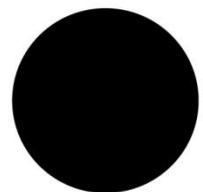


**RETAIL DISTRIBUTION REVIEW:  
EQUIVALENCE OF REWARD POSITION  
PAPER**

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## 1. PURPOSE OF PAPER

- 1.1. In 2014 the initial Retail Distribution Review (RDR) stated with regards to the Equivalence of Reward, proposal RR that:

***“Proposal RR: Equivalence of reward (EoR) to be reviewed*** *Specific standards will be set to clarify and strengthen the principle of “equivalence of reward” as the basis on which long-term insurers may remunerate their tied advisers. These standards will include provisions:*

- *Confirming that the principle of equivalence applies at the level of each individual tied adviser.*
- *Detailing the nature of remuneration and benefits to be taken into account in assessing equivalence. This will be based on a “total cost to company” approach, whereby all benefits payable to the adviser are taken into account in applying the principle – including commissions, fees, salary-based payments, allowances, medical and pension benefits, non-cash incentives, participation in conferences and events, share options, etc. So-called “sign- on bonuses” and all forms of production or other performance incentives or rewards, whether or not they are conditional or deferred, will also be included.*
- *Providing for how to apply the principle of equivalence at appropriate time periods or across appropriate tranches of business, bearing in mind that the equivalent value of commission that would have been payable to a non-tied adviser can only be calculated with hindsight.*
- *To clarify that the equivalence model relates to remuneration relating to life insurance risk benefits only (being the products in respect of which product supplier commission and fees remain payable), with remuneration relating to investment products being determined with reference only to the quantum of customer agreed advice fees paid. Any portion of a tied adviser’s “total cost to company” remuneration that is attributable to advice on or sale of investment products, may not in aggregate exceed the value of customer advice fees in fact paid by customers in respect of such products over an appropriate period.”*

- 1.2. Several updates on the RDR were released in the years following publication of the initial review.

- 1.3. In the first of these (Status Update: Retail Distribution Review Phase 1, 2015) the then FSB acknowledged the need for further technical work that took into account the wide range of existing models of adviser remuneration and the link with policy developments in other areas, delaying the implementation of the recommendations set out in the 2014 paper. That update nevertheless emphasised the imperative of urgent intervention to address the market imbalances that could arise from inequities in the respective provisions applying to tied agents and independent intermediaries. The then FSB announced that it would identify those practices regarded as inconsistent with the EoR provisions.

- 1.4. Small changes were made to the regulations<sup>1</sup> late in 2017 that took effect on 1 January 2018. These modifications formally granted to the Authority the power to specify those forms of remuneration that would be considered compliant, or not, with the principle of EoR.
- 1.5. Also, in late 2017, the FSB issued a Board Notice<sup>2</sup> releasing, for public comment, the principles under which EoR would be assessed. The Board Notice defined specific forms of remuneration to representatives as not compliant with these principles, for example:
- any loan, advance or credit facility extended to a representative on terms more beneficial than the equivalent terms available on an arm's-length open-market basis,
  - any remuneration intended as consideration for switching customers to the insurer, whether directly to the representative or an associate of the representative,
  - any remuneration, outside of standard benefits, that exceeds 15% of the ordinary remuneration of the representative over a 12-month period,
  - any other arrangement similar in substance to any of these, and
  - any undertaking to pay a similar amount at some date in the future.
- 1.6. The 2018 update on the recommendations of the RDR (Retail Distribution Review: Status Update June 2018, FSCA) announced that formal consultation on proposals had taken place and that further research into current practices would be undertaken prior to any announcements on whether or how interim measures would be implemented.
- 1.7. This Position Paper provides an update on the further research that took place during the course of 2019 and the FSCA's updated view on the way forward with regards to EoR.

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<sup>1</sup> *Long-term Insurance Act, 1998: Amendment of Regulations made under Section 72*, Government Gazette No. 41334, 15 December 2017

<sup>2</sup> *Draft Determination on "Equivalence of Reward"*, Regulations under the Long-term Insurance Act, 1998 (Act No. 52 of 1998), Deputy Registrar of Long-term Insurance, Government Gazette No. 41237, 10 November 2017

## 2. BACKGROUND<sup>3</sup>

- 2.1. Equivalence of Reward (EoR) is a subject that has been under consideration by the Financial Sector Conduct Authority (FSCA) and its predecessor, the Financial Services Board (FSB), for some time.
- 2.2. EoR is the principle that, while tied agents of long-term insurers are not subject to the regulatory commission ceilings that apply to independent intermediaries, their total compensation should be broadly no more than the equivalent compensation that they would have received for the same set of sales were they paid on the basis of the regulated commission scales that apply to independent intermediaries. Under EoR, non-cash components of the remuneration payable to tied agents should also be taken into account in determining the equivalence of the package of incentives.
- 2.3. At heart is the apparent or actual payment of remuneration in excess of the commission limits applicable to independent intermediaries by long-term insurers as a means to secure a larger set of customers. The benign rationale for this is the ability to recruit already-successful independent intermediaries, or the best tied agents of other insurers, as tied agents of the insurer, leading to improved sales levels. Concerns are however that this behavior increases the risk of incentive-based churning with the insurer expecting the intermediary to make an effort to convince existing financial customers to purchase a policy from the insurer, even if this means cancelling an existing policy. Evidence of sign-on bonuses and other incentives have added to this concern.
- 2.4. As mentioned above, the issue of EoR has been under discussion for some time. A survey of the respective practices of a number of insurers was requested by the Registrar of Insurance in 1984. Further surveys were completed in 1986 and in 1989 and an assessment was undertaken in 1995. The discussion was picked up again around 2008, when another survey was considered by the Life Offices Association (LOA) but discarded in favour of a qualitative analysis of contracts and benefit arrangements in place. The LOA conducted its own reviews in the intervening period, but these were not at the formal behest of the FSB?
- 2.5. Two recent sets of consultation have been undertaken with industry players, the first following the release of the RDR in 2014 and the second towards the end of 2017 in response to the Board Notice.
- 2.6. In the first instance, where comments were received on the initial recommendations of the RDR, the key points raised against the initial EOR proposals were as follows:
  - technical complexity could render the rules-based approach at individual level unworkable, add unduly to operational cost, or encourage arbitrage of various forms,
  - EoR at individual level would be unworkable for new advisers,
  - the impact of different business models should be recognised in the

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<sup>3</sup> Background section extracted from independent EOR Report commissioned by the FSCA  
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recommendations,

- other proposals in the RDR are sufficient to ensure that the ultimate objective, ensuring that clients were not prejudiced, would be achieved,
- a higher reward for tied agents may be regarded as appropriate compensation for the loss of the independence that is enjoyed by independent intermediaries,
- insufficient scope remained for rewarding tied agents on a mix of outcomes reflecting both the quantity and the quality of business sold,
- insurers with large cohorts of agents play an important market-development role, concerns regarding the shift from independent intermediaries to tied agents are overstated,
- the appropriate treatment of the VAT payable to independent intermediaries in the calculation of EoR, and of the impacts of income tax on advisers, are not clear,
- allowing appropriately for the revenue earned on other products and services, banking, short-term, health-care and employee-benefit products, for example, and trust- and fiduciary services, would be complicated,
- capping employee compensation may be illegal or unconstitutional, and insurers must also meet the provisions of the Labour Relations Act, and
- the principle of EoR is inconsistent with the corresponding principles of TCF that call for a change of culture in organisations.

2.7. Recommendations forming part of those comments included the possibilities of:

- as an alternative to implementing the principle of EoR at individual level, permitting aggregation at the level of the adviser category,
- establishing a special dispensation for new advisers to avoid raising barriers to entry and inhibiting the development of previously disadvantaged individuals,
- excluding the provision of infrastructural support from the reckoning, which could also address the problem of developing new entrants to agency ranks,
- measuring EoR over a period that reflects the term of the products rather than on an annual basis,
- considering a different approach to microinsurance products, particularly composite products, or to salaried advisers earning less than a stipulated threshold,
- excluding telesales agents responsible for selling low-premium products, and
- allowing separately for tied agents with management responsibility or other duties, like legal advice, that requires them to be registered as agents but does not necessarily lead to them writing material business volumes.

2.8. Comments were also received in response to the Board Notice issued late in 2017. Some comments from that group that had not already been identified in 2014 were the following:

- customers benefit from the advice given by tied agents because product providers are fully bound by the actions of these agents,
- the balanced-scorecard approach utilised by some insurers, whereby quality measures are a factor in tied agents' remuneration levels, results in better overall outcomes for customers, and
- the national minimum wage might have a bearing on the application of EoR principles in practice.

2.9. The following recommendations were received:

- financial services providers who are not insurers should be subject to the same limitations as those applied to insurers,
- "salary" should not be too strictly defined as some mandated representatives are not employees, but contractors,
- consideration should be given to the possibilities of:
  - adding short-term bonuses to ordinary remuneration for the purposes of determining the limit of allowable remuneration,
  - waiving the 15% requirement<sup>4</sup> in those cases in which remuneration from all sources is below the equivalent remuneration due under maximum commission rules,
  - excluding office costs, restraint of trade payments and possibly, travel costs, from the 15% limitation,
  - exempting management staff, sometimes themselves rewarded with bonuses for sales targets achieved, from the parts of the provisions, and
  - applying the 15% limit to the overall adviser profile, and
- transition measures should be considered for any changes introduced.

2.10. As even this brief summary of comments shows, the issues involved are complex. A number of insurers reiterated earlier invitations to the regulator to study their practices more closely regarding compensation and incentives of their tied agents before determining regulatory changes.

2.11. The Authority undertook a procurement process for the appointment of a specialist that could undertake a review of the compensation practices and report to the Authority in this regard.

2.12. This paper reports on the investigation of these practices.

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<sup>4</sup> The 15% is referencing the percentage proposed in the *Draft Determination on "Equivalence of Reward"*

### 3. OUTLINE OF STUDY UNDERTAKEN<sup>5</sup>

- 3.1. The study described in this position paper resulted from the long-standing assurances by the FSCA and its predecessor, the FSB, to understand in more detail the practices of insurers under their commitment to EoR principles, as part of the process of improving the system of regulation.
- 3.2. The study is built around three objectives:
  - analyse practices in the industry,
  - in the event that any remuneration practices are considered inconsistent with the principle of EoR, assess the impacts of these practices, and
  - recommend changes to the regulatory and supervisory framework governing the system of EoR, to the extent considered necessary.
- 3.3. This was formally described in the tender documents through which the service provider was appointed:

*“The successful bidder will be required to: (1) provide an analysis of prevailing remuneration and incentivisation practices by identified long-term insurers in order to assess the extent to which such practices may be inconsistent with the principle of EoR as contemplated in the LTI Regulations and the outcomes envisaged in Proposal RR of the Retail Distribution Review [...] published [...] during November 2014; (2) model the impacts of determining that certain general and specific remuneration and incentivisation practices are inconsistent with the principle of EoR; and (3) recommend possible enhancements to the regulatory and supervisory framework in respect of EoR, if necessary.”*
- 3.4. The largest portion of the effort involved in completing the study proved to be in the first part. The steps undertaken to assess insurer practices are set out in the description that follows.
- 3.5. Assessment was undertaken in two parts, written responses to questionnaires and detailed face-to-face interaction. The largest part of the analysis was based on the written responses. The impressions gained were then confirmed, enlarged upon or refuted through engagement with the executive teams of insurer’s distribution units, along with the compliance officers and, in some cases, senior managers of those insurers.
- 3.6. As responses to the questionnaire formed the basis of the assessments of each insurer, these questionnaires were detailed. Insurers were requested to provide responses in six areas:
  - a detailed description of the tied agency force,
  - the costs of running the agency channel,
  - remuneration policies,
  - supporting data at the level of individual agents,

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<sup>5</sup> Outline of study section of Position Paper extracted from independent EOR Report commissioned by the FSCA  
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- a sample of agent contracts, and
- a number of supplementary questions.

3.7. The rationale for the questions posed is set out in the discussion below

### **Description of the tied agency force**

3.8. Part 1 of the questionnaire sought a description of the tied-agency distribution force of the insurer, covering

- the size of the sales team, in total and in the categories defined for internal management purposes by the insurer,
- the volumes of new business sold by the force as a whole and by the agents within each of the categories considered and
- the split of business across four types of product, (1) funeral, (2) individual risk business, (3) individual investment business and (4) (group) employee benefits products or services, along with the number of agents who sold products under each of these categories.

3.9. It was considered appropriate to allow the insurer to define the categories of agent for the purposes of sub-dividing the agency channel.

3.10. All respondents had to determine how to deal with agents who contributed to sales during the course of the year in question but were no longer representatives of the insurer at the end of the year. Some insurers clarified their proposed approaches with the FSCA prior to preparing the information. The approaches used to address the issue were broadly consistent across insurers.

3.11. Part 1 also sought to establish a foundation for the philosophy of remuneration, asking insurers to explain:

- how they chose to incentivise and reward each of the identified categories, and
- how they determined whether and how many agents to utilise in each category and each organisational division of the company.

3.12. The answers to these questions were used to test for consistency of practice with the corresponding declared approach of the insurer.

### **Costs of the channel**

3.13. Part 2 of the questionnaire sought aggregate information on

- the total cost of the tied agency force, the allocation of this cost to nine specified categories:
  - i. cash salary,
  - ii. commission,
  - iii. short-term cash bonuses,
  - iv. non-cash short-term bonuses,
  - v. long-term incentives,
  - vi. other elements of typical cost-to-company remuneration,
  - vii. contributions to infrastructure cost,

- viii. management and other support overheads, and
  - ix. any other expenses of running the channel,
- the corresponding cost of commission paid to independent intermediaries, and
  - the hypothetical cost of the agency channel on the alternative basis that the only expenses incurred had been commission on the basis paid to independent intermediaries.
- 3.14. This information was requested at aggregate level, but also at the corresponding level of the agent categories defined by the insurer in its answers under Part 1.

### **Remuneration policies**

- 3.15. The written policies of insurers were requested in order to obtain evidence that EoR had been considered at an appropriate level in the organisation and to check for consistency of practice with internal policy.
- 3.16. As different policies might address the matter of EoR in different ways, three documents were requested:
- the remuneration policy, if any, explaining the operation of EoR principles,
  - the remuneration policy required under the regulatory provisions that govern risk management at insurers, and
  - the corresponding policy prepared under the requirements of the market-conduct framework in place at the insurer.
- 3.17. Insurers that did not have these papers in place were invited to submit alternative documentary evidence of their approach to the principles of EoR.

### **Agent-level data**

- 3.18. Part 4 requested quantitative evidence supporting the corresponding totals provided in Part 2. Agent-level data was requested covering remuneration information across six of the nine categories identified under Part 2, essentially those categories covering the direct remuneration of agents, and showing how the corresponding totals under the last three questions might be verified.
- 3.19. This information was requested not primarily to verify the corresponding totals provided under Part 2, but to establish the extent to which the principles underlying the EoR were (or could be) applied at the level of the individual agent. The details at agent level facilitated a deeper understanding, also, of the variations that existed in practice between agents.

### **Contracts**

- 3.20. A sample of the employment contracts of agents was requested in order to verify the terms under which these agents were employed or contracted. With reference to the agent-level data requested under Part 4, a list of agents in each of the insurers' categories was specified so that insurers could not cherry-pick the contracts that they might have wished to provide.

## Supplementary questions

- 3.21. Seven supporting questions were asked. These aimed to gather further information on any issues that arose during the consultation process, particularly the apparent contradictions identified.
- 3.22. The first question, for example, asked if there was merit in the position that agents should be incentivised on quality of business as well as volume. The second then asked whether the same argument ought to be applied to independent intermediaries and whether it was, in practice, so applied by the insurer.
- 3.23. Question three asked whether EoR provisions should be waived for new entrants in order to facilitate the provision of appropriate training and financial support. The next question asked how this was implemented in practice and whether experienced intermediaries were effectively subsidising their more junior counterparts.
- 3.24. Question six interrogated the position that tied agents should be rewarded for giving up the autonomy available to them were they to work as independent intermediaries. The final question asked how this argument would stack up against an alternative position that the risks and costs associated with independence called for higher remuneration.

## Process

- 3.25. The period granted for completion of the questionnaire and provision of supporting information was approximately one month. This proved difficult and a number of insurers requested extensions. These were granted within reason.
- 3.26. Responses were by-and-large of a high quality and some of them were exceptional in the clarity with which they conveyed the issues. Detailed assessments were thereafter undertaken in random order to avoid unconscious bias. The write-up of each insurer was completed only after the meeting with that insurer had been concluded.

## 4. RECOMMENDATIONS

- 4.1. The EOR Report commissioned by the FSCA made various recommendations. The FSCA has considered the recommendations provided and agree with those measures set out below. In general, we agree with the recommendation that the approach to EOR should consist of principle level requirements creating the EOR framework and then specific technical measures that support the principle-based measures.

### Recommended framework measures

- 4.2. **Principles-based approach.** Insurers must prepare a policy covering the remuneration of their tied agents that includes measures with regards to compliance with the requirements of EoR. The policy must be approved by the board of the insurer.
- 4.3. **Annual reporting.** Included in the conduct report to the FSCA must be a

submission covering the overall EoR ratio, factors impacting on that ratio and, if the ratio is above the limits specified in the requirements, plans in place to reduce it. An exception report is to be included, where any tied agency sub channel has an EoR more than 10 percentage points or any individual agent more than 20 points above the specified EoR limit, giving reasons for these anomalies and explaining how management has assessed the appropriateness of the overall remuneration approach in the context of these exceptions.

### **Recommended technical measures**

4.4. It is proposed that the EoR ratio<sup>6</sup> be set at 115%, with various supporting requirements on the calculation of the ratio, namely:

- the initial RDR proposal to prescribe EoR at individual level will no longer be pursued. Instead, EoR will be required at the level of an insurer's full tied agency channel.
- VAT should be excluded from the hypothetical commission<sup>7</sup> on the basis that what matters is what the agent receives, not what the insurer pays;
- For consistency of practice, any VAT payable to tied agents, for example to contractors that are registered for VAT, should also not be included in the calculation of agent remuneration.
- Management expenses should be excluded from the calculation, but all other expenses pertinent to the tied agency channel should be included; The FSCA will consult on the details of items to be included as management expenses.
- EoR ratios must be determined on the basis of accounting statements in each reporting period but may be calculated on a present-value approach.
- The EoR calculation must exclude any agents operating in the first two years of their careers (FAIS date of first appointment to be used), to accommodate and allow for the cost of training along with the differences in the types of financial support given to newly-joined agents;
- Instances of high EoR ratios at an individual or tied sub-channel level should be managed on an exception basis by insurers and reported to the FSCA. Reward at individual level is an important factor in managing the risk of inappropriate behavior, therefore notwithstanding the fact that EOR levels will not be prescribed at individual level, individual EoR ratios should nevertheless be monitored by the Insurer;
- Considering the options of calculating EoR ratios at, tied sub channel level or any other segmentation along the lines of target market or business model type have been considered but such models are not

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<sup>6</sup> As an example R115m of actual remuneration against R100m of hypothetical commission gives an EoR ratio of 115%.

<sup>7</sup> The hypothetical cost, if all the products distributed were actually sold through independent intermediaries paid commission.

easily defined and doing so raises the possibility of arbitrage. For this reason, the suggested approach is that Insurers be requested to specify and explain their approach to EoR where such approach differs for different tied channels, as set out in 4.3 above.

- The income of tied agents that carry out duties for the insurer in the role of contractors (rather than employees) should be treated in the same way as the corresponding income of other agents for EoR purposes.

4.5. Additional rules can be introduced at a later stage if any shortcomings in the system are identified.

## **5. WAY FORWARD**

5.1. The proposed approach to the calculation of EoR suggested above will be drafted into legislation in 2020 and opportunity will be provided for comment on these legislative instruments/s in accordance with the usual prescribed consultation processes.

5.2. For further information or clarity regarding the contents of this Paper please contact the Regulatory Framework Department of the FSCA by emailing [FSCA.rdrfeedback@fsc.co.za](mailto:FSCA.rdrfeedback@fsc.co.za).