additional class of policies for incumbent insurers on which they need to report and for which they need permission. Product category-based regulation is an existing feature of the South Africa market, so this will be a quantitative change rather than a qualitative one. Such product category-based regulation, where classes of policies are defined for which an insurer is then licensed, and where insurance is demarcated according to the types of products sold, must be distinguished from *product regulation*, where the regulator must approve each product separately.

Furthermore, the regulator will need to ensure that new micro-insurance licensees do in fact provide only micro-insurance products and not offer other higher risk products which should not fall under the reduced compliance regime. This could mean product approval upon the licensing of a micro-insurer, and ex post monitoring to ensure that products reported as micro-insurance do in fact meet the criteria for micro-insurance. Individual approval of products before they can be launched is likely to be inefficient and not bring major, additional benefits. However the product supervision process will require additional monitoring capacity of the FSB, in the same way that current monitoring of correct classification of business is conducted. Improved recourse mechanisms will support this process. Product standards will also have to be revised on a periodic basis which will require interaction between the FSB and the industry associations.

Likely supervisory capacity impact of micro-insurance. New insurers are likely to enter the market under these changes, and apart from product regulation, it may mean that more inspection visits have to be made, especially since many of these insurers will be newer and smaller than the current average.

Current supervision methods. The FSB currently monitors compliance in two ways.

Firstly, all registered insurers (long- and short-term) are required to submit financial returns on a quarterly and annual basis to ensure that they meet the solvency requirements and are in compliance with their license conditions. Should micro-insurance be introduced, it implies that there will be an additional class of policies reported to the FSB and additional insurers doing the reporting.

Secondly, in addition to scrutinising returns, the FSB conducts on-site visits, usually triggered by the prudential information stated in the returns. In line with the introduction of a risk-based approach to supervision (as stated in the FSB's Strategic Plan of 2004-2007), the on-site visits are now to be based on the overall risk rating of insurers. These audits will no longer be limited to prudential matters, but will also include market conduct, registration and policy matters. The

implication is that not all insurers will be visited on an annual basis – those with a higher risk rating will be visited more regularly than their lower-risk counterparts.

Going forward, the increased scope of FSB responsibilities will require a change in supervision strategy. While the focus was only on prudential regulation, this could be achieved through reporting requirements and by high-skilled staff conducting periodic, but infrequent inspections focusing on the largest insurers which presented the biggest prudential risks. With the extension to market conduct regulation this will now require a lower-skilled staff contingent to monitor a large number of transactions and, in particularly, the smaller transactions as these are made by individuals who are more vulnerable to abuse. To limit the additional capacity required, it is suggested to move to intervention on the report of abuse rather than trying to monitor all transactions. This, however, will require a significant improvement in the current complaints and recourse mechanisms. In addition, the focus will, at least temporarily, be on unregistered insurers and intermediaries. To deal with these also require adjustment to current recourse mechanisms as these often only deals with registered insurers. The extension of FSB powers of enforcement is welcomed in this respect.

Prior approval and ex post supervision. The likely implications for regulatory capacity depend to a large extent on whether supervision is done on an *ex ante* or *ex post* basis. Some countries require their regulatory authorities to conduct prior checks of regulatory compliance, the quality and the pricing of new insurance products being offered. Should a new class of policies be introduced, it would mean that added regulatory capacity is required. The ex ante supervision approach is recommended by the OECD in their document “Twenty Insurance Guidelines for Economies in Transition”, which also recommends making allowance for the adaptation of this approach to the particular market in each country. However, only very few countries within the OECD itself practice this approach, notable Hungary, Korea (for products considered sensitive) and the United States. The European Union has issued Directives for both life and non-life insurance sectors which requires all member states to adopt an exclusively ex-post system of regulation. The goal of this form of supervision is to encourage insurance companies to innovate with new products, while at the same time ensuring, after the product has been launched, that these products meet regulatory requirements and that their pricing does not put the firm in financial jeopardy. India also follows a prior approval approach, but on a file and use basis: if the regulator does not respond to the product application filed within 30 days, companies can go ahead and launch the product. While this seems like an innovative way to avoid regulatory bottle necks initial reports on the Indian experience suggest that bottle necks are not necessarily avoided. Under the pressure of limited capacity, the regulator only needs to submit requests for information or changes on day 29 to avoid the product being released and giving themselves more time to investigate.

It is important to note that ex-post control does not prevent the regulatory authorities from requiring insurance companies to submit information (main characteristics, policy documents, pricing methods, etc) about new products, just that the products are not subject to prior approval (OECD International Survey of Insurance Regulation, 2001).

Recommendation. Given the FSB’s current risk-based approach to supervision and given capacity constraints, a “file and use” approval system is recommended. This means that all companies will need to submit information on planned products to the FSB prior to launching so that glaring violations of the product definition could be picked up. It however does not force

the FSB to scrutinise each product before approval, and does not delay market processes. This is to be enhanced by ex post monitoring of the returns submitted, as well as through periodic inspections. In this way the additional strain placed on the FSB is minimised, while the incentives of firms to "illegally" classify products as micro-insurance without qualifying as such are reduced. The FSB, as part of its risk-based approach, will identify the less risky areas and apply less strict supervision to them. This may include micro-insurers above or below a certain size. Furthermore, it is suggested that product standards should be drafted by the industry and only approved by the FSB. This will further reduce capacity requirements and ensure that the standards are tailored around product offerings.

What aspects of the micro-insurance product should be monitored? Micro-insurance products can be monitored in terms of the sum assured, the term of the policy and the type of insurance offered. "Softer issues" such as simplified policy documents or flexible policy terms are harder to monitor from a regulatory perspective and we recommend that a limited set of indicators be identified which can be monitored easily and cost-effectively. Industry standards and the accreditation to be obtained via industry bodies may then help to enforce such standards.

Enforcement capacity implications

At least temporarily, capacity will be required in an attempt to boost enforcement, particularly for the funeral parlour market. As outlined in the proposed framework, a number of recommendations are made on co-operation with dti, the Department of Health (DoH), SARS and SAPS in order to harness their joint capacity.

Inspection: To conduct an enforcement campaign on thousands of funeral parlours will be a challenge. The suggested approach on funeral parlours is to collaborate with the DoH and industry bodies in order to compile an updated database of registered parlours. As a next step it will be necessary to find some information on the size of operations in order to prioritise the largest entities. Co-operation from SARS should be sought to prioritise the list in terms of size, but this is likely to be difficult. In the absence of this, it is suggested that a process of randomised checks be imposed though the list can be systematically reviewed. Combining this with improved recourse (including illegal insurers/intermediaries) will ensure that problem cases are flagged and these can then be prioritised.

Tribunals: The tribunal processes that are currently being developed for other areas within the FSB can be usefully applied to support this process of enforcement.

Ombudsman offices: As described in Section 6, enforcement can be supported by consumer recourse mechanisms. It is proposed that the micro-insurance reform process initially focuses on implementation of the micro-insurance regime, with complaints and abuses dealt with by the statutory ombud (when falling outside of the FAIS, Long-term or Short-Term Ombudsmans' jurisdictions). Over the longer term, the idea of a dedicated micro-insurance ombudsman can be revisited. Regardless of the route taken and the avenue of recourse open to the consumer, the simplified policy document should explicitly state the circumstances under which a consumer may lay a complaint, and where this complaint should be directed.

9. COMPARING THE PROPOSED FRAMEWORK TO INTERNATIONAL EXPERIENCE AND PRACTICES

The proposed framework stipulated above incorporates learning from international experience on several aspects, for example in considering appropriate corporate governance requirements for mutual organisations and in informing the debate on the appropriate fit and proper educational/training requirements to be applied to micro-insurance intermediaries. However, it must be noted that South Africa is in many respects ahead of the pack and that the opportunities for learning from other developing countries' experience is, therefore, limited. This is particularly the case for voluntary insurance as much of the international micro-insurance market is dominated by compulsory credit life products.

The experience of two countries, India and the Philippines, were found to be of particular interest and their relevance will be discussed in this section. India and Philippines are two of the few countries that have created a specific micro-insurance space within regulation and have approached this in very different ways. While India has focused on the regulatory space around the *distribution* of micro-insurance products, the Philippines has focused on creating a regulatory space for micro-insurance *providers*.[62] The lessons from these two examples are discussed below and, where relevant, references to other country experiences are included.

Distribution allowances: India. India has made no concessions in terms of capital or operational requirements for entities wishing to offer micro-insurance. However, it represents one of the clearest examples of where regulatory requirements around *distribution* have been relaxed for micro-insurance products. Furthermore, in order to promote the penetration of insurance products within the low-income market, a quota system has been implemented. This can be compared to the access targets set under the South African Financial Sector Charter, although the requirements in India are more direct and the targets are regulator- rather than industry-driven. Recognising the distributional challenges this posed for insurers, who are being forced to enter rural, under-serviced markets, micro-insurance products were defined in regulation and were subjected to streamlined distribution rules. These rules allow for a new type of intermediaries, called micro-insurance agents, to distribute products that meet the criteria for micro-insurance (most notably minimum and maximum benefit caps). Only NGOs, micro-finance institutions and community self-help groups are allowed to register as micro-insurance agents. Such agents have to undergo fewer hours of training than other intermediary types, although they are subject to the same code of conduct.

UK also moving towards product-based intermediation regulation. The United Kingdom is also currently considering a new distribution regulatory regime whereby certain low-risk products may be exempted from more onerous requirements relating to the distribution of products. This stems from a major study which suggested that consumers do not require complicated disclosure documents for some products, as the risk of misselling presented by such products

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[62] The experiences of India and the Philippines are discussed in more detail in Appendix 2.

was sufficiently low. The framework envisaged here is a differentiated regulatory regime, based on risk assessments of product lines. The suggested regulatory framework for South Africa follows this principle and will allow micro-insurance products to be distributed under a reduced regulatory burden.

Prudential and operational requirements: the Philippines. A good example of where provision of insurance has been extended beyond traditional insurance companies is the Philippines. A second tier of micro-insurance *providers* which traditionally focus on the lower income market was introduced by regulation in 1974. Mutual Benefit Associations or MBAs (similar to South African friendly societies) are allowed to offer insurance products to their members under a reduced regulatory burden and with lower capital requirements. Recent changes to these regulations allow the creation of Micro-insurance MBAs who may offer limited benefit products with regulated premiums. These 'third tier' providers have even lower capital and reporting requirements than full insurance MBAs. This means that informal, community based insurance schemes have the legal space to become MBAs and register with the Insurance Commission. They are then subject to a certain degree of oversight by the regulator, and have to fulfil certain requirements (such as actuarial assessment of their products and pricing), but this oversight is not as stringent, and therefore not as costly, as that for full insurers. Capital requirements are also much lower than for traditional insurers ($0.1m vs $20.1m), and all types of MBAs enjoy favourable tax treatment. Mutual organisations This type of special treatment for friendly society type organisations is not unusual within the international insurance environment. Depending on size, these kinds of organisations are usually subject to lesser capital and compliance requirements

The suggested regulatory framework for South Africa resembles that of the Philippines in that it sets out reduced capital and compliance costs for entities wishing to offer micro-insurance products, thus extending the scope for micro-insurance provision beyond traditional insurers. Within the micro-insurance category no differences in capital requirements are however proposed, that is: capital requirement differentiation is based on product category offered, rather than institutional form per se.

The table below summarises the key features of the regulatory environment for India and the Philippines.

	India	Philippines
Product definition	Product parameters are defined according to 3 characteristics which vary depending on the type of insurance: • Min and max *benefit levels* ($113 - $1130) • Min and max *policy term* (1 – 15 years) • Min and max *age at entry* (5 – 70 years)	A micro-insurance product is a product where: • Daily premium does not exceed 10% of the minimum wage rate for non-agricultural urban workers • Max amount of life insurance coverage is no more than 500 times the minimum wage mentioned above.
Risk carrier	Only full insurers may offer insurance products, although both long- and short-term insurers can provide all micro-insurance products.	Legislation allows a *second tier of insurance providers*: Mutual Benefit Associations (MBAs), which are subject to lesser capital and reporting requirements than full insurers. Recent changes to regulations allow Micro-insurance MBA's which have significantly lower capital requirements, thus creating a third tier of providers.
Distribution	Micro-insurance products are subject *to lesser distribution requirements,* and NGOs, MFIs and self-help groups may become agents of the insurer and offer micro-insurance products	No allowances are made, but requirements around simplicity of policy documents and the clear identification of terms, benefits and the face amount of the policy are made.
Difference in Commission caps between MI and full insurers?	Yes – Commission cap of 10-20% of premium, depending on premium payment method vs 60% over 5 years for full insurers. Aggregated, the overall commission for MI products is higher than for conventional insurance products.	No regulated differences
Drivers of micro-insurance provision	Industry quotas forced insurers to target low income market	Demand for micro-insurance from communities who have traditionally practiced risk pooling techniques.

Table 2: Key features of micro-insurance regimes in India and the Philippines.

Source: various regulatory documents

What can we learn from the micro-insurance experience in these two countries?

Underlying the systems discussed is the need to define a micro-insurance product category within regulation. Only once defined, can appropriate regulation (be it in terms of intermediation regulation as in India or prudential regulation as in the Philippines) be designed for this product category.

Targets rather than quotas. While the Financial Sector Charter targets incentivise the provision of products to the low-income market, we do not subscribe to the quota system instituted in India. Due to the unrealistic nature of the latter system this has resulted in loss-leading initiatives by insurers simply to meet the quota with limited efforts to pursue further market development beyond the quota.

A distinct micro-insurance category to which intermediation regulation can be tailored. In drawing up the framework, the fact that the Indian system allows for the registration of micro-insurance intermediaries/agents was taken into account as an element that South Africa can learn from. Explicitly defining such a category (in the proposed South African framework this

will entail an extension of the current Category A intermediaries) allows regulation to be tailored to the consumer protection risk characteristics of this category, for example in terms of commission regulation and also education or training requirements, as is the case in India. It is recommended that South Africa adopts a similar system of hours of training as one element of the Fit and Proper Determination process. However, whereas the Indian system only allows NGOs, MFIs and Self-Help Groups to be registered as micro-insurance agents, the proposed South African framework seeks to create a level playing field by opening it up to all who can meet the requirements. In working towards a differentiated regulatory regime, based on risk assessments of product lines, South Africa is also in line with insurance regulatory developments in the UK.

Caution on excluding particular legal entities. As noted, achieving the quotas in the Indian case was supported by creating a regulatory space for micro-insurance agents. Although this space holds several benefits for such intermediaries, it has been defined to exclude MFIs operating as trusts or non-profit companies as well as commercial intermediaries. As a result, the largest providers of micro-insurance currently are not able to benefit from the regulation. No clear reasons have been provided by the regulator for excluding these entities from the definition. Furthermore, intermediaries may only work with one life and one non-life insurer. As not all insurers are offering all products in the micro-insurance space, the result is to limit to products on offer through these intermediaries.

A prudential micro-insurance regime. South Africa shares its drive for formalisation in the micro-insurance sphere with the Philippines and can learn from the Philippine experience in accommodating Mutual Benefit Associations within its prudential framework by submitting them, based on the principle of mutuality, to lower capital requirements, but then limiting their product offering to limited benefit products (with regulated premiums in the case of the Philippines). The proposed South African system, similarly, defines a lower-risk micro-insurance product group. Organisations providing only such products and adhering to the product requirements are then subject to lower minimum capital requirements.

The proposed regulatory framework for South Africa therefore seeks to achieve the “best of both” by making explicit provision for both insurance provision and intermediation. It is only by addressing the full range of steps to provide insurance to the poor that the market can be developed without being undermined on another front.

10. WAY FORWARD

The document is released for public comment on 7 April 2008. Appendix 11 contains more detail about the requested comments and the format in which these should be submitted. The comment period will end on 31 July 2008. National Treasury will road-show the regulatory design proposals, and is committed to ongoing consultation and engagement with industry stakeholders.

A response document containing more detailed design features is scheduled for late 2008.

The consumer awareness strategy will be implemented in parallel to the legislative and regulatory reform process; engagement with stakeholders is already underway.

Draft legislation and regulations are scheduled for release in 2009.

It is proposed that the micro-insurance structure be introduced during the course of 2010.

11. APPENDICES

APPENDIX 1: COMPARISON OF REQUIREMENTS OF INSURANCE ACTS AND REGULATIONS

Areas of primary difference are bolded.

RISK ADDRESSED	Long-term Insurance Act, 1998	Short-term insurance Act, 1998
Return on investments is less than expected	Restrictions on types of assets, which are admissible, value calculation guidelines	Restrictions on types of assets, which are admissible, value calculation guidelines
Risks presented by different classes of business	Registrar can restrict activity to certain classes of business, limit sums assured, premiums, require reinsurance, etc.	Registrar can restrict activity to certain classes of business, limit sums assured, premiums, require reinsurance
Premiums are insufficient to cover claims	• Access to an actuary • Actuarial soundness of premium rates	Provision of a Unexpired Risk Provision in the case of an underwriting loss in consultation with the auditors
Base reserves set aside to cover future claims are insufficient	• Access to an actuary • Liabilities valued using relevant experience (mortality, morbidity), interest rates, methods • Additional reserves as necessary (security, AIDS, mismatch)	Guidelines for calculation of: • Unearned premium reserve • Reserve for incurred but not reported claims (subject to a minimum of 7% of net premium) • Outstanding claims • Contingency reserve of 10% of net premium over the last 12 months
Additional reserves required	• Capital Adequacy Requirements, calculated as per guidelines produced by the Actuarial Society of South Africa • Minimum capital adequacy requirement (the greater of R10m and thirteen weeks of operating expenses)	An additional margin of the greater of R3m or 15% of net premium in previous financial year (2004 regulations)
Operational risk	• Registration (unless short-term insurer, co-operative, friendly society writing <R5k), costing over R30k in 2004) • Public company • 'financial resources, organisation or management that is necessary and adequate for the carrying on of the business concerned' [9 (3) (b) (i)] • Fit and proper director or managing executive • Independent auditor, audit committee	• Registration (unless short-term insurer, co-operative, friendly society writing <R5k) • Public company or approved form • 'financial resources, organisation or management that is necessary and adequate for the carrying on of the business concerned' [9 (3) (b) (i)] • Fit and proper director or managing executive • Independent auditor, audit committee
Misleading information provided to stakeholders	Audited annual return, unaudited quarterly returns	Audited annual return, unaudited quarterly returns
Overall compliance	• Appointed public officer to ensure compliance with Act • Fit and proper requirement on key individuals • Submitted 5 year business plan projections • Levy – a % of liabilities	• Appointed public officer to ensure compliance with Act • Fit and proper requirement on key individuals • Submitted 5 year business plan projections • Levy – a % of gross premiums

APPENDIX 2: INTERNATIONAL EXPERIENCE

This appendix outlines the micro-insurance experiences of three countries: India, where the micro-insurance regime is distribution-focused, the Philippines, where the micro-insurance regime is provider-centred, and Uganda, where micro-insurance products have emerged but there is no specific regulatory regime for them yet. These three countries were selected because they are developing countries which exemplify three different approaches to the regulation of low income insurance.

INDIA

India is one of the most often-quoted examples of a country where micro-insurance has been provided for within the insurance regulatory framework. The Indian Insurance Regulatory and Development Authority (IRDA) has a dual role of regulating insurers and promoting the development of the insurance market. The latter has led to a number of initiatives to develop the market and improve the density of insurance penetration. It opted to do so via a model for micro-insurance based on distribution, rather than on provision.

Obligations placed on the market

In 2002, the IRDA adopted minimum requirements for insurers to serve rural areas and people living below the poverty line. The approach has been largely coercive or prescriptive, aimed at forcing companies to engage with the low income market, but then addressing regulatory obstacles to profitable operation. The measures instituted include:

- Encouraging the presence of an adequate number of insurers to provide competition and choice to customers;
- Prescribing rural and social sector norms in order to achieve adequate social security and health protection;
- Asking the insurance companies to devise new covers and products addressed to specific sectors in the economically weak population;
- Recommending, at the time of granting registration to new companies, and in suitable cases, the establishment of branches and offices in places where activities are on a low key;
- Encouraging awareness campaigns to improve insurance literacy levels by conducting workshops, distributing literature, etc.

IRDA has furthermore set up a quota system specifying targets for private companies operating in the market. These quotas do not apply to public insurers. The following targets, expressed as percentages of policies or premium, are set for rural areas and “social sectors” (IRDA, 2002):

- *Rural: life policies*. Policies sold in rural areas must in year one account for 7% of *total policies written* by life insurers in that year, gradually phasing up to 16% by year 5.
- *Rural: general policies*. General insurers must sell a minimum of 2% of total *gross premium income* in rural areas in year 1, going up to 5% in the third year.

- *Social sector policies*. Social sectors are defined as the "backward classes", "economically vulnerable" and "unorganised workers" irrespective of whether they live in urban or rural areas. Each insurer (regardless whether life or general) must have 5,000 active social sector persons covered in the first year. By year 5, this number must reach 20,000. For general insurance, the obligations include the provision of crop insurance.

Should targets be missed, financial penalties are imposed. Some insurers ignore the requirements and accept the penalties as a cost of doing business. Others are proactively looking at this as a market opportunity, and exceed their quotas, e.g. ICICI-Lombard and TATA-AIG (Wiedmeister-Pfister & Chatterjee, 2006).

Regulatory initiatives to facilitate the market

Encouraging the partner-agent model. IRDA recently issued new micro-insurance regulations to facilitate operation of formal insurers in the low income market. The regulations are aimed at partnerships between regulated and unregulated entities (IRDA, 2005). Thus the regulations focus on expanding micro-insurance access through setting up a partner-agent model rather than allowing for increased provision of micro-insurance through second tier insurers.

Micro-insurance specific intermediation provided for. The regulation makes provision for a new type of intermediary, called the micro-insurance agent. This can be an NGO, a microfinance institution, or a community self-help group organisation, which is appointed by the insurer to distribute micro-insurance. Therefore the partner-agent model is to work via linkages between insurers and micro-insurance agents. Each of these agents can then employ specified persons, with the approval of the insurer, to discharge their duties.

As part of this relationship, the agent has to:

- Enter a deed of agreement with *one insurer only*, clearly specifying roles and duties, e.g. collecting forms, declarations, premiums; distributing policy documents; maintaining a register of insured lives and details; assisting in claim settlement, etc.
- Comply with the *code of conduct* of the IRDA. The Code of Conduct is standard for all intermediaries. Violation of the code of conduct will lead to termination of the appointment as a micro-insurance agent.

The differences between what is required of a conventional insurance agent and a micro-insurance agent are captured in the table below:

Micro-insurance agent	Conventional insurance or corporate agents
NGO, self help group, microfinance institution	E.g. bank, company, co-operative, NGO, etc
No management requirements specified in regulations	Organisation requires a Chief Executive responsible for overseeing insurance business
25 hours of training, in the local language, at the insurer's expense	100 hours of training to be paid for by agent (reduced if certain qualifications already met).
No examination specified	Examination required
Commission cap of 10-20% of premium, depending on premium payment method	Total cap of 60% of the first five years of premium (in aggregate this is less than that of micro-insurance agents)
Can sell micro-insurance products only	Not limited in terms products allowed to sell
No fee specified in regulations	Fee of Rs250
Has to adhere to the same code of conduct	
Works for one life and/or one general insurer only	

Table 3. Comparison between conventional corporate agent requirements and micro-insurance agent requirements.
Source: IRDA, 2005 (Microinsurance Regulations); IRDA, 2000 (Licensing of Insurance Agents Regulations).

Only very general requirements or specifications are set with regard to advice, with the code of conduct merely directing agents to "take into account the needs of the prospect while recommending a specific insurance plan". The insurer is responsible for the overall compliance of all micro-insurance transactions in terms of the Insurance Regulatory and Development Act of 1999. Insurers are also responsible for handling and resolving complaints about micro-insurance agents

Product design

Product limits, no demarcation restrictions. Certain features of the product, specified below, have to fall within specified limits in order for the product to qualify as 'micro-insurance' and be eligible for distribution through these agents. The product must also be labelled as a 'Micro Insurance Product'. Although insurance is demarcated into life and non-life, any insurer can offer both life and non-life micro-insurance products.

Actuarial sign-off required, then "file and use" approval. Product design and pricing need to be signed off by an actuary (either appointed in the case of a life company or a consulting actuary if preferred in the case of a non-life company). This has to be submitted to the IRDA thirty days in advance of launch, during which the IRDA has the opportunity to request clarifications or changes – if there are none, the product can proceed, i.e. on a 'file and use' basis.

Product parameters. Cover and term limits are set for different product lines:

Product line	Minimum cover	Maximum cover	Min / Max Term of policy	Min / Max Age at entry
Life	5000Rs ($113)	50 000Rs ($1130)	5 / 15 years	18 / 60
Non-Life	5000Rs per asset	30 000Rs ($678)	1 year	N/A
Health	5000Rs	30 000 Rs	1 / 7 years	Insurers discretion
Personal Accident	10000Rs ($226)	50 000Rs	1 year	5 / 70

Table 4. Limits imposed on micro-insurance products in India

Source: Insurance Regulatory and Development Authority (Micro-Insurance) Regulations, 2005

Non-life cover or general insurance is designed to insure huts, livestock, tools, implements and other assets against “all perils”.

The regulator decided to institute a minimum amount of cover, as it felt insurance needed to provide a tangible benefit, and amounts below this would not achieve this aim. In the concept paper which preceded the issuing of regulations, the minimum amount of cover was set at 10,000Rs for all product lines, but it was subsequently lowered in the regulations.

What can South Africa learn from the way in which micro-insurance is provided for in India?

Criticisms

The IRDA has focused exclusively on the distribution, and not the provision of micro-insurance. The regulations do not facilitate the entry of additional players into the micro-insurance market, but rather facilitate the entry of different distributors. The minimum capital requirements of an insurance company remain at $22m, hampering entry of new competitors to the market. (There are however, proposals to reduce this to $11m in the class of health insurance).

The restriction of micro-insurance provision to the partner-agent model has raised many concerns, notably from co-operatives, mutuals and NGOs engaged in health insurance among the rural poor. There are essentially no concessionary regulations for companies wishing to offer only micro-insurance, and so small, community based groups currently offering informal insurance are given no favourable conditions to register as insurers and formalise. This excludes smaller enterprises from entering the sector and limits competition in the market. There is also concern over the requirement for each micro-insurance agent to limit their business relations to one insurer.

It has furthermore been argued that the regulation must ensure that any person willing to buy insurance should be able to do so, on the same terms that others can if providers are willing to offer cover. The age limits placed on micro-insurance products have therefore also come in for criticism.

Positive aspects

India is one the few countries worldwide who have made specific regulatory adaptations for micro-insurance. The partial relaxation of distribution rules, in line with product simplification and standardisation, has minimised the extent to which customer protection is compromised. Although no concessions have been made to the requirements of formal insurance providers, the fact that these rules remain ensure customer protection in respect of the validity of benefit guarantees. There has also been a relaxation of the demarcation of insurance, which means that any insurance company can offer micro-insurance products, whether they are long- or short-term.

Key lessons for South Africa

Relaxation in demarcation. South Africa can learn from the Indian experience of relaxing the demarcation requirements between long and short-term products in the case of micro-insurance. It was argued that, based on the product limits set, micro-insurance presents a single type of product and that insurers registered under any license could provide all micro-insurance products.

*Quotas extend coverage, but often not in a meaningful w*ay. It is not advisable to follow a quota system as implemented in India. In an often-quoted case, an Indian insurers has bundled insurance with the sale of sacks of fertiliser (the policy document is printed on the bag). This model has managed to sell in excess of 25m policies (Roth & Chamberlain, 2006). Whether actual take-up is achieved, or whether premium payment will always be a function of the demand for fertiliser (whether monthly or more sporadically) is however not clear. It would seem that demand is, in the first place, determined by demand for the fertilizer, not for the insurance and that people who had wanted insurance could have bought a separate insurance product. The model does, however, enable the insurer to meet its target. The meaningfulness of the quotas can therefore be debated. As a direct form of intervention, a quota system is also bound to introduce market distortions. In South Africa, it must be ensured that micro-insurance products are meaningful and will achieve take-up and are not merely token products for charter purposes. The Charter and the targets set under it must also not be the sole driving force behind the development of a micro-insurance framework.

New entry to be encouraged as well, not just intermediation. The Indian example illustrates the role for regulatory accommodation of micro-insurance intermediation. Though this enables wider distribution channels, it still does not allow micro-insurance agent groups to graduate into becoming insurers in their own right, as the barriers to entry for formal insurers remain very high and no specific provision is made for a class of micro-insurers.

PHILIPPINES

Micro-insurance provision

A second tier of insurance providers serve the low-income market. Insurance in the Philippines is governed by the Insurance Code of 1974. This law generally requires all insurance providers, regardless of type or ownership structure, to apply for a license from the Insurance Commission. The code sets out guidelines, prudential rules and regulations in the operations of insurers, with the overall objective that these entities will be able to provide the benefits due to consumers as specified in the insurance policy contract. Formal insurance in the Philippines is provided by one of four types of insurers, namely life insurance providers, non-life providers, composite providers and mutual benefit associations. The first three can be considered as 'first tier' formal insurers, while mutual benefit associations are a second tier of insurance providers, subject to lesser regulation. Mutual benefit associations (MBAs) are insurance schemes run on a not-for-profit basis, and exist for the sole purpose of helping their members (Insurance Commission, 1974). Recent regulatory changes have allowed the formation of "micro-insurance MBAs" which can offer only micro-insurance products. There were 18 registered MBAs in 2004. MBAs are a primary mechanism for insurance delivery to the low-income market, largely because of reduced capital requirements and lower compliance costs.

Co-operatives are also permitted to organise co-operative insurance societies for their members. The precise rules and regulations governing this provision (contained, as in South Africa, in the Co-operative Code and not in the Insurance Code) are still being developed. However, it is stipulated that the requirements regarding capitalisation, reserves and investments may not be reduced to less than half of those under the Insurance Code and applicable to traditional insurers.

There are 17 other non-formal insurance providers in the Philippines, including co-operatives and micro-finance institutions, who provide micro-insurance products (ILO, 2003). Despite the actuarial weakness of these products and the lack of financial capacity of these organisations, strong consumer demand has resulted in their ongoing availability. Though not licensed, it seems that many of these institutions are nevertheless implicitly allowed to operate by the regulator, though the regulator is working to encourage their formalisation, for instance through the MBA route.

Second tier insurers

The requirements to create an MBA are relatively straightforward and manageable. Any non-charitable organisation that takes regular, fixed dues from members can create an MBA. These are "mainly for the purpose of paying sick benefits to members, or of furnishing financial support to members while out of employment, or of paying to relatives of deceased members a fixed or any sum of money". Organisations cannot undertake these functions unless they register as an MBA, although in practice there are thought to be many small MBA-like organisations offering similar products that are unregistered and therefore unregulated. MBAs are not subject to any legislated benefit caps or product parameters, however the nature of the market which they serve means in practice these are low value, simple policies with small premiums. MBAs must be member owned and managed. Recognising the unique members-only ownership structure of MBAs, the Insurance Code provides special provisions to govern

the registration and operation of MBAs which are separate and distinct from the general provisions that govern other insurance entities (Insurance Commission, 1974). Recent regulations concerning *micro-insurance MBAs* allow for lower capital requirements for this type of provider. While specific solvency and stability standards have yet to be set, the regulations make provision for the Insurance Commission to monitor and evaluate micro-insurance MBAs compliance with these standards (Insurance Commission of the Philippines, 2006). These micro-insurance MBAs therefore constitute a second tier of insurance provider.

MBA registration provides better protection. Since the oversight provided by the Insurance Commission reduces the scheme's vulnerability to fraud and mismanagement, registered MBAs better protect consumers than their unregistered counterparts. The Mutual Benefit Associations Act thus limits the number of significantly sized informal or unregistered insurers. In practice, the insurance commission, due to the limit of its supervisory capacity, does not aggressively challenge non-registered MBAs (Wiedmaier-Pfister and Chatterjee, 2006).

MBAs are still subject to prudential requirements. They have to hold 10% of total assets in their guarantee fund, at least 50% of member contributions need to be set aside as a reserve requirement and their liabilities cannot be more than 80% of their non-risk assets. In addition, MBAs have to submit their books to the Insurance Commission for examination at east once every two years. Under capital requirements issued in 2006, new *micro-insurance MBAs* have to have in place minimum capital of at least $2.4m, though existing MBAs require $100 000 and can build up to the $2.4m over time. Every year they are expected to increase their capital reserves by 5% of their gross premium collections, until their guarantee fund reaches this level The Insurance Commission requires them to engage the services of an actuary for the purpose of their insurance functions. .

Insurance Provider	Previous capital requirements (USD)	Capital requirements post-2006 (USD)	Approximate percentage of formal insurer requirement
Formal insurer	$1.05m	$20.1m (50% in paid up capital, remainder as contributed surplus)	100%
Co-operatives	-	Still being decided	50% (minimum, stipulated in legislation)
New micro-insurance MBA	$210	$2.4m	12.5% (minimum, stipulated in legislation)
Existing micro-insurance MBA	$210	$0.1m (increasing by 5% of premium collection every year until reaching $2.4m)	0.5%

Table 5: Capital requirements for various institutional forms of insurance providers

Source: Philippines Micro-insurance regulations; Llanto et al (2006)

New developments

Micro-insurance products and providers have been defined for the first time. Insurance providers who offer only micro-insurance products are subject to lesser capital requirements, and in all likelihood reduced compliance standards (which are currently being developed) than both MBAs or formal mainstream insurers.

A micro-insurance product is defined as having a premium (computed on a daily basis) which is not more than ten percent of the current daily minimum wage for a worker in metropolitan

Philippines. The maximum amount of life insurance coverage is limited to 500 times the same minimum daily wage rate. This effectively defines micro-insurance policies as policies with a maximum premium of $12.60 per month and maximum benefits of $3166.50. In addition to these product parameters, the regulations stipulate that the policies shall stipulate the amount, benefits and terms of the insurance coverage. Micro-insurance providers are also directed to ensure that the insured person can easily understand the provisions of the contract, that the documentation requirements are simple, and that premium collection is geared towards cash flows experienced by the insured person (Insurance Commission of the Philippines, 2006). Precisely how these requirements will play out in the Philippines insurance market is yet to be seen.

Micro-insurance distribution

Separate from the *provision* of micro-insurance, there are currently three ways in which micro-insurance can be *distributed* in the Philippines. Commercial insurers can act as the direct providers and market and sell their own products in the lower end of the marker. In general, commercial insurers do not focus on the micro-insurance market. The main reason for this appears to be economic, as insurers will have to deal with a high volume of small insurance policies and operate in remote rural areas. This is simply financially unattractive with current business and technology models.

Micro-finance institutions (MFIs) act as agents or brokers for commercial insurers, often to offer credit life insurance. MFIs are ideally situated to provide micro-insurance, as they have significant experience in this end of the market. However, the Insurance Commission requires entities registering as general insurance agents to provide a list of all individuals who will be acting on their behalf. To avoid this level of regulation and compliance costs, many MFIs in the Philippines have designed their own micro-insurance systems and products which are not registered with the Insurance Commission. These are often prone to fraud, unsound financial practices and failures (ILO, 2003).

Finally, an MBA or insurance society may offer insurance products to their members if they are registered with the Insurance Commission. There is currently no incentive or compulsion for small, members based, informal micro-insurers to become legalised and register.

A case study: the CARD-MBA Experience

An oft cited case of a successful micro-insurer in the Philippines is CARD-MBA. Its experience outlines some points of relevance to the suggested South African micro-insurance regulation.

The Center for Agriculture and Rural Development (CARD) was established in 1986 as a non-profit, non-political foundation. In April 1988 it started its operations with a training and livelihood assistance program for landless coconut workers, and subsequently started a successful micro-financing programme. A Members' Mutual Fund (MMF) was established by CARD in April 1994 for the primary purpose of providing credit life insurance to pay off the micro loan in case of death of member-borrowers. This developed into an insurance fund providing death benefits for the members and their legal dependents and loan redemption for member-borrowers. In December 1996, a Pension Plan was implemented providing retirement, medical and disability benefits to members. All of these micro-insurance products proved

extremely popular. However, after two years auditors drew attention to the fact that the pension plan was unsustainable and that its liabilities would bankrupt CARD if not addressed. This unsustainability could largely be traced to the absence of actuarial input and insurance expertise when designing the micro-insurance products

The regulatory framework in the Philippines allowed CARD to spin the MMF off into an MBA. The benefits of an MBA to institutions like CARD are that the capital requirement is low, and registration and licensing are relatively easy for a legitimate institution. However, an MBA license also restricts insurance sales to members, thus severely limiting the potential market for micro-insurance products. Members who held insurance products were automatically made members of the MBA, and the remaining assets from the MMF were transferred to the MBA. The rules governing MBAs meant that actuarial input was required, and following this the pricing of the products was adjusted. This was part of the registration process of the MBA, as they came under the Insurance Commission’s supervision. In 2004 the CARD MBA provided micro-insurance products to around 600 000 people in the Philippines (CGAP, 2004).

What can South Africa learn from Philippines experience?

Criticisms

Capital requirements are relatively high. The evolution of micro-insurance in the Philippines is fundamentally different to that of South Africa. The recent increases in capital requirements in the Philippines seem to indicate that the regulator would like to restrict market development to larger players. . The capital requirements for new micro-insurance MBAs have also been increased significantly, and at $2.4m, will provide a significant barrier to entry into the micro-insurance market. The minimum requirement for existing micro-insurance MBAs of $100 000 is more achievable though.

Limited enforcement capacity implies limited incentives to formalise. Also to be noted is the low level of enforcement. As indicated by the CARD example, organisations not registered as MBAs are not prevented from offering insurance products, even if the products are unsound to the point of risking the viability of the organisation. The initiative to formalise into an MBA came more from CARD itself, based on actuarial advice, rather than from the regulator. However, the regulator is starting to push harder against informal insurance operations.

Positive aspects

Capital requirement differentiation. There is however an obvious differentiation in capital requirements for various institutional forms of insurers, made explicit by the use of percentages in regulation to peg the requirements for non-formal insurers to those of formal insurers. This appears to recognise that co-operatives and MBAs pose a different risk than larger insurers, and partly for this reason, they should not be subject to the same initial start-up costs. The creation of this second tier of less regulated micro-insurance providers is facilitating the provision of micro-insurance to the low-income market. It should be noted that the space for the second tier is based on institutional form, rather than products offered. The recent developments in the Philippines around micro-insurance MBAs closely mirror the proposed micro-insurance framework for South Africa. Under this scheme, it is envisaged that micro-

insurance providers will offer products with lower benefits, and so will be subject to lower reporting and capital requirements.

APPENDIX 3: THE REGULATION OF CELL CAPTIVES

International practice: cell captives defined in company legislation. Desktop research indicates that although the insurance cell captive model was developed in South Africa, internationally this model has been evolved into a more formal and regulated alternative type of company (under company law). Legislation from countries such as Gibraltar and the Jersey Islands extends the insurance cell captive model by allowing for independent cells, but not restricting these to the insurance industry.

Two types of cell companies have developed: Protected Cell Companies (PCCs) and Incorporated Cell Companies (ICCs). PCCs are found in a few countries, whereas ICC is a new form of company currently only found in Gibraltar and Jersey. Both are very attractive to investment funds and companies who might want to set up a series of structured financial transactions, and in fact a PCC/ICC can conduct any kind of business. The main attraction appears to be the ring fencing of a cell's assets and liabilities – if one cell should go insolvent then creditors would not be able to lay claim to any assets belonging to other cells within the PCC or ICC. In South Africa, in contrast, the ring fencing is not complete, as creditors of each cell have an ultimate claim on the assets of the cell provider. Even though there are rules restricting the sharing of risks between cells, the final risk remains that one cell collapses, leading to claims on the cell provider and thus undermining the security of the other cells.

PCC and ICC's are forms of companies which currently do not exist in South Africa, therefore PCC and ICC regulation can only happen when/if South Africa passes legislation defining and allowing companies to register as one of these types. A PCC operates in much the same way as cell captives currently operate in South Africa, with the 'cell captive' being a legal entity, and each cell falling under this legal identity but being completely independent from each other. An ICC differs from a PCC in that in an ICC each *cell* is a separate legal entity and in fact is a separate company in the case of Jersey (who pioneered ICC's in February 2006). The initial legislation allowing the formation of these types of companies governs their operation. For example, in Jersey each cell of a PCC/ICC has to have the same board of directors, secretary and registered office as the PCC or ICC itself. The independence of cells, ring fencing of a cell's assets, etc is all regulated through legislation.

South African cell captives are provided for on an ad hoc basis in insurance licensing. There is no special regulatory dispensation for cell captives in South Africa. A cell captive company is registered as an insurer, but the FSB imposes certain conditions/requirements on its license that are specific to the business of a cell captive (for a long-term cell captive license, there are additional requirements). So, for example, no cross-subsidisation is allowed across cells and each cell is required to be individually sound. Thus the main difference between PCC/ICC regulation and the regulatory setup in South Africa is that in South Africa the FSB merely regulates cell captives through discretionary insurance registration requirements. If South African legislation was passed permitting the formation of PCC/ICCs then this form of company and its operation would be regulated through that legislation. The dti is responsible for company law in South Africa and so would have to be the driver of any legislative process. If the dti decided to do this, PCCs would probably be able to continue offering 3rd party insurance in the same way cell captives do currently in South Africa, although internationally PCCs usually offer fairly sophisticated insurance solutions to larger corporates. However, given that

international PCC/ICC legislation allows these company types to be used for any other type of business activity, presumably the same would apply in South Africa unless the legislation specifically restricted them to the provision of insurance.

Specific areas of regulation of relevance in South Africa

Shareholder agreement. The relationship between the cell captive and the cell owner in South Africa is currently governed by the shareholder agreement between the two. According to the cell-captives consulted, this agreement applies the solvency principles of the LT and ST Acts, but in a more flexible way than would be the case under PCC legislation. For example: PCC legislation would require full solvency from day one. According to the shareholder agreements in South Africa, the promoter cell, which is also capitalised, can however "rent out" solvency to a specific cell, as long as the cell is solvent on average over a period, or at the end of the period. This helps in the setting up of cells.

Solvency (Financial Condition Reporting). Cell captives are specifically provided for in the FSB's FCR issues paper. In paragraph 179 it states that: "The risk profile of cell insurers is vastly different from that of non-cell insurers. Also, between cell insurers and within cells, there is great difference in the underlying risk. Internal Models are, thus, the only method of accurately reflecting the inherent risk for a cell insurer."

As it is recognised that the internal model will be resource-intensive, an "express certification[63]" procedure is suggested whereby 1st party cells can adhere to a certified model in the interim while making "the inevitable transition" to internal models. This, it is stated in paragraph 180, will however only be possible if South Africa should follow the international trend in ring fencing cells more absolutely through PCC or ICC legislation. This will furthermore not apply to 3rd party cells. It is stated (Par. 187) that "the FSB will apply stricter criteria in evaluating any applications to replace prescribed requirements for 3rd party cells". The idea is thus, ultimately, for cell captives' solvency to be determined fully on the basis of internal models.

The SAIA's suggestion is that cell captive insurers be exempted from the legislation until PCC legislation is introduced, as they "are able to effectively operate given [the] current solvency regime" (SAIA finance committee presentation to FCR workshop, 25 January 2007).

The FSB FCR Issues Paper allows for a single application "to replace prescribed requirements for third party cells" *across cells*, but it is not sure whether, under the internal model to be adopted, solvency requirements will be set for the individual cells, or whether solvency requirements will be set for the cell captive itself/as a whole. It seems that a lot of this will be determined by whether or not PCC legislation is adopted (and whether or not it will at all be appropriate given the unique characteristics of 3rd party cells).

Note that the FCR issues paper may change as soon as the work on the prescribed method is concluded. The "certified model" referred to above may disappear (although partial internal models will still be allowed).

[63] This would seem to entail an express application to be allowed to use a certified model with certain specific parameters.

FAIS. The cell owner will need to be registered as a financial service provider, registering staff as representatives. The same arguments on the appropriateness of full FAIS compliance for distribution to the low-income market therefore apply (. In addition, cell captive insurers have raised concern that, because they are held accountable to the policy holder, significant risk to them is created, should a cell owner or the intermediaries it interacts with transgress FAIS. Therefore FAIS enforcement is in effect delegated to the cell captive insurer.

Conclusion. On the regulatory front, it seems that uncertainty regarding future regulation, as well as uncertainty regarding duties placed on the cell captive insurer by FAIS, rather than the current insurance regulatory set-up, is the main concern for cell captives. In encouraging this option in the micro-insurance market, some regulatory certainty will therefore be needed (e.g. that PCC will not suddenly be implemented, or is planned over a certain time period, or upfront communication of what it will entail).

APPENDIX 4: ISSUES SURROUNDING THE CO-OPERATIVES ACT OF 2005

The Co-operatives Act (no. 54 of 2005) is much more comprehensive than its 1981 precursor in that it not only focuses on agricultural co-operatives, but makes provision for a number of distinct categories of co-operatives which include that of *co-operative burial society* and of *financial service co-operative*. Though enacted in 2005, the commencement of the Act was only proclaimed in May 2007.

Application to register as a co-operative is made to CIPRO (the dti's Companies and Intellectual Property Registration Office)[64]. No details of the application requirements are set out in the act, apart from the minimum number of members needed. The guide to the Co-operatives Act states that a registration fee will apply, and that the amount will be determined in regulations to be issued under the Act[65]. Once registered, a co-operative is incorporated as a legal person.

The Act is of interest in the realm of micro-insurance for a few main reasons:

- *Friendly society vs co-operative interplay*. It appears to communicate the intention for burial societies currently registered as Friendly Societies to be converted into Co-operative Burial Societies in that it holds that an organisation registered as a co-operative burial society does not need to be registered under the Friendly Societies Act of 1956. It is the intention of the dti's Co-operatives Unit to give Friendly Societies the option of an alternative institutional form which would allow them to deregister as Friendly Societies. Yet, as will be discussed below, no incentive is created for organisations to become co-operatives rather than friendly societies.

- *Compulsory registration under insurance act*. When a co-operative wishes to provide insurance, the Co-operatives Act (Schedule 1, Part 3, Section 3) holds that "[a] financial services co-operative providing long-term or short-term insurance to its members is required to register in terms of the Long-term Insurance Act, 1998 (Act no. 52 of 1998), or Short-term Insurance Act, 1998 (Act no. 53 of 1998), despite its registration in terms of this Act". Thus, whereas a burial society guaranteeing benefits not exceeding R5,000 need not be registered as an insurer when it is registered as a friendly society, all burial societies registered as co-operatives would need to do so.

- *Exclusion for non-guaranteed benefits*. An exclusion (Part 3, Chapter 13, Section 94)applies, in that the "provisions of the Long-Term Insurance Act, 1998, do not apply to co-operatives in respect of their activities in so far as they relate to a scheme or arrangement in terms of the constitution of the co-operative under which the amount of the benefits afforded by such scheme or arrangement is not guaranteed…". Thus, for example, a burial society that provides benefits to its members of which the value is not guaranteed, does not need to be registered as an insurer. This effectively provides for burial societies

[64] Note that the Companies Bill of 2007 proposes to replace the CIPRO with a new Companies and Intellectual Property Commission.

[65] http://www.thedti.gov.za/Co-operative/pdfs/4registration.pdf

that provide "risk-pooling" and support, rather than insurance in the true sense of the word, to be unregulated on the financial services front, though they will still be "on the regulatory radar screen" in terms of their registration with CIPRO as a co-operative and the associated requirements placed on them.

- *Corporate structure*. Under the Long-term and Short-term Acts, a registered insurer must either be a public company that has the carrying on of insurance as its main object, or must be "incorporated without a share capital under a law providing specifically for the constitution of a person to carry on long-term insurance business as its main object" (Section 9(3)(a)(ii) of the Long-term Act, mirrored in the same section of the Short-Term Act). According to the FSB, this latter provision does not make room for entities created under a general act, such as co-operatives, and any co-operative wishing to provide insurance would therefore need to register as a public company as well, thereby further defeating the purpose of the Co-operatives Act.

- *Joint functional regulations*. The Act explicitly makes provision for co-operation between the dti, the Long-term Insurance Registrar and the Short-term Insurance Registrar for the drafting of regulations of particular relevance to co-operatives providing insurance, also creating the possibility for exemptions from certain insurance act provisions for co-operatives. In Schedule 1 (Part 3, Section 7) the Act holds that "the minister [of Trade and Industry] may, in consultation with the Registrar of Banks, or the Registrars of Long-term or Short-term Insurance, or the Registrar of Medical Schemes, as the case may be, *make regulations regarding any matter relating to the operation or administration of financial services co-operatives or any category of financial services co-operatives*" (emphasis added). This paves the way for the dti as institutional regulator of co-operatives, with the FSB as the functional regulator of the service provided, although a plan towards practical implementation has yet to be established.

- *Secondary co-op as service provider to primary co-ops*. The Act makes provision for secondary and tertiary co-operatives, which have primary co-operatives as members. According to Section 16(1)(a), the main objectives of a secondary co-operative must include "the provision of sectoral services to the primary co-operatives that are its members". A tertiary co-operative serves to advocate and engage organs of state, the private sector and stakeholders on behalf of its members (S.16(1)(b)). The Act therefore makes provision for a secondary co-operative to provide services, which could include insurance, to its members, much in the same way that members would get underwriting from an insurance firm. A secondary co-operative may therefore register as an insurer and sell its insurance products to primary co-operatives, implying that there is only one insurance license for many co-operatives acting as "intermediary groups".

- *Self-regulation*. A further role envisaged for the secondary co-operative is that of a self-regulatory body (while there can be more than one secondary co-operative, it is our understanding that only one of them will be designated the "self-regulatory body"). Section 6 of Part 3, Schedule 1 states that the registrar may, in consultation with *inter alia* the registrars of Long-term or Short-term insurance "direct that all co-operatives to whom this part applies, or any category of co-operative to whom this part applies, belong to a secondary co-operative that will act as a self-regulatory body, in compliance with any requirement for exemption from any provision of the Banks Act, 1990 (Act No. 94 of 1990),

The Long-term Insurance Act, 1998 (Act No. 52 of 1998), the Short-term Insurance Act (Act No. 53 of 1998), or the Medical Schemes Act (Act no. 131 of 1998)." The Act therefore apparently intends self-regulation to fulfil some role in the co-operative sphere, but it does not yet give any details as to the rationale or expectations for such self-regulation. The dti has indicated that the rules governing co-operatives will be statutory, but that the supervision will be delegated to the self-regulatory body. It is therefore likely to be an instance of delegated supervision, rather than "self-regulation" in the strict interpretation of the word. No timeline has been identified for instating self-regulatory bodies.

APPENDIX 5: THE PROPOSED INTRODUCTION OF FINANCIAL CONDITION REPORTING AND LIKELY IMPACTS THEREOF

There is a clear international move towards insurance regulation which is tailored more closely than previously to the specific risks presented by an insurance business. This approach is most clearly seen with regard to the capital requirements on insurance businesses. Most countries are trying to move away from an approach where capital requirements are calculated for example as a crude percentage of total premium, to a more refined approach where they relate to the amounts that will need to be in place to absorb specified shocks to the business, e.g. capital required to deal with a 20% increase in expenses, 10% fall in asset prices, etc.

South Africa is following this international trend towards risk based regulation. The area in which the move towards risk based regulation has manifested itself most clearly thus far in South Africa is the forthcoming introduction of Financial Condition Reporting (FCR) for insurers (initially to be implemented for short-term insurers). FCR will require insurers to either internally develop a model or use prescribed methods to assess their capital requirements, which will take into account the underlying risk of their portfolio, rather than using a crude formula based on a percentage of their premium collection as is currently the case. This means that although all firms will have to adhere to the same regulatory principles, insurers with a riskier book will be required to hold more capital than insurers with a less risky book. The European Union,UK, Canada and Australia have either adopted, or are in the process of adopting, similar measures.

According to the FSB (presentation to industry workshop, 25 January 2007), the current solvency requirements (set in relation to net premiums) make no allowance for the underlying risks, the size of the insurer, or the need for active risk management. In line with international trends, they want to move to a system of risk-based supervision, where each company will be supervised according to its risk-rating. The introduction of FCR is deemed to be part of this process and brings South Africa in line with the IAIS Roadmap and Structure Papers on the Assessment of Insurer Solvency (issued 2006 and February 2007, respectively). At the same time, the FSB argues, it will serve to bring the ST industry more in line with solvency practices in the LT industry. The process started in 2002 and since 2003 an industry working group has been considering the matter, resulting in calibration and recalibration of the model, which culminated in the release of the Issues Paper titled “Financial Condition Reporting – Proposed Solvency Assessment for Short-term Insurers” in 2006.

The likely introduction of FCR is of relevance to this Discussion Paper as: it will place South Africa on par with international best-practice (only the UK, Australia and Canada have implemented these models thus far[66]) and (ii) as currently outlined it is likely to have capital requirement and cost implications for the short-term industry, and raise barriers to entry.

Though the necessary regulatory amendments still need to be made for FCR to be enforced, the intention is that it should be fully implemented for the 2009 year-end (a five year phase-in

[66] Solvency 2, the equivalent as applied in the EU, is expected to be implemented by 2009/10 (http://www.fsa.gov.uk/Pages/About/What/International/solvency/index.shtml).

will be allowed to reach 99.5% sufficiency for the prescribed model, but not for the others – see below). This implies that companies with a 31 December year-end will need to start using the model by 30 June 2008 in order to build up a 12 month track record by the deadline.

Overview of the FCR Issues Paper

The issues paper has two main components: (i) it imposes the need to submit an annual[67] Financial Condition Report to the FSB, and stipulates the contents of such a report, and (ii) it introduces three possible models for calculating solvency requirements, one of which is to be applied by every insurer. These models represent a new, risk-based regime of determining capital adequacy ratios. Three options are provided:

- **Prescribed model.** The prescribed model has 8 defined business categories. For each, the average industry structure and parameters are used to calibrate the model. This is the model that will apply by default, should an insurer not develop an internal model (or use a certified model in the interim).
- **Certified model**. In the certified model, the general industry structure still applies, but company parameters can be incorporated. This model has to be "certified" annually by a statutory actuary and submitted to the FSB and must only be an interim measure in working towards an internal model (it should be accompanied by a strategy and time frame for developing the internal model).
- **Internal model**. When an insurer uses an internal model, it has the flexibility to apply its own structure and parameters to the model. Though some quantitative standards are set for sufficiency rates, no calculation method is prescribed. Rather, each company is invited to calculate its own capital requirement based on its own risk profile, and submit it to the FSB for approval.

The FSB intends allshort-term Insurers to eventually implement the internal model, as it agrees that the prescribed model is general/average in nature and therefore ill-suited to especially niche insurers (according to FSB projections, required capital levels may increase significantly under the prescribed regime). The general industry view however seems to be that, due to the cost and resource implications of developing an internal model, it is likely that the prescribed model will, contra to the FSB's intentions, become the rule rather than the exception. This is regarded as problematic – as the prescribed model is calibrated on industry averages, it sits uncomfortably with any firm whose parameters do not resemble the average. Also, it does not adequately allow for non-proportional re-insurance (which would, it is argued, significantly reduce risk) and is calibrated from the industry's return data submitted to the FSB, which is not always reliable, especially in terms of the categories of insurance applied.

The effect of the prescribed model will be most pronounced for organisations without the resources to develop an internal model and it may make the hurdle even higher for dedicated micro-insurance providers. It is therefore recommended that micro-insurance, as defined in this Discussion Paper, be excluded from the proposed FCR regime. The reserving requirements set out for micro-insurers in this Discussion Paper should remain those that currently apply to

[67] Or more frequently as and when the FSB requests it.

short-term insurers. It is proposed that this be upheld for micro-insurers, even should Financial Condition Reporting change the regime for short-term insurers.

APPENDIX 6: CORPORATE GOVERNANCE REQUIREMENTS FOR CO-OPERATIVE OR MUTUAL INSURERS

What is corporate governance?

According to the OECD (2004, paraphrased in Qureshi, 2006), corporate governance involves "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. "

What are the current corporate governance requirements for friendly societies?

Friendly societies are required to appoint a principal officer, draw up and submit rules for the society and report their financial statements (signed off by an auditor) to the FSB. Furthermore, some societies (those providing guaranteed benefits) may be required to undergo actuarial valuations.

The rules need to specify, amongst others, "the custody of the securities, books, paper and other effects of the society the manner of altering and rescinding any rules, and of making any additional rule", and "the manner of calling the annual general meeting and special general meetings of members, the quorum necessary for the transaction of business at such meetings and the manner of voting thereat".

However, no explicit corporate governance requirements are included (such as the need to form a board, the responsibilities of the board, fit and proper requirements for board members, the role division between board and management, etc). It would seem that, based on the mutuality of the organisation, it is assumed that the society will only exist on the basis of some member governance arrangement. The exact nature of the arrangement is however not specified.

What are the current corporate governance requirements for co-operatives?

In contrast to the Friendly Societies Act, the Co-operatives Act of 2005 does make quite extensive provision for corporate governance. Amongst others, it notes that the highest decision making powers within the co-operative rest with the members at the general meeting and that the board of directors is accountable to the general meeting (S.27). The AGM has the responsibility to appoint an auditor, approve the annual report to be compiled by the board, approve financial statements and auditor's reports, elect directors, decide on future business of the co-operative, etc (S.29). The board of directors are then responsible for the management of the co-operative (S.32), subject to the scrutiny of the members (via the AGM) and the constitution of the co-operative (as adopted by the members). Co-operatives have to decide and specify in their constitution what number of directors they require. The Act stipulates that directors may not be elected for a term longer than four years (S.32). While the Act mentions

the need for co-operatives to report the full names, address and identity number of directors to the regulator within 30 days of their appointment, directors are not required to have certain skills or be deemed “fit and proper” for their position (S32)[68]. Within the board, majority votes are passed (unless otherwise provided for in the constitution). Minutes must be taken. The board of directors may delegate management functions to a specific director, committee, or appointed manager (S.36). All interests and possible conflicts of interest must be disclosed, to be lodged in a register kept by the board. Acceptance of any type of remuneration/reward for a transaction that the co-operative is involved with is not allowed. In addition to the board of directors, a co-operative may decide to form a supervisory body to oversee the functioning and decision of the board of directors. If a co-operative does decide to establish a supervisory body, it is required to insert a provision for its establishment its constitution (S.14).

It therefore seems that fairly comprehensive corporate governance requirements are in place for co-operatives. However, whether they sufficiently address the corporate governance issues that can arise in a co-operative or mutual organisation is another question.

Will mutuality prevent the rise of corporate governance dilemmas?

As early as 1977, UNCTAD (quoted in Fisher & Qureshi, 2006) passed a resolution to endorse the provision of co-operative insurance in developing countries. Among the reasons quoted for the fact that co-operative structures are particularly suitable in serving the low-income segment of the market, is quoted the fact that the policyholders are also the “shareholders”[69]. This affords them direct control over decision-making and gives them a special interest in the health of the organisation. Qureshi (2006 – micro-insurance compendium) agrees that “corporate, mutual or other popularly based micro-insurers have an advantage over corporate insurers because they are closer to and more familiar with, and often themselves are, the target market.

During 2004, Her Majesty’s (HM) Treasury in the United Kingdom commissioned an in-depth review of the governance of mutual life insurers by John Myners[70]. The Myners Review (as it is now known) was commissioned after the discovery of gross management problems (some

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[68] The Act does not specify the skills and characteristics directors are required to have. However, it does specify which persons are “not deemed to be competent directors” (S33): persons of an unsound mind, unrehabilitated insolvents and persons with a criminal conviction relating to theft, fraud, forgery, perjury or “any offence involving dishonesty in connection with the formation or management of a co-oeprative or other corporate entity”.

[69] According to the International Co-operative Alliance (http://www.ica.coop), co-operatives should function based on seven principles. It includes the following:

- **Voluntary and open membership:** Co-operatives are voluntary organisations that should be open to all people that want to use their services and are willing to accept the responsibilities of membership.
- **Democratic member control:** This principle is best enshrined in the idea of one member-one vote that applies at primary co-operative level. Other levels of co-operatives are required to be organized in a democratic manner, with all members being able to actively participate in decision and policy making.
- **Member economic participation:** Members contribute to and control the capital of their co-operative. Any surpluses should be utilized to the benefit of the co-operative.
- **Autonomy and independence:** Co-operatives are autonomous organisations controlled by members.
- **Education, training and information:** Co-operatives provide education and training to members, elected representatives, manager and employees.
- **Co-operation among co-operatives:** Co-operatives should strive towards strengthening the co-operative movement through co-operation on local, national, regional and international level.
- **Concern for community:** Co-operatives should strive towards the sustainable development of their communities.

[70] HM Treasury, 2004. *Myners review of the governance of life mutuals: Final report*. December.

caused by inappropriate corporate governance arrangements) at a mutual insurer, Equitable Life. The report argues that although the nature of co-operatives or mutual insurers[71] helps to alleviate the principle-agent problem that arises with other financing arrangements (such as public companies), it also creates a number of corporate governance dilemmas.

One of the main characteristics of co-operatives or mutuals is that each member, irrespective of the size of their initial investment, has only one vote. In contrast to public companies where shareholders have a vote or “voice” proportional to the size of their investment, members of a co-operative or mutual are unable to build up a controlling position where they might have a greater interest (in terms of benefits that can be derived) in understanding the day-to-day functioning and business of the organisation. Where this problem, if it had arisen in a public company, might have been overcome by the presence of market discipline (movements in share price or a hostile takeover), there is no such discipline available for a mutual insurer. This would then imply the need for stronger controls or external monitors (such as rating agencies), but these are generally absent in the case of mutuals.

Corporate governance for mutual insurers is made even more difficult by the fact that insurance is a complex business. This can make effective monitoring by members and non-executive directors, especially if they have prior in the insurance environment, very difficult.

Lastly, corporate governance and the measurement of success within a mutual insurer are complicated by the fact that that there the goal towards which the organisation is striving is not always clear. In the case of public companies, the goal is to maximise shareholder value. In contract, co-operatives or mutual organisations generally have it as their goal to maximise member benefit. What this means in practice, however, is less clear than the meaning of shareholder value and it is possible that the organisation’s goal(s) could become subject to conflict between various members personal interests.

One way to overcome these problems, strongly recommended in the Myners Review, is to pay specific attention to the composition of the board and to ensure that a sufficient number of non-executive (independent) directors with the right skills are present on the board. The Myners Review recommends the adoption of an amended code of corporate governance (applicable to public companies) by mutuals. Within the code, a number of specific recommendations related to board balance and independence, board structure an committees, skills and support for non-executive directors are inserted. Specifically, it recommends that the board should have “more rather than fewer independent directors”, “that non-executive directors should meet without the executive present” and “that a formal and rigorous appraisal of the board take place each year” (HM Treasury, 2004: 18).

While mutuality creates the incentive for members to participate in the organisation’s decision-making processes, it will not always lead to the best outcome from a corporate governance perspective. This conclusion rings even truer for the complex business area of insurance. Some regulatory mechanism is required to ensure effective corporate governance within mutual or co-operative insurers.

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[71] The members of the organization are also funders and policyholders thereof.

International example

The Australian Prudential Regulation Authority (APRA) has taken the approach of issuing prudential standards on governance and fit and proper requirements that apply to the management and boards of all institutions operating under the Life Insurance Act 1995[72] (*including friendly societies*).

The key requirements of the prudential standard that applies to governance of life insurers, include:

- The board of a life company is required to have a minimum of five directors;
- Of these directors, the majority should be independent directors;
- The chairperson the life insurers' board is required to be an independent director of the organisation;
- An Audit committee has to be established;
- All life companies are required to have an internal audit function; and
- The board must have a policy on board renewal and the procedures for assessing board performance.

In addition, the key requirements relating to the fit and proper nature of management and the board, include:

- Life companies are required to have a written fit and proper policy that meets the standards as set out in the Prudential Standard;
- The fitness and propriety of all responsible persons (including senior managers, the board, directors, the approved auditor and the appointed actuary) has to be assessed before their appointment and then re-assessed on an annual basis;
- Information must be submitted to APRAS on the fitness and proprietary of responsible persons.

What is the minimum level of corporate governance that should be built into a micro-insurance license?

Should the micro-insurance license remain silent on corporate governance, reverting to the corporate governance provisions in place in the acts governing the respective institutional forms? The Friendly Societies Act makes limited reference to corporate governance requirements, while the Co-operatives Act does not include any requirements on board composition or fit and proper requirements that apply to the board and/or management. It is therefore recommended that some type of minimum level of corporate governance arrangement should be satisfied before issuing any institutional form with a micro-insurance license.

[72] **Prudential Standard LPS 510** sets out the governance requirements, while **Prudential Standard LPS 520** sets out the fit and proper requirements that apply to all life insurers operating under the Life Insurance Act 1995.

The corporate governance requirements could draw, as a minimum level, on the requirements applicable to co-operatives (as specified in the Co-operatives Act), as well as the following requirements/recommendations that have to be adhered to:

- Some type of requirement or recommendation on the presence of non-executive or independent directors on the board; and
- The necessity for the board and management to be demonstrated fit and proper for their positions, especially with reference to their skills set. The fit and proper requirements should not only be stipulated in terms of what the directors should not be (i.e. their negative attributes), but required positive attributes should also be emphasised, e.g. necessary skills.

APPENDIX 7: PROFILE OF INSURERS HOLDING MINIMUM CAPITAL AMOUNTS

The charts below show that there was a concentration of insurers licensed under both Acts holding the minimum capital requirement, according to the 2005 FSB returns. (A log scale is used because the enormous range of sizes of insurer by gross written premium otherwise obscures the phenomenon.)

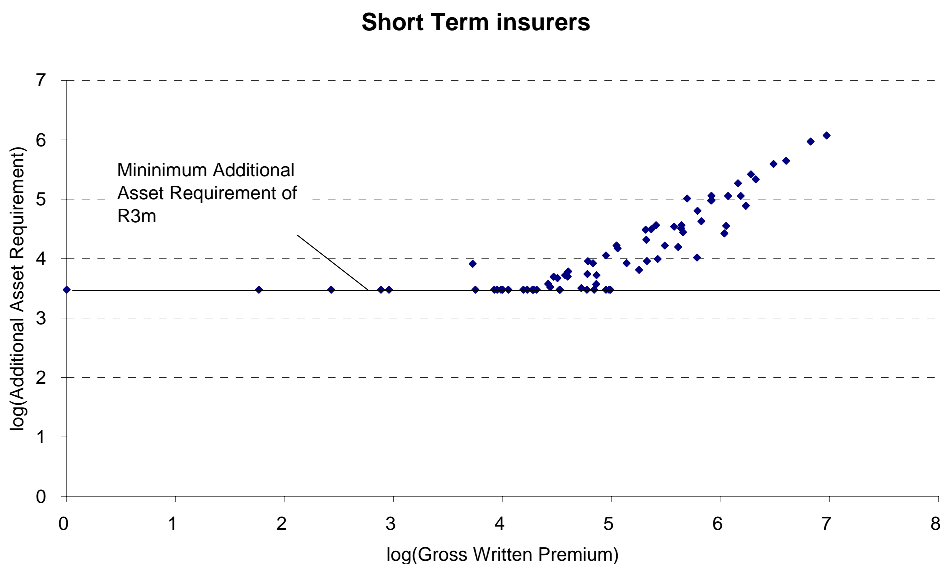

Figure 7: Short term insurers minimum asset holdings

Source: FSB (2005), Genesis Analytics

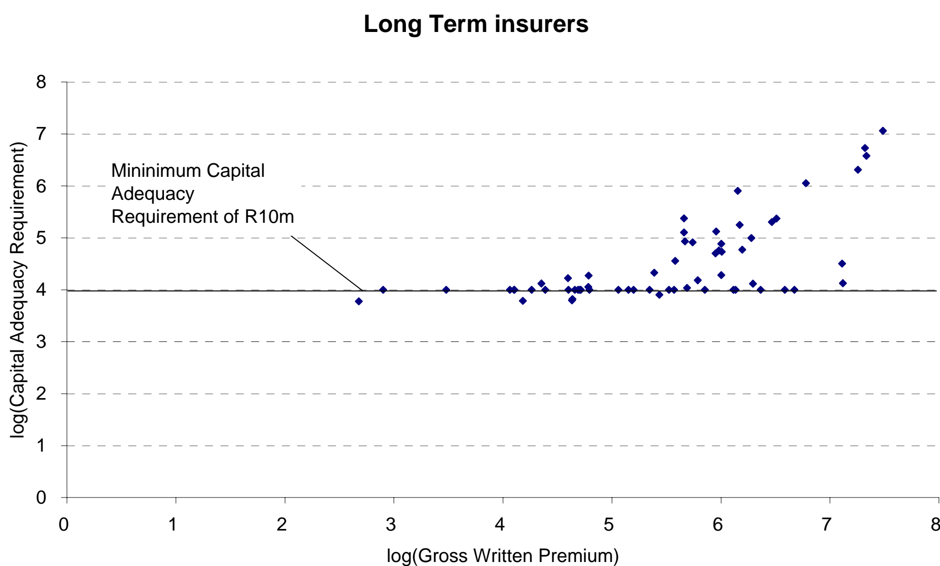

Figure 8: Short term insurers minimum asset holdings

Source: FSB (2005), Genesis Analytics

APPENDIX 8: INSURANCE CAPITAL REQUIREMENTS

An insurer holds base levels of capital to secure its liabilities in respect of future claims and additional capital against the chance that it may have underestimated these liabilities. Sufficient capital backing ensures that if claims, investment or expense experience is worse than expected at the time of pricing of the products, the insurance provider can still meet claims as they become due. Regulatory regimes differ in terms of the terminology for these different layers of capital but in South Africa they can represented as in the following diagrams:

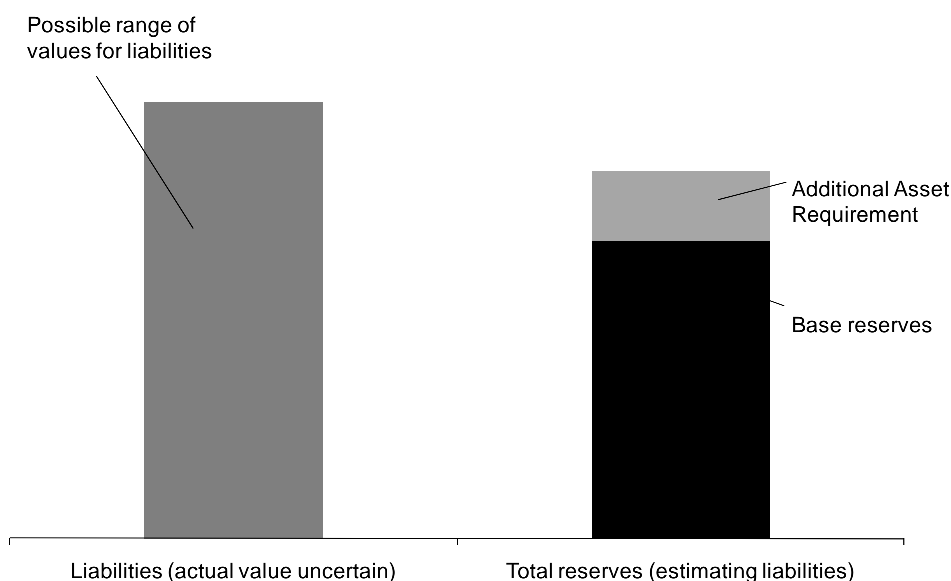

Figure 9: Capital requirements for Short Term Business

Source: Genesis Analytics

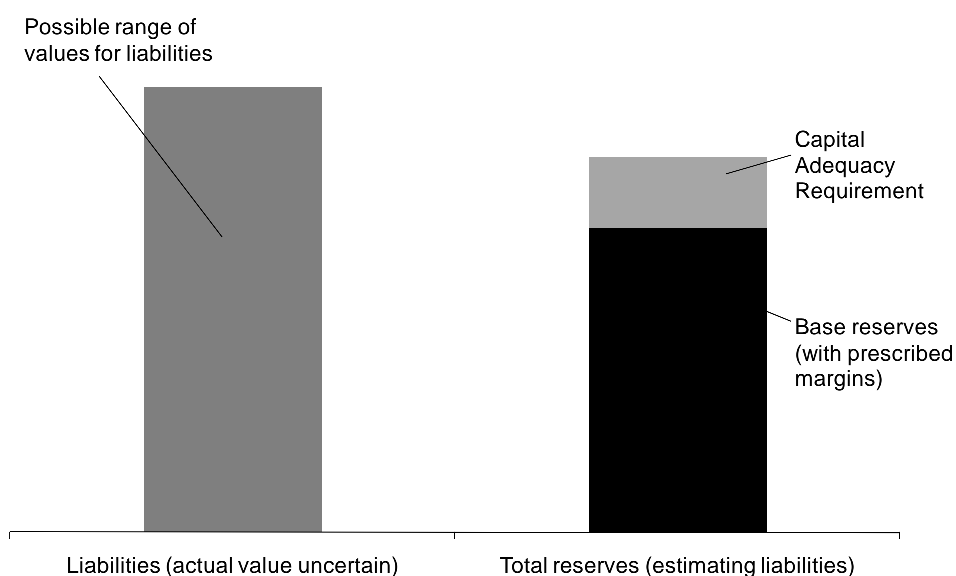

Figure 10: Capital requirements for Long Term Business

Source: Genesis Analytics

Base level of capital

An insurer needs to hold a base level of capital to meet its best estimate of its liabilities. Effectively it is backed by assets equal in value to expected future claims. These may be in respect of policies that are in force where there are no claims as yet, but claims are expected, e.g. over the term of a twenty year R1 million life insurance policy and insurer would have to build up a reserve so that it pay the claim when it ultimately fell due. Or they could be in respect of claims the insurer is aware has happened but they haven't been reported yet, e.g. asbestosis claims which may only become evident many years after the policy has expired. Or they could be claims that have been reported but where the amount hasn't been finalised yet, e.g. where a property insurer performs a claims assessment to determine the value of the loss experienced by the policyholder.

Additional capital calculations

Additional capital is required (called an Additional Asset Requirement under the Short-term Act) to allow for the possibility that the base reserves calculated may be insufficient. Higher risk lines of business, like long term endowment insurance, or short-term employer's liability insurance will tend to be more vulnerable to these fluctuations in experience and so will in general attract higher additional capital requirements. Shorter term business based on predictable claims events will tend to need less additional capital to reduce prudential risk to an acceptable level.

Additional capital is currently worked out using guidelines in the Long- and Short-term Insurance regulation. For example, on the Long Term side capital adequacy requirements are set with reference to specified scenarios in which experience deviates from expected, e.g. the total capital required to compensate for expenses being 10% higher than expected, claims being 7.5% higher than expected, etc. And this total is subject to a minimum of the greater of R10million and 13 weeks of operating expenses.

On the Short-term side, the requirements are specified as the greater of R3m and 15% of net premium. (There are currently proposals to implement the FCR process and impose an overall minimum of R10million.)

It is also true that insurers need to operate at a certain size in order to be able to pool together sufficient individual risks for their aggregate impact to be predictable. (For example, predicting if one forty year old will die this year is much harder than predicting how many will die out of twenty thousand forty year olds.) All other things being equal, a smaller insurer will tend to be more vulnerable than average therefore to the impact of the pattern of claims turning out differently than expected and would be expected to hold relatively more capital as a result. This points towards a *minimum* additional capital requirement being needed which would apply both to brand new insurers, or small ones.

APPENDIX 9: MICRO-INSURER CAPITAL REQUIREMENT CALCULATIONS

As discussed, it is proposed that micro-insurers, writing at most one-year policies should be subject to similar base capital reserving requirements to current Short Term Act business, that is allowing for unexpired premium reserves, incurred but not reported reserves, etc.

These calculations give a sense of the order of magnitude of the capital which would be required by some sample micro-insurers to meet expected claims and allow for adverse experience. They are intended to show that current minimum capital requirements may be inappropriate for low risk micro-insurance. More detailed modelling of risks will need to be completed as part of the discussion paper process bringing in industry data and expertise. The calculation proceeds by assuming three micro-insurers of different sizes, with fairly standard policy sizes, expense profiles, etc. The first step is to calculate the base capital requirements these insurers could require, using the methodologies laid out in the Short Term Act and Regulations.

Assumptions	Micro-insurer 1	Micro-insurer 2	Micro-insurer 3
Number of policies (one year renewable)	10000	20000	40000
Number of lives covered	50000	100000	200000
Annual total premium	R 5,000,000	R 10,000,000	R 20,000,000
Risk premium	R 3,000,000	R 6,000,000	R 12,000,000
Expense allowance in premium	R 2,000,000	R 4,000,000	R 8,000,000
Initial expenses allowance	R 1,000,000	R 2,000,000	R 4,000,000
Other expenses allowance	R 1,000,000	R 2,000,000	R 4,000,000
Initial expenses per policy	R 100	R 100	R 100
Lapses allowed for in pricing (20%)	2000	4000	8000

Table 6: Assumptions for capital requirements calculation

Source: Genesis Analytics

Capital requirements **1) Base reserve requirements**	Microinsurer 1	Microinsurer 2	Microinsurer 3
a) Reserve for premium which has been paid but for future periods of risk (Unearned Premium Reserve)			
Same calculation method as for short-term business. UPR can be expected to be low (half a month's premium) if monthly renewable business is being written			
e.g. UPR = 1/24 * 3000000 = 125000	R 125,000	R 250,000	R 500,000
b) Reserve for claims incurred but not yet reported (IBNR) is likely to be low, as reporting is expected to be fairly quick. So assume 6% of risk premium for IBNR (based on motor insurance level in FCR report)			
e.g. IBNR = 6% * 3000000 = 180000	R 180,000	R 360,000	R 720,000
c) Other reserves, e.g. if there is reason to think UPR is insufficient, if there are outstanding claims which have been reported but not yet settled.	0	0	0
Total	R 305,000	R 610,000	R 1,220,000

Table 7: Illustrative capital requirements for a microinsurer

Source: Genesis Analytics

The second step is to calculate the additional layer of capital required on top of this to allow for the risk that the base capital is insufficient. We assess these with reference to the key strains identified in the Long Term regulations prescribed margins, and CAR guidance in ASSA PGN104. These are probably conservative for short term micro-insurance as defined because they are designed to offset longer term risks which tend to be higher. But they give a sense of the type of strains an insurer may face and put an upper limit on the capital that such an insurer would require.

For instance, insurers tend to incur substantial costs up front in selling a policy, associated often with high distribution costs. They have to recover these costs over the life of the policy and so are at risk that the policy lapses before they can recover their costs. One strain therefore is a potential increase in lapse rates. Other strains include heavier risk, expense or investment experience than expected by the insurer. Obviously not all of these strains are likely to occur in practice at the same time so an adjustment is performed (using sums and square roots of the individual requirements generated by each strain) to approximately allow for this.

2) Additional capital requirements	Microinsurer 1	Microinsurer 2	Microinsurer 3
a) Lapse, surrender risk – the insurer needs to be able to handle up to a doubling of lapse rates (CAR requirements)			
This has a low impact on short-term policies, as initial expenses are recovered fairly quickly.			
e.g. rough cost of 40% lapse rate = extra 2000 lapses * 100 = 200000	R 200,000	R 400,000	R 800,000
*b) Mortality – the insurer should be able to handle 7.5% heavier mortality (from prescribed margins) and put aside a CAR of 45p/sqrt(n)**			
This can be high.			
e.g. 7.5% * 3000000 = 225000	R 225,000	R 450,000	R 900,000
and, 45*3000000/sqrt(50000) =approx 600000	R 603,738	R 853,815	R 1,207,477
*n = number of lives assured in the category (net of lives fully reinsured) and			
p = annual risk premium on the valuation basis or expected strain (net of reinsurance).			
c) Expenses - the insurer must handle a 10% increase in expenses (from prescribed margins), as well as provide a CAR of up to 20% of expenses.			
e.g. conservatively, Expense additional capital = 30%*2000000 = 600000	R 600,000	R 1,200,000	R 2,400,000
d) Investment risk - the insurer should be able to deal with falls in asset values of approximately 20%, and lower asset returns of 15% less than expected			
The microinsurer will tend to hold liquid assets in the short term so investment risk will be fairly low			
e.g. conservatively, 20% * 3000000 = 600000	R 600,000	R 1,200,000	R 2,400,000
An extra reserve can be put aside for AIDS and other risks if this is not covered by the other requirements	0	0	0
Squares of additional capital amounts	40000000000	1.6E+11	6.4E+11
	50625000000	2.025E+11	8.1E+11
	3.645E+11	7.29E+11	1.458E+12
	3.6E+11	1.44E+12	5.76E+12
	3.6E+11	1.44E+12	5.76E+12
Sum of squares	1.17513E+12	3.9715E+12	1.4428E+13
Square root of sum of squares	1084032	1992862	3798421
Divide by 0.7 to allow for investment risk on these reserves,			
Final additional capital:	**R 1,548,617**	**R 2,846,946**	**R 5,426,315**

Table 8: Illustrative additional capital requirements for microinsurers

Source: Genesis Analytics

The results are all less than the R10m currently required for insurers writing funeral business. This suggests that from an insurance risk point of view, the current capital requirement on micro-insurers writing fairly low risk business is high and could be reduced. This would permit more efficient allocation of capital and allow increased entry and competition into the micro-insurance space.

APPENDIX 10: DETAILED FAIS REQUIREMENTS

The following table captures the main FAIS provisions regarding the authorisation and requirements set for financial service providers and their representatives:

Main FAIS requirement fields	Specific requirements
Authorisation of financial service providers (FSPs)	• Need to be licensed to act as FSP, satisfying application requirements, fit and proper requirements. • Authorisation may be limited to certain categories, etc, upon the registrar's discretion.
Registration of representatives of FSPs	• Financial services to clients *on behalf of* somebody else may only be done by a registered representative of an authorised FSP (unless no "intermediary service" as clarified in the guidance note is provided). • FSP must keep a register of representatives with name, business address, the business categories in which each representative is competent. FSB then maintains central register, updated frequently, based on information supplied by FSPs. • Once on the register, a person is subject to the provisions of the Act relating to representatives. • FSP must ensure that representatives are competent and that they comply with the code of conduct.
Duties of authorised financial services providers	• must have a compliance officer; • draw up procedures to ensure compliance; • submit reports to the registrar, as may be requested by the registrar; • keep records for five years: • premature cancellations, complaints received and whether resolved; • continued compliance, both of the FSP and all representatives; • cases of (and reasons for) non-compliance; • maintain full and proper accounting records, updated monthly, • prepare annual financial statements and have them audited externally; • maintain records of money and assets held on behalf of clients; • submit auditor's report to registrar.
Fit and proper requirements	Personal characteristics of honesty and integrity, competence and operational ability, financial soundness, etc
Qualifications of representatives and authorised FSPs (part of Fit and Proper requirements)	FSPs and representatives selling Category A products (assistance business) must have Grade 10 (Standard 8) or equivalent and min. 6 months experience. Exempted until 31/12/2009.
Advice requirements (where provided – no obligation)	• financial needs analysis; • identification of product appropriate to needs of client; • full disclosure of fees, replacement charges, terms, any impact on premiums, etc when advising that an existing product be replaced; • keep records of the advice provided etc.
Code of conduct	"A provider must at all times render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry." This entails requirements regarding: • correct information provided; • set of information to be supplied to the client (e.g. name and business of provider; details on which financial services authorised to provide, name and contact details of compliance department, etc); • information about the product (name and type, nature and terms, nature and extent of benefits, charges and fees, increases and additions, what happens if lapse, nature, extent and frequency of incentive to person selling product, e.g. commission, special terms and conditions, any tax considerations, etc); • instruct clients to lodge complaints in writing; keep records of complaints for 5 years; have a complaints policy and maintain transparency and visibility of complaints procedures to the client; etc Most of these requirements also apply to a direct marketer.

Table 9. FAIS requirements and scope for relaxation thereof for micro-insurance

Source: Genesis Analytics, based on FAIS legislation.

APPENDIX 11: FORMAT IN WHICH COMMENTS ARE TO BE SUBMITTED

In order to deal with all the comments received in an effective manner, we request that comments be submitted in the format indicated below. Comments received in the correct format on or before 31 July 2008, will be acknowledged and considered.

Format of comments submitted:

1. Heading: Comments on Discussion Paper: The Future of Micro-insurance Regulation in South Africa

2. Date comments are submitted

3. Name of Entity on whose behalf comments are submitted (including contact details)

4. Type of stakeholder (e.g. government department, regulator, insurer, funeral parlour, co-operative, etc)

5. Summary of comments (number each paragraph). No more than one short paragraph for each comment and paragraphs structured as follows:

a. Reference to relevant paragraph in the discussion document (e.g. Section 4.1. Product-Based Drivers of Prudential Risk)

b. Outline the specific National Treasury proposal / assertion to which the comment relates

c. Outline concern and revised proposal / assertion (i.e. commentator's proposal/ assertion)

6. Detailed description of comments (use same numbering for each comment, than the number used before – see par 5). Detailed description should:

a. state why the National Treasury proposal / assertion is of concern and give a practical example where possible (and relevant); and

b. state the commentator's proposal with special emphasis on how the proposal supports National Treasury objectives as stated in the discussion document (references to international trends, with specific examples of detailed design features as well as why these should be followed by South Africa (i.e. do these design features support National Treasury objectives, administrative and/or operational simplification etc), will also add support for a convincing argument).

Comments received will be made public in the response document referred to in Section 10 of the discussion paper.

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MEETING LIST

Organisation	Person	Date
African Life	John Solomon	14-Dec-06
Centriq	Michael Blain (CEO)	09-Mar-07
Discovery Life	W van der Merwe	01-Feb-07
dti	Co-operatives Unit: Acting Chief Director Jeffrey Ndumo and team members	01-Mar-07
FSB	Billy Clarke and Melonie van Zyl	12-Mar-07
FSB	Mashudu Munyai, Jacky Huma, Kamcilla Naidoo, Billy Clarke, Suzette Vogelsang, Patrick Ward	19-Feb-07
FSB: Actuarial division	Hantie van Heerden (actuarial specialist)	13-Apr-07
FSB: FAIS Department	Manasse Malimabe	19-Mar-07
FSB: Friendly Societies (part of Retirement Funds division)	Alta Marais (Research and policy) and team members	20-Mar-07
FSB: prudential	S Vogelsang	20-Apr-07
Guardrisk	A Dienst (Chief Actuary), H Schoeman (CEO) , N Pather	18-Apr-07
Guardrisk	R Eales & N Pather	10-Jan-07
Hannover Re	P Tomlinson	12-Apr-07
Hollard	R Inglis	15-Jan-07
Independent actuarial consultant: short-term and assistance business	Pebs Nel	01-Nov-07
Legalwise	T Fornali & J Luwes	16-Jan-07
Lesaka	Derick le Roux	05-Feb-07
Life Offices Association	Anna Rosenberg (Deputy Executive: Legal)	22-Mar-07
Life Offices Association	Gerhard Joubert (CEO)	14-Mar-07
Old Mutual	W Louw	19-Apr-07
Pep	John Edwards	16-Jan-07
Real People	Emile Mouton	26-Jan-07
South African Underwriting Managers' Association	Douglas Everitt	19-Dec-06
SAIA	V Pearson & L Moondo	12-Jan-07
Santam	Kobus Olivier (Head of Alternative Distribution) and Simon Mokhena (Manager: Business Development)	07-Dec-07
Small Enterprise Foundation	Dale Lampe	07-Feb-07
Swiss Re	G Jenkins et al	17-Apr-07
The Best Funeral Society	John Turnbull (MD) & Randall Mocke (Director: Finance & Operations)	15-Feb-07