Ref: Information Letter 2/2014 (LT)

FINANCIAL SERVICES BOARD
REPUBLIC OF SOUTH AFRICA

LONG-TERM INSURANCE ACT, 1998 (ACT 52 OF 1998)

Addressee:	Long-term insurers registered for assistance and life policies	**File:**	10.41.1.7.2
Issue date	**Reply date**	**Information Letter**	**Status**
29/8/2014	-	2/2014 (LT)	**ISSUED**
-	-	-	-
-	-	-	-
Subject:	**CONDUCTING OF INSURANCE BUSINESS IN RESPECT OF ASSISTANCE AND LIFE POLICIES THROUGH CO-ADMINISTRATION AGREEMENTS (ALSO REFERRED TO AS PROFIT SHARING OR 80/20 AGREEMENTS)**		

1. PURPOSE

1.1 The purpose of this Information Letter is to raise certain regulatory and conduct of business concerns in respect of co-administration agreements (also referred to as profit sharing or 80/20 agreements) entered into by long-term insurers ("insurers") in respect of assistance and / or life policies.

2. THE CO-ADMINISTRATION AGREEMENTS

2.1 It has come to the attention of the Registrar of Long-term Insurance ("Registrar") that insurers are actively pursuing co-administration agreements with funeral parlours[1] or funeral administrators[2], which agreements (directly or indirectly) provide for or include the following arrangements to a larger or lesser extent[3]:

2.1.1 the funeral parlour or funeral administrator makes the policies of the insurer available to the clients of the funeral parlour;

---

1 An entity whose primary business is the providing or facilitating of funeral or burial services.

2 An entity that intermediates / interfaces between funeral parlours and insurers and provides administration services on behalf of funeral parlours or insurers.

3 Note that this paragraph merely describes the practices. Regulatory concerns with these practices are discussed in paragraph 4 below.

2.1.2 the funeral parlour or funeral administrator, in addition to marketing the policies of the insurer (i.e. making policies available) to the funeral parlour's clients, intermediates between these clients and the insurer and performs certain binder functions[4] and outsourced services[5] (to a varying degree) in respect of those policies;

2.1.3 in addition to the above, the funeral parlour or funeral administrator collects the premiums that are payable in respect of these policies;

2.1.4 the funeral parlour or funeral administrator pays an agreed percentage (usually very minimal, e.g. 5% of premiums collected) of the premiums to the insurer and retains the remainder of the premiums in its business account for the purpose of paying claims to policyholders[6];

2.1.5 The funeral parlour or funeral administrator then follows one of the following processes –

2.1.5.1 forwards claims submitted by the funeral parlour's clients to the insurer for consideration and pays the claim once the insurer has indicated that the claim must be paid;

2.1.5.2 considers and pays or rejects claims submitted by the funeral parlour's clients in accordance with the criteria provided for in the arrangement; or

2.1.5.3 pays claims submitted by the funeral parlour's clients in advance if the basic criteria provided for in the arrangement are met and then forwards the claims to the insurer for consideration. If the insurer decides that a claim was paid in error the insurer recovers the claim amount from the funeral parlour; and

2.1.6 at the end of an agreed period, the funeral parlour or funeral administrator becomes entitled to the remaining premiums, if any (i.e. the premiums retained for the payment of claims where the claims paid are less than the premiums collected). The insurer settles all pending claims in instances where claims exceed the retained premiums.

2.2 In certain instances where the co-administration agreement is entered into

---

4 As referred to in section 49A of the Long-term Insurance Act No. 52 of 1998 read with Part 6 of the Regulations.

5 As per the definition of "outsourcing" in Directive 159.A.i (LT&ST): Compliance with sections 9(3)(b)(i) read with sections 12(1)(c) of the Long-term Insurance Act and Short-term Insurance Act, respectively: Outsourcing, issued on 12 April 2012 (Directive 159.A.i (LT&ST)).

6 In some instances the total premiums are "paid" by the funeral parlour to the insurer via journal entry (no physical payment occurs) and simultaneously a claims float is "paid" by the insurer to the funeral parlour also via journal entry. The rationale behind this arrangement seems to be practicalities and saving of costs associated with actual funds transfers. However, the effect of this is the same as those instances where the premiums are retained by the funeral parlour after paying a percentage thereof to the insurer.

between the insurer and a funeral administrator the latter sub-contracts or sub-outsources certain functions (intermediary services, binder functions and outsourced services) to funeral parlours.

2.3 Insurers that have entered into these co-administration agreements argue that the above practice is not inconsistent with the regulatory framework (the Long-term Insurance Act No. 52 of 1998 ("LTIA") or the Financial Advisory Services and Intermediary Services Act No. 37 of 2002 ("FAIS Act")) as the funeral parlours or funeral administrators are –

2.3.1 remunerated for intermediary services[7] by way of commission only and are not remunerated for binder functions or outsourced services because commission paid for intermediary services rendered in respect of the policies is sufficient so as not to justify additional fees for binder functions or outsourced services; or

2.3.2 not remunerated for the intermediary services, binder functions and outsourced services (they are alleged to provide these services free of charge in the interest of their clients), but share in the profits of the insurance business emanating from or *via* them, or are remunerated for referring clients to the insurer or allowing the insurer to use their businesses as distribution points. The agreement and the related remuneration are therefore structured to refer to the business relationship between the parties as opposed to the rendering of intermediary services, binder functions or outsourced services.

3. CLARIFICATION OF TERMINOLOGY USED IN THIS INFORMATION LETTER

For the purpose of this Information Letter, any word or expression to which a meaning has been assigned in the LTIA (including the Regulations[8] made thereunder) has the meaning so assigned to it.

4. REGULATORY CONCERNS IN RESPECT OF THESE AGREEMENTS

GENERAL

4.1 These agreements are not consistent with the legislative framework. This is so because it is evident that these co-administration agreements relate to the rendering or performing of regulated functions and services (intermediary services, binder functions and outsourced services) only.

The arguments referred to in paragraph 2.3 are therefore superficial and designed to circumvent the legislative framework, specifically in respect of

---

7 As per the definition of "rendering services as intermediary" in Part 3A of the Regulations.

8 Means the regulations made under the Long-term Insurance Act, as published in GN R1492 of 1998 and amended by GN R197 of 2000, GN R164 of 2002, GN R1209 of 2003, GNR.1218 of 2006, GN R186 of 2007 and GN R952 of 2008GN R1493 of 1998, and substituted by GN R1077 of 2011.

remuneration matters.

4.2 These agreements are not in the public interest and give rise to serious business conduct concerns as these agreements –

4.2.1 create untenable conflicts of interest and inappropriate incentives for or behaviour by funeral parlours and / or funeral administrators;

4.2.2 create unlevel playing fields between insurers;

4.2.3 seriously undermine appropriate, affordable and fair treatment of potential and existing policyholders (including members of group schemes); and

4.2.4 bring the insurance industry into disrepute.

4.3 The following specific concerns arise in respect of the legislative framework:

REMUNERATION

4.4 The LTIA (including the Regulations made and Directives issued thereunder) specifically addresses remuneration payable in respect of intermediary services, binder functions and outsourcing services.

Commission

4.5 Section 49 of the LTIA provides that no consideration shall be offered or provided by an insurer or a person on behalf of an insurer or accepted by any independent intermediary for rendering services as intermediary as referred to in the Regulations, other than commission or remuneration contemplated in the Regulations and otherwise than in accordance with the Regulations.

4.6 Commission payable in respect of life policies may therefore not exceed the maximum commission prescribed in Part 3A of the Regulations. In respect of assistance policies, although the maximum commission payable in respect of assistance policies is not prescribed, it follows that the commission payable per policy must be determinable to enable the insurer to comply with the other requirements relating to commission provided for in the Regulations.

4.7 From the description of co-administration agreements in paragraph 2.1 it is clear that funeral parlours and / or funeral administrators render intermediary services for which commission is payable.

4.8 An arrangement whereby the funeral parlour and / or funeral administrator becomes entitled to the remaining premiums (i.e. the premiums retained for the payment of claims where the claims paid are less than the premiums collected and retained), is therefore not permissible in respect of intermediary services, as the exact percentage or rate of commission payable is not determinable at point of sale, thereby undermining compliance with the Regulations.

4.9 By the same token, a nil Rand commission may lead to the skewing of the contractual obligations between the parties and may not necessarily be in the best interest of the insurer or its policyholders. This is so because the funeral parlours and / or funeral administrators have no incentive to perform or render the services in accordance with the legislative framework requirements or the co-administration agreement.

Binder fees

4.10 Section 49(2)(g) of the LTIA states that a binder agreement must state the basis on which a binder holder will be remunerated for the rendering of binder functions, which basis must be consistent with any requirements, limitations or prohibitions as may be prescribed by regulation.

4.11 Regulation 6.4(1) of the Regulations provides that –

4.11.1 an insurer may pay a binder holder a fee (a binder fee) for the services rendered under the binder agreement, which fee must be reasonably commensurate with the actual costs of the binder holder associated with rendering the services under the binder agreement, with allowance for a reasonable rate of return for the binder holder;

4.11.2 any binder fee payable to a non-mandated intermediary[9] that may settle claims or determine the value of policy benefits under a binder agreement may not constitute or be based on a percentage of the difference between an amount claimed or the maximum value of policy benefits payable under a policy and the policy benefits actually provided to a policyholder in settlement of a claim; and

4.11.3 a non-mandated intermediary that is a binder holder, in respect of the services rendered under the binder agreement, may not directly or indirectly receive or be offered any share in the profits of the insurer attributable to the type or kind of policies referred to in the binder agreement.

4.12 From the description of co-administration agreements in paragraph 2.1 it is clear that certain funeral parlours and / or funeral administrators perform binder functions on behalf of insurers for which a binder fee may be paid. It is also clear that they perform these binder functions in the capacity of a non-mandated intermediary as they perform acts directed towards entering into, maintaining or servicing a policy on behalf of an insurer, a potential policyholder or policyholder[10].

4.13 The argument that no binder fee is paid in respect of binder functions

[9] As defined in Regulation 6.1 of the Regulations.

[10] As per the definition of "rendering services as intermediary" in Part 3A of the Regulations read with the definition of a "non-mandated intermediary" and "underwriting manager" in Part 6 of the Regulations.

rendered by the funeral parlours and / or funeral administrators because commission paid in respect of intermediary services rendered in respect of the same policies is sufficient so as not to justify additional fees for binder functions or is sufficient to also cover the costs associated with binder functions, is flawed. This amounts to a simulated transaction as it attempts to conceal the true nature of the arrangement and is therefore an attempt to circumvent Part 6 of the Regulations as the net result of the above situation is that the binder holder is indirectly remunerated for the binder functions performed without the binder fee having to comply with the Regulations.

4.14 The structuring of commission (where commission paid also remunerates the funeral parlours and / or funeral administrators for binder functions performed, as per paragraph 4.13) as premiums minus claims constitutes a share in the profits of the insurer attributable to the policies in respect of which intermediary services and binder functions are rendered and performed, which is not permissible under Part 6 of the Regulations.

4.15 By the same token, a nil Rand binder fee may lead to the skewing of the contractual obligations between the parties and may not necessarily be in the best interest of the insurer or its policyholders. This is so because the funeral parlours and / or funeral administrators have no incentive to perform or render the services in accordance with the legislative framework requirements or the co-administration agreement.

Outsourcing fee

4.16 Directive 159.A.i (LT&ST) provides that remuneration paid in respect of outsourcing must –

4.16.1 be reasonable and commensurate with the actual function or activity outsourced;

4.16.2 not result in any function or activity in respect of which commission or a binder fee is payable being remunerated again;

4.16.3 not be structured in a manner that may increase the risk of unfair treatment of policyholders; and

4.16.4 not be linked to the monetary value of insurance claims repudiated, paid, not paid or partially paid.

4.17 The principles referred to under paragraph 4.16 also apply to any sub-outsourcing where sub-outsourcing is authorised under the co-administration agreement.

4.18 From the description of co-administration agreements in paragraph 2.1 the extent to which funeral parlours and / or funeral administrators perform outsourcing services on behalf of insurers for which an outsourcing fee is payable is not ascertainable.

4.19 The argument that no outsourcing fee is paid in respect of outsourced services rendered by funeral parlours and / or funeral administrators because commission paid in respect of intermediary services rendered in respect of the same policies is sufficient so as not to justify additional fees for outsourcing services or is sufficient to also cover the costs associated with outsourcing services, is flawed. This amounts to a simulated transaction as it attempts to conceal the true nature of the arrangement and is therefore an attempt to circumvent Directive 159.A.i (LT&ST) as the net result of the above situation is that the funeral parlours and / or funeral administrators are indirectly remunerated for the outsourcing services performed without the outsourcing fee having to comply with Directive 159.A.i (LT&ST).

4.20 The structuring of the commission (where commission paid also remunerates the funeral parlours and / or funeral administrators for outsourced services rendered, as per paragraph 4.19) as premiums minus claims means that the remuneration for outsourced services rendered is linked to the monetary value of insurance claims repudiated, paid, not paid or partially paid. This is contrary to Directive 159.A.i (LT&ST).

4.21 By the same token a nil Rand outsourcing fee may lead to the skewing of the contractual obligations between the parties and may not necessarily be in the best interest of the insurer or its policyholders. This is so because the funeral parlours and / or funeral administrators have no incentive to perform or render the services in accordance with the legislative framework requirements or the co-administration agreement.

SERVICES

Segregation of services

4.22 The agreements do not address the different types of services rendered by the funeral parlours and / or funeral administrators on behalf of the insurer in a clear and precise manner.

4.23 This impedes the ability of –

4.23.1 the Registrar to supervise compliance with the legislative framework; and

4.23.2 the insurer to ensure compliance with the legislative framework.

Services: General

4.24 It should be noted that the legislative framework (including, but not limited to the LTIA, the FAIS Act and the regulations and codes made thereunder) imposes requirements in respect of whom and how intermediary services, binder functions and outsourcing services (in addition to remuneration matters) may and / or must be rendered, which requirements must be complied with.

Binder function: Separate binder agreement

4.25 Specifically, the inclusion of binder functions in these agreements is not in compliance with Regulation 6.3(3) that provides that a binder agreement may only provide for matters referred to in section 49A of the LTIA, the Regulations and matters incidental thereto, and may not regulate any other arrangement or relationship with the binder holder, irrespective of such other arrangement or relationship being dependent on the conclusion of a binder agreement or that the binder agreement is in addition to or consequential on such other arrangement or relationship.

Binder function: Enter into

4.26 Further, it must be noted that the test of whether or not a person performs the binder function of entering into, varying or renewing a policy on behalf of an insurer rests on whether or not such person has the authority to bind the insurer (i.e. to create or vary a policyholder liability on behalf of the insurer). The fact that a person is not afforded discretion in respect of a binder function is irrelevant.

4.27 From the description of co-administration agreements in paragraph 2.1 it appears that certain funeral parlours and / or funeral administrators perform the binder function of entering into policies on behalf of the insurer, despite the fact that the funeral parlours and / or funeral administrators do not exercise discretion.

Binder function: Settle claims

4.28 Furthermore, it must be noted that the test of whether or not a person performs the binder function of settlement of claims rests on whether or not such person has the authority to take a decision that binds the insurer (i.e. to provide or not to provide policy benefits under the policy).

4.29 As noted in paragraph 4.12 above, where funeral parlours and / or funeral administrators perform binder functions on behalf of insurers they can only do so in the capacity of a non-mandated intermediary as they perform acts directed towards entering into, maintaining or servicing a policy on behalf of an insurer, a potential policyholder or policyholder.

4.30 Regulation 6.3(4) and (5) therefore apply. Regulation 6.3(4) requires that any binder agreement with a non-mandated intermediary must limit the discretion of the binder holder in respect of -

4.30.1 the maximum value of policy benefits that may be determined under each policy or the maximum value of any claim that may be settled by the binder holder under the policies to which the binder agreement relates;

4.30.2 the morbidity and mortality risk factors, where appropriate, that must be considered by the binder holder when entering into, varying or

renewing a policy or determining the value of policy benefits under a policy; and

4.30.3 other parameters in accordance with which the binder holder must render the services provided for in the binder agreement.

4.31 Regulation 6.3(5) provides that an insurer may not authorise a non-mandated intermediary that is a binder holder to –

4.31.1 refuse to renew a policy;

4.31.2 reject or refuse to pay a claim for policy benefits or a part thereof;

4.31.3 terminate, repudiate or deny an insurer's liability to provide policy benefits under a policy; or

4.31.4 declare a policy void.

4.32 From the description of co-administration agreements in paragraph 2.1 it appears that certain funeral parlours and / or funeral administrators perform the binder function of settlement of claims on behalf of the insurer. However, it is not clear that Regulation 6.3 is indeed complied with.

FINANCIAL SOUNDNESS REQUIREMENTS AND REPORTING

4.33 Section 31 of the LTIA provides that all assets of the insurer must be invested in assets of the kind specified in Schedule 1 of the LTIA (other than assets in respect of linked liabilities) for financial soundness purposes and, *inter alia*, be spread according to the requirements provided in section 31. Where a percentage of the premiums is retained by or paid to funeral parlours and / or funeral administrators as a claims float, the requirements of section 31 of the LTIA may not be met.

4.34 Section 34(1)(b) of the LTIA prohibits an insurer from allowing its assets to be held by another person on its behalf without the approval of the Registrar. As premiums paid in respect of policies constitute assets of the insurer, the approval of the Registrar must be secured prior to a percentage of the premiums being retained by or paid to funeral parlours and / or funeral as a claims float.

4.35 As the policies are in the name of the insurer all premiums, claims and expenses relating to the policies must be reflected, in full, in the statutory returns of the insurer submitted under section 35 of the LTIA. The total premiums (as indicated in the policy document) must therefore be reflected in the statutory return of the insurer and not the net amount (i.e. after a percentage of the premiums is retained by or paid to funeral parlours and / or funeral administrators).

4.36 Current practice where a percentage of the premiums is retained by or paid to funeral parlours and / or funeral administrators therefore appear to be

inconsistent with the financial soundness and reporting requirements under the LTIA.

5. ALIGNMENT OF CO-ADMINISTRATION AGREEMENTS WITH THIS INFORMATION LETTER

5.1 Insurers must refrain from entering into new co-administration agreements and amend existing agreements to comply with the legislative framework.

5.2 Insurers must ensure that all existing co-administration agreements are aligned with the legislative framework and this Information Letter by no later than 120 days after the issue date of the Information Letter.

5.3 An insurer that is not able to align its agreements with the legislative framework and this Information Letter within the period referred to in paragraph 5.2, must notify the Registrar accordingly within 60 days after the issue date of the Information Letter. A notification must be submitted electronically to the Registrar, at FSB.INSCo-adm@fsb.co.za and be accompanied by a detailed motivation and action plan.

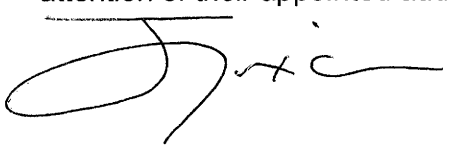
6. REGULATORY ACTION

6.1 The Registrar will take regulatory action against those insurers found to be acting outside of the regulatory framework as clarified and explained in this Information Letter.

6.2 Any non-compliance with the legislative framework as clarified and explained in this Information Letter may be referred to the enforcement committee in accordance with section 6 of the Financial Institutions (Protection of Funds) Act No. 28 of 2001.

7. AVAILABILITY AND INFORMATION SHARING

This Information Letter is available on the website (www.fsb.co.za) of the Financial Services Board. Insurers must bring this Information Letter to the attention of their appointed auditors and statutory actuaries.



REGISTRAR OF LONG-TERM INSURANCE